



Inventory Surprise!

The unwelcome event might arrive with a crash, with the discovery of one big variance that defies explanation. But inventory surprises can also be smaller and more insidious, like continual mismatches that resist every effort at solution.

“I wish I didn’t have to do a physical count every month,” says one factory owner. “But every month we find variances, and the adjustments are significant. We can’t stop until we get tighter.”

Bankers’ eyebrows go up. “If they don’t know their inventory, how do they know what’s happening in their business?” It’s a fair question, and it sums up the two main consequences of inventory variance.

The Eyes of Lenders Are Upon You

In a bank’s view, an inventory shortfall might not loom too large for a company with good cash flow, strong equity and healthy earnings. “They had an event,” the banker shrugs. “We’ll hope it doesn’t happen again.”

Another company, after breaking even for a few years, begins making money. With monthly financial reports, it builds trust with a bank. An “inventory event” can erode that rapport quickly and bring the company under intense scrutiny.

Who’s Minding the Store?

Inventory adjustments, over or under, can also have a more direct impact on a business. For example, if your shelves come up missing \$5,000 worth of subassemblies, and you operate on a 5 percent margin, you’ll need \$100,000 in sales to make up for the shortage. Meanwhile, you’ll be hard-pressed to fill orders if you neglected to

order from your suppliers because of inflated inventory figures.

If your inventory count is high, on the other hand, you may have ordered too much from suppliers. At best, you've loaned money on bad terms; at worst, you've bought some expensive scrap.

Analyzing these inventory variances costs time and money too.

Operational Errors

Inventory problems often reveal patterns of everyday mistakes. Each slip is small in itself, but eventually the slippage becomes a landslide. And the software that compensates for faulty human input has not yet been written.

Bad practices can usually be addressed with training, and software vendors will always tout new miracles, but company culture is at the root of the question. A firm can warehouse accurately, even with less sophisticated software, if its leadership sets a strong tone and compensates employees in a way that encourages excellence.

Counting Errors

Variances can also reflect errors made during a physical count. Usually simple omissions or double-tallies, these errors can be minimized with planning and proper procedures.

Before the count, for example, ship all you can and then stop cold. Count outliers (surplus and slow movers) early, and straighten up and map your warehouse.

Conduct the physical count by location, instead of by product line, to ensure nothing is missed, and simply record facts — you can fix warehousing errors later. When you audit the count, instead of checking random items, focus on your high-value items.

Cycle counting is another measure to consider. This system essentially spreads physical inventory out by counting one portion at a time, sequentially, and making adjustments on the spot. And cycle counting, by its nature, is always testing your system. It helps you find problems before they grow.

Costing Errors

Most inventory adjustments, however, arise from something else entirely. A company can fine-tune its day-to-day procedures and

conduct perfect counts but still show significant shortages if its inventory management system doesn't account properly for changes in costing.

Tracking moving parts on cost is complicated. Standard costs must be distinguished from actual ones, and labor must be assigned to cost centers. The intricacies of deals, discounts, rebates and freight variations must also be captured correctly.

All these factors and others are reflected in many different reports, and when figures from the wrong report creep into a calculation of inventory value, they're difficult to spot. But such figures, applied to even a modest physical variance, can inflate the monetary value of the mismatch geometrically.

Perfect, the Enemy of Good

All inventory variances, however complicated and whatever their origin, can be explained with sufficient analysis. Not all discrepancies are critical, however — and too detailed a parsing could cost more than the stock in question is worth.

Thus most manufacturers and wholesalers tolerate variances of from two percent to five percent, and many apply stricter standards to high-value items than to bulk goods.

A reasonably good inventory system need not attain perfection. With continuous training, sensible vigilance and old-fashioned management discipline, such a system can keep surprises to a minimum.

Finally, most variances can be ascribed to errors — but not all. Then, as Holmes told Watson, “when you have eliminated the impossible, whatever remains, however improbable, must be the truth.”

Theft happens, and it's usually a lot better hidden than mere mistakes. But ongoing analysis of inventory variances can lead to discovery of theft or an even better result: It can rule theft out.

If you'd like to look into some ideas for minimizing inventory variances and adjustments, our firm can help you get started.