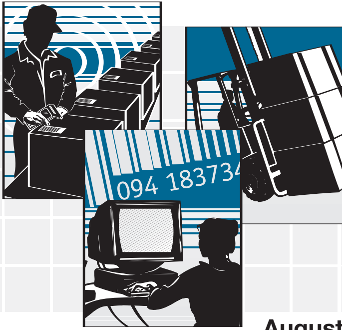

Distribution Center MANAGEMENT

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From the Golden Zone

Is your inventory accuracy really as good as your auditors report?

By Fred Kimball

When it is close to the end of your financial year, your company's auditors have to report your year-end inventory for the financial reports. How the auditors measure inventory accuracy can give you a false sense of comfort about how well your operation is really performing. Is your inventory accuracy really as good as your auditor's report?

A question in an operational audit is, "What is your inventory accuracy?" The most common answer is something like "99 percent plus," with many managers reporting 99.6 percent or higher. However, the next question should be, "How do you measure that accuracy?" It is amazing how many operations managers struggle to answer how the operation's accuracy is measured. To some, it's the first time they ever heard the question.

Two methodologies: Financial accuracy and operational accuracy

What surprises many experienced operations managers is there are two methodologies for measuring and reporting inventory accuracy. Because there are two, managers need to identify which methodology they are using when reporting results. The first is financial accuracy, and the second is operational accuracy. Most companies use only financial accuracy.

Financial accuracy is the net dollar difference of the adjustments after an inventory, and it is the measurement used by most internal auditors and accounting firms. It answers the question, "Are the processes sufficient in controlling the inventory to avoid making large adjustments to the inventory value on the company's books?"

> The only good measure of how well the operation controls inventory is the operational accuracy.

Operational accuracy answers two very different questions. The first is, "When we promise the last unit of an item to a customer, do we have a high degree of confidence we actually have the unit?" And the second question is, "Can we be very sure the picker will find the right item, in the right quantity, at the specified location, on the first try?"

Operational accuracy is stricter than financial accuracy. An example of financial accuracy is as follows:

- Assume there are two stockkeeping units (SKUs) in inventory.
- Each SKU's value is $1.00.
- The "book record" for each SKU is 100 units on hand.
- A physical inventory counts each item: One has 101, and the other has 99.
- The net dollar difference is zero dollars.
- Inventory accuracy is 100 percent.

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An example of operational accuracy for the same scenario is:

- The entire inventory is in two storage locations. The units of one SKU are in one storage location, and the units of the second SKU are in a second location.
- The physical inventory counts each location: One SKU has 101 units, and the other has 99.
- Both locations are incorrect compared to book record.
- Inventory accuracy is 0 percent.

While the examples are simple, the point is clear. Operational accuracy is usually very different from financial accuracy unless operational accuracy is very high. If operational accuracy is 99 percent or better, financial accuracy will also be extremely high.

The true measure of a distribution center's accuracy is the operational accuracy. A very high level of operational accuracy is needed to maintain superior customer service and excellent productivity. When customer service has taken an order for something based on inventory a vailability, a bond is established with the customer. When distribution has to backorder the item because they cannot find the item or allocated quantity, the bond with the customer is broken.

As for productivity, there is too much wasted time in a distribution center when an associate cannot find the right item, in the right quantity, in the right location as specified in the picking instructions, regardless of whether those instructions are paper-based or electronic. Once the picker cannot find an item, the search begins and productivity starts a downward spiral. It is also common for a picker who cannot find the item to enlist another person's help. When this happens, there are two people doing one person's job. Talk about declining productivity!

Real-life examples

Distribution Design recently completed two operational audits that demonstrate this difference. Both companies had financial accuracy measured by auditors, and the results showed that it was greater than 99 percent. As a result, distribution management did not think accuracy was a problem. Based on the accountants' view, the companies were not losing a significant amount of inventory.

However, Distribution Design found the operational accuracy at the first company was 85 percent. And, since the company's system did not track quantity by location, this meant that only 85 percent of the picking locations had the correct SKU. The second company's operational accuracy was just 66 percent. This means that 34 percent of the time when pickers went to the specified location, they did not find the correct item and/or there was an insufficient quantity to complete the customer's order.

What inventory accuracy really is to a distribution operation

Inventory accuracy is not the net dollar difference after all counts and corrections. While operational managers will have to continue to assist the accountants with the financial inventory, resting on those laurels of a 99 percent net dollar difference does nothing to address the likely productivity and service issues that exist in the operation.

The only good measure of how well the operation controls inventory is the operational accuracy: the percent of locations that are 100 percent correct for SKU, quantity, and sometimes lot. If the operational accuracy is below 99 percent, there are real opportunities for process improvement that will have a positive impact on productivity and customer service.

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