Cycle Counts of Inventory, A Practical Guide

Background

The most successful are continually looking for ways to improve the efficiency and effectiveness of their operations. Following the widespread adoption of lean manufacturing practices, many manufacturing and distribution companies are now re-evaluating their internal accounting policies and procedures over inventory.

Historically, the most common way for Companies to count their inventory was to periodically perform counts of 100% of inventory on hand, whether this is weekly, monthly or annually. While this approach can be effective, it also has many drawbacks. The process is disruptive to the business cycle, often requiring the shut-down of operations and requiring temporary staff to facilitate the counts in a relatively small time window.

When counts are performed annually, significant errors may build up over time and not be detected until the end of the year. If the annual inventory counts result in significant adjustment to the year-end balances, the Company’s ability to produce accurate financial statements during the year can be called into question. Unanticipated adjustments to the numbers at the end of the year are rarely viewed as a positive, and this is not one of those situations.

For many companies, the adoption of cycle counts can be an effective way to address these problems.

Cycle counts defined

Cycle counting is the process of counting a partial amount of a Company’s inventory on a frequent basis, usually daily or weekly. Implementation of cycle counts can have numerous benefits, including:

- It is less disruptive. Performing a 100% physical count of inventory as previously noted will typically require the shut-down of manufacturing, shipping, and/or receiving. Cycle counts can be performed in conjunction with a Company’s daily operations.

- Allows for a small specially trained team to perform cycle counts.

- Increases accuracy of the perpetual inventory system. This will prevent significant adjustments at year-end and will increase the ability of the operations department to rely on the system for ordering and production scheduling, thus supporting a reduction in inventory levels.
• Reduces risk by focusing on inventory items with a higher inherent chance of misstatement by counting them more frequently.

Cycle counts are most effective in situations where there is a rapid turnover of inventory, and where the value of the inventory is deemed material to the Company. In enterprises where inventory is a smaller component of operations, it may not be cost effective to implement such a program. The costs of implementing such a program should always be weighed against the related benefits and risk mitigation to ensure that it adds to the bottom line.

Training a team

Companies that perform 100% physical counts have a significant amount of work that needs to be performed within a small window of time. Frequently, this involves hiring temporary staff, commonly without any knowledge of the Company’s operations or commitment to accuracy.

The assignment of dedicated cycle count teams allows the Company to train a number of individuals in the organization to perform these tasks. The size of the team will be dependent on the size and complexity of a Company’s inventory. A large organization could have a cycle count team of several full time employees, while a smaller organization could have as few as two employees that perform cycle counts for a small part of their work day and perform other daily tasks as well.

It is advised that additional employees be trained as backups for the in the cycle count process in the event one of the trained cycle counters is sick or departs the Company.

ABC Grouping

Traditionally, periodic inventory counts assume that all items in inventory are of equal importance, with each item being counted with equal effort as all others. Such an approach does not include a risk assessment process into the selection of the counts. The most effective accounting department managers focus their efforts in the areas of highest risk first, and spend less time where less risk exists.

Most effective cycle counts utilize what is called an “ABC” grouping. This is a risk based approach where items with higher value or higher turnover are counted more frequently. Every company is different, and the grouping within the categories needs to be tailored to the specific situation and risk assessment of the entity.

The most common way to assign inventory items to groups is summarize the historic cost of goods sold by item (typically referred to as a “stock keeping unit” or “SKU” for short) number, sorted high to low by total
cost. Most Companies will notice that a relatively small number of items comprise a high percentage of cost of goods sold - those items would be categorized in the “A” group. The “A” group should also include specific items that are judgmentally identified as higher risk due to their susceptibility to theft, loss, or if they have historically have been prone to errors that have slowed production in the past. The “A” Group represents items that are determined to be critical to the Company based on the selection criteria.

“B” items are the second level of risk assessment. Typically, there will be a larger number of items in this group, but their total cost will be lower than that of the A group. These items would be counted with less frequency than the “A” group.

“C” items typically account for a large number of the items in inventory, but will account for a relatively small amount of total costs. These items will typically include smaller components and supplies. Due to the lower risk of misstatement associated with these items, they will be counted with less frequency.

In summary, an example of the ABC assignment could look as follows:

<table>
<thead>
<tr>
<th>Group</th>
<th>Description</th>
<th>Percentage of total SKU’s</th>
<th>Percentage of total COGS</th>
<th>Counts of each SKU per Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Critical</td>
<td>5%</td>
<td>70%</td>
<td>12</td>
</tr>
<tr>
<td>B</td>
<td>Significant</td>
<td>20%</td>
<td>20%</td>
<td>6</td>
</tr>
<tr>
<td>C</td>
<td>Other</td>
<td>75%</td>
<td>10%</td>
<td>2</td>
</tr>
</tbody>
</table>

It is important to remember that every Company is different and that the categories above and counts of each item per year will and should be adjusted to fit the specific situation and risk assessment at each Company. Some entities may have only a small number of total items in inventory, each with a high dollar value that should be counted more frequent basis than monthly. Others may have a large number of low value items in inventory where a significant number of the items would be considered to be in the “B” group. A careful analysis of the historic cost of goods sold account will likely reveal natural groupings that can be applied for this purpose. There is also no reason to limit the analysis to three groups. In certain situations substantially more groups may be assigned to further refine the cycle count process.

**Measure twice cut once**

Items should be counted by two individuals working independently of one another, and a blind comparison of their counts should be made before adjustments are recorded. One of the primary purposes of cycle counts is to increase the accuracy of the inventory information. Before overriding existing quantities with new information from the cycle counts, it is critical to ensure that this information is accurate. The two counts
should be independent of each other in such a way that neither counter sees the results of the other’s work so as to not bias the outcome of their own counts.

**Scheduling**

It is important to set expectations and timing with the cycle count teams to ensure that the cycle counts become a part of their daily or weekly routine. Managers should also calendar appropriate time to review the results of the cycle counts, and to follow up on any significant adjustments recorded.

Many ERP systems can track the ABC assignments and provide the employees with a list of SKU’s to count each day. In the absence of such capability, a spreadsheet can be used to track the cycle counts. It is critical that the cycle count schedule includes any new SKU’s added to inventory, and the cycle counts should be cross checked against the inventory balances to ensure that no items are overlooked.

**Tools of the trade**

In Companies with more sophisticated inventory management systems, inventory can be counted with bar code scanners attached to hand held computers that feed the cycle count results directly into the inventory database. The automation of these tasks will generally lead to more efficient cycle counts with fewer errors. For smaller Companies, the process may be more manual but in all situations, the process needs to be well defined and systematic in nature.

Based on the nature of the Company, basic tools such as calculators, clipboards, or protective gear should be provided to employees on an as needed basis. Having the right equipment available will help prevent any delays to the cycle count process.

**Units of measurement**

Many times a Company will buy product in bulk, with units of measurement such as pounds, kilograms gallons etc. It is critical that the inventory system clearly labels the unit of measurement for each item in inventory to prevent significant errors. An example of such an error would be where an inventory system values inventory based on kilograms, but the inventory counter mistakenly enters a quantity number based on grams.

It is a best practice to configure inventory management software in such a way as to conspicuously display the units of measurement on each report to prevent any confusion during the cycle counts.
Reviewing adjustments

All cycle count adjustments recorded should be summarized and reviewed by the employee in charge of the inventory.

The existence of such adjustments may be indicative of other operational problems, and it is recommended that where practical, the source of the errors is tracked down and remediating action is taken to ensure such mistakes do not happen in the future.

How will my auditors react to the implementation of cycle counts?

Auditors are required by generally accepted auditing standards to physically observe a Company’s inventory if it is material to the financial statements. There is specific audit guidance on the topic of cycle counts that allows auditors to test the cycle count processes and to rely on them for purposes of their audit.

The significant change here is that the auditors will be testing cycle counts as an internal control, as opposed to a substantive test of details. This will enable them to test the inventory quantities at an interim date, and if the cycle count procedures are determined to be adequate and they are in place as of year-end, can be relied upon without the need to perform test counts on the last day of the year.

Auditors are required to gain and document an understanding of the cycle count procedures, including their conclusions as to the effectiveness of their design and implementation. Robust internal documentation of the cycle count procedures will reduce the amount of hours (and fees) the auditors require to audit inventory.

Other key controls over inventory

In addition to a properly designed and implemented inventory cycle count process, it is critical that the Company have entity level controls in place over inventory. This would typically involve a high level member of management reviewing any significant swings in the overall inventory balances or production variances. Often times such a high level review can detect inventory errors as the inventory balances are being viewed in light of their overall financial statement impact.

GALLINA can help

The implementation of cycle counts is a best practice in the manufacturing and distribution industry. Such an implementation may encounter numerous challenges, but the experts at GALLINA can help. If you have any
questions on cycle counts or any other accounting question, please feel free to reach out to us by email at solutions@gallina.com or by phone at 1-877-638-1188 to discuss the right steps for you and your Company.