

Seven Steps to Optimize Your Physical Inventory

PROFESSIONALS

Michael Cole

Michael Cole, Audit Partner
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The year-end is rapidly approaching and that means it's almost time for your annual physical inventory. Performing physical inventories are a fact of life for manufacturing, retail and distribution companies, particularly when the financial statements are being audited by a Certified Public Accountant ("CPA"). Generally accepted auditing standards require the Company's auditors to observe the physical inventory taking place, and therefore proper planning procedures are critical to executing a complete and accurate physical inventory count.

The following seven steps can help your organization in planning a successful physical inventory:

Select a Date: It is best to select the date and time for the physical inventory when inventory movement will be minimal. Factors that need to be taken into account in selecting a date include the cost-benefit of a plant shut down during normal business hours or additional payroll and benefit costs if the counts will be performed on a weekend or a holiday.

Communicate with Team Members: Communication with team prior to the count is another important aspect of the inventory observation. Proper planning, timing and organization are keys to a complete, accurate and efficient count. The Company should have an internal meeting with all team members prior to the count to make sure that everyone clearly understands the counting procedures and their respective roles in the process.

Written Instructions: The Company should consider documenting written inventory instructions prior to the physical inventory and distributing the instructions to all team members participating in the counts. Also provide a copy of the instructions to the CPA in advance of the physical inventory. The CPA may wish to tour the warehouse prior to the date of the physical inventory.

Organize the Warehouse: The warehouse personnel should make an effort to organize the warehouse prior to the counts, which will make the physical inventory process much more efficient and cost effective. This includes separating loose items from bulk items and minimizing work-in-process in inventory, when possible. Make sure that obsolete or damaged inventory is clearly marked and segregated in the warehouse. It is a good practice to keep supplier or customer owned inventory in the warehouse separate from Company owned inventory. In addition, the Company should make special considerations for inventory located in refrigerators, freezers and containers outside the warehouse or held at third-party locations. Finally, consider performing pre-counts for items where minimal movement is expected, which will help reduce the time commitment on the date of the physical counts.

Tags or Barcode Scanners: The warehouse manager should decide if the Company will utilize pre-numbered inventory tags, barcode scanners, manual count sheets or another method to document the counts. Management should designate a responsible employee to control the tags and tally the results. Unused, voided or damaged tags should always be tracked. If manual count sheets are used, management should determine how they can verify that all inventory items were counted and that items were not double counted.

Performing the Counts: The team members should arrive on time on the day of the counts. Supervisors can be designated for the counts performed in each area in the warehouse and those team members will report to the supervisor. Counts should be performed by at least one, if not two, team members for accuracy. Blind counts are almost always recommended. Proper cut-off is vital to ensuring the inventory is complete, and therefore any receipts or shipments of inventory on the date of the counts should be accounted for separately.

Reconciling the Results: Once all counts have been completed, the count sheets, tags or barcode scanners should be submitted to the tag control employee to be reconciled against the pre-count inventory listing. Variances in the counts should be subject to a recount. Supervisors should tour the warehouse making sure that all items have been counted. Any final variances should be approved by management and true-up adjustments should be recorded to the inventory subledger. If the inventory is not performed at year-end, a rollforward of the activity from the date of the physical to year-end will likely be necessary to reconcile to the Company's general ledger as of the financial reporting date. As a final point, it is a good practice to maintain separate offsite back-up files of the inventory data included in the Company's information systems both prior to and after the physical inventory date.

To learn more about optimizing your physical inventory, contact Michael Cole at 562.216.1806 or michael.cole@hcv.com.