KIRTANE & PANDIT

Use of Technology in Inventory Verification

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Introduction

Inventory Verification is the process of assessing the stock maintained in your company's books and comparing it against the physical stock to ensure they match. It is basically a process done manually to ensure data in the system is correct.

This process may be conducted internally or at the request of an external auditor. Physical inventory counts are the only way to verify system numbers and ensure that actual inventory is accounted for. It will also let you know if it's time to take some actions like devaluing non-moving or slow-moving items, eliminating redundant items, categorizing inventory into ABC brackets for better control, and so forth.

Today, to address complex procurement models of organizations, diverse storage locations, different product lines, varying production processes amongst product lines, etc., the support of Technology in inventory verification has become the need of the hour.

Types of Inventory Verification: PIV and One time

There are two types of inventory verification- Perpetual inventory verification and One-time inventory verification. Perpetual Inventory verification or PIV, as the name suggests is an ongoing inventory verification process while One-time inventory verification is done per your Company's need/requirement.

Perpetual inventory verification (PIV):

In PIV, at the start of the year, the system stock or the total inventory list of your company is classified into A, B, C, and if required D classes. The classification is based on the value, importance, lead time, material type, or a combination of these and other such parameters. In general practice, 'A' classes are high value items or items of high importance and hence they should be counted at a higher frequency.

The ratio in which the inventory items of these classes must be covered during the year is decided by the organization. Usually the A: B: C class is covered in the ratio 3:2:1. The inventory items are planned for verification in such a way that they are covered in the decided ratio.

Both- the verification team (either in-house or external) and Company (store in-charge or any authorized signatory present) sign on the physical count report to portray agreement on the physical stock. Once the physical verification is complete, a comparison of this physical stock is made against system stock, and deviations are calculated and circulated with your Inventory management team for reconciliations.

Deviations, if any, are reconciled within a specified time and finalized. The final deviation is adjusted in the system on an ongoing basis at specific periodicity so that the difference between system quantity and physical quantity at any given time is at a minimum.

One-time Verification:

One-time inventory verification is preferred in situations where the items of inventory are fewer, verification may require complete halting of production, where production is automated with minimal human intervention, etc. It may be a complete inventory verification or selected inventory verification depending on location, importance, risk, value, and similar factors. A complete list of identified inventory items needs to be drawn from the system at the decided cut-off date.

The further process is similar to that in PIV of verification and reconciliation. The final deviation is adjusted in the system so that the difference between system quantity and physical quantity at that particular cut-off date is nil or at minimum.

Regulatory requirement

Reporting of Inventory in CARO 2020 (Companies Auditor's Report Order), 2020

There have been noticeable changes in Clause ii of CARO 2020. Initially, the auditor was only required to report whether physical verification of inventory has been conducted at reasonable intervals by the management and if any material discrepancies were noticed, and if so, whether they have been properly dealt with in the books.

Now the Auditor has to also report on the following

- Whether the coverage and procedure of physical verification by the management is appropriate or not
- Whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books
- If during any point in time the company has sanctioned working capital limits exceeding Rs 5 crore, from banks or FI's on the basis of security of current assets, then the auditor is to verify whether quarterly returns/ statements filed by the company with such banks or FI's are in agreement with the books.

If the same are not in agreement, details of the same are to be furnished.

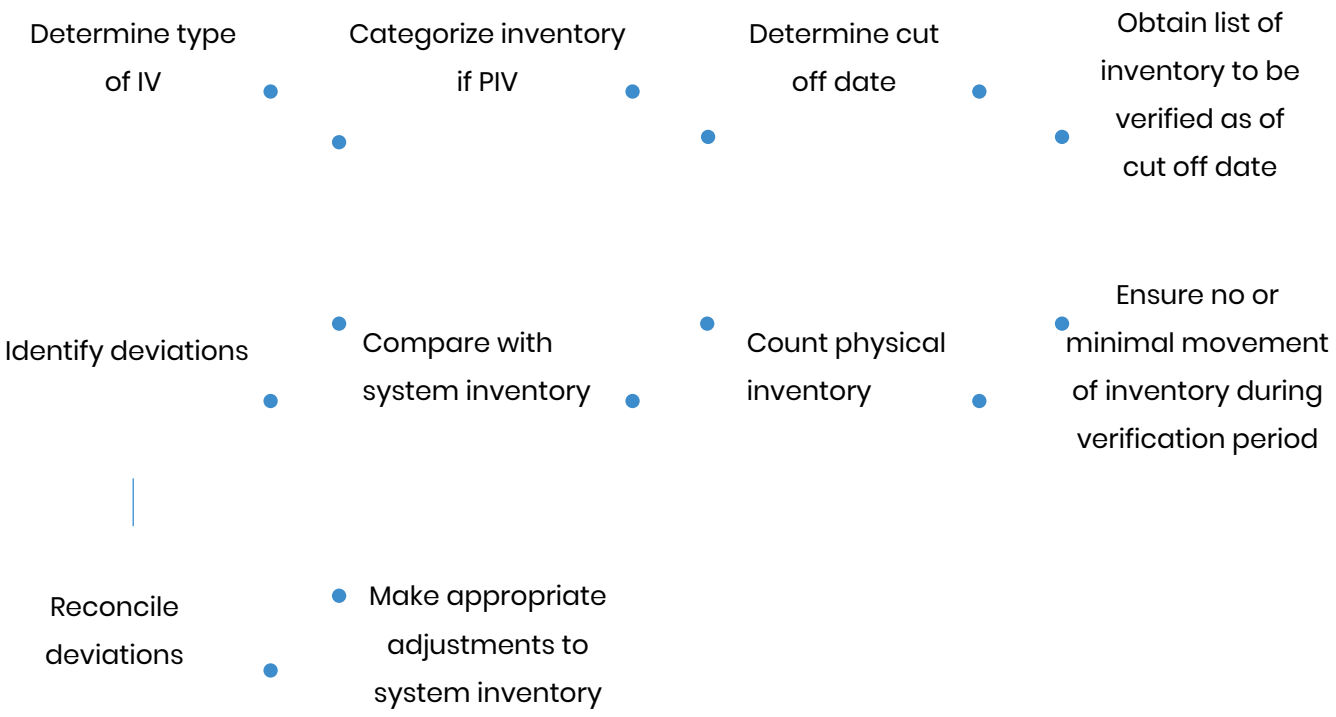
Inventory Verification Process

To comply with the regulations pertaining to inventory as required by Goods and Services Tax, Income Tax Act, Companies Act, etc. the entity needs to maintain proper records for its inventory such as –

- Item-wise stock report as of 31st March
- Physical verification reports
- Cost sheet of products
- Stock Valuation reports
- Aging statement of inventory

Companies can carry out Inventory verification as an internal process either with the help of an in-house team or preferably through a third party to maintain independence.

The process of Inventory Verification (IV) can be summarized in the following steps –



Focus areas of inventory verification – Audit perspective

While compliance is one of the angles of Physical inventory verification, its benefits can be far beyond. So to make the output more fruitful and cover all aspects of the audit, the following areas need to be focused upon –

- Coverage – Based on the criticality and value of inventory items, whether they are appropriately covered in inventory verification
- Cut-off date – Whether a proper cut-off date on decided and followed so the movement of inventory did not or minimally affect the verification
- Error-prone items – Based on past reports, whether error-prone items are verified

- Condition – Whether inventory items are in good condition, if rejected items are kept separate from approved items, whether adequate safety measures are in place

- Location – Whether inventory items are stored in a place designated for same. Whether these locations and racks are adequately labeled. Also if access to inventory location is restricted and properly guarded

- Non-moving / slow-moving items – Whether during verification, non-moving and slow-moving items are identified. Whether these are separately stored and provided for

- Semi-finished and Finished goods – Where possible analyze the BOM and trace its inclusion in the semi-finished and finished goods

- In-transit goods – In-transit goods cannot be physically verified but can be analyzed from consignment notes or goods dispatch notes

- Ownership – Sometimes inventory items are stored at other than company locations like vendor locations or shared warehouses or retail outlets. In such cases, periodic verification on a sample basis is recommended

Challenges of inventory verification

- Time-consuming: Inventory verification is a time-consuming process and also requires a lot of planning.
- Personnel: It requires major involvement of skilled and unskilled labor which can lead to loss of productive time.
- Halting operations: If a 100% verification of inventory is to be done, then it may require the operations to be halted till the time the verification is completed for an accurate count.
- Errors/mistakes: Since it is a time-consuming, tedious process there is a high possibility of errors/mistakes happening while writing like misreading, miscounting, use of the different measuring unit, etc., and in turn when updating the data.
- Reporting: Due to the errors in counting and manually updating data, there are chances that the deviations that are derived can be error-prone as well.

To minimize errors, overcome challenges, improve efficiency, and speed up the process, the use of technology is of the essence.

Possible avenues for use of technology in inventory verification

Planning

Inventory verification needs to be planned meticulously, specifically if it's PIV. The use of tools to categorize inventory into ABC categories based on certain conditions can help in objective bifurcation and coverage on a pre-decided basis. Cloud-based tools can easily support inventory classification into type/date of purchase/value/storage location for planning the physical verification.

Execution

Technology intervention for execution can take care of most of the challenges. The following aspects can be handled through technological intervention –

- Use of tools to input Inventory lists as obtained from the planning stage to form a basis for counting at the start of the activity.

- Counts can be performed physically while data gets entered into the tool against the predefined list. If an inventory is tagged with QR-coded stickers, the capture of data can also be automated through the reading of QR codes and mapping of data.

- Specific observations, if any, regarding additional, differential, or non-existing inventory can be recorded with corresponding photo(s) or documents attached to each of them.

Reconciliation

Since data will be available in the tool – the original list of inventory vs data captured during the actual physical count, there can be seamless inventory reconciliation taking place ensuring live reconciled status at any given moment.

Reporting

In detail, reporting can become possible with reports like inventory item-wise deviation, deviation % wise item list, non-moving item list, slow-moving item list, damaged item list, etc. along with the combination of such reports. Reports can show the inventory coverage with class, reconciled items, and deviation in quantity and value (excess and shortage) with the ability to drill down into categories or departments, relevant graphs, and observations for the period.

The tool can be used with or without integrating with your ERP system. As it is expected to be a cloud-based tool, it can work with the available infrastructure and from remote locations.

Advantages of automating the process

- Reduction of human errors
- Reduction in time of reconciliation and reporting
- Algorithm-based list of inventory. Ensures independence and can help reduce bias in the selection of items to be verified
- Easy tracking of changes and reasoning for same, if any
- An audit trail that ensures Auditors get a transparent view of the physical inventory verification process
- Easy comparison against previous cycles of inventory count
- Records can be maintained such as date of verification, place of verification, etc.
- Performance can be captured – targeted vs actual count of inventory items getting verified
- Live reconciliation can help come up with reasoning and help resolve queries on spot rather than revisiting after reconciliation on some other day
- Time reduction in the entire verification process will ensure minimum disruption to the production process
- Time spent by the inventory management team/storage team on the verification process will be reduced ensuring an increase in their productivity
- Live recording and data collection can help reduce duplication of efforts within the inventory verification team
- Multiple locations can be tapped simultaneously ensuring easy reconciliation of misplaced items
- Tailor-made reports can be generated as per your requirement

Disadvantages of automating the process

- Use of technology will require the use of gadgets like laptops, tablets, or phones and cloud-based servers which may add to the cost
- Basic connectivity to the internet will be a must
- Proper training will be required to correctly handle tools and input complete and correct data
- Human error in inputting data into the tool will remain

Conclusion

It's important to conduct inventory audits to maintain inventory accuracy, identify deviations, and ensure that the inventory levels are maintained as per the margin of safety stock which would in turn be aligned with the procurement policy of the company. Using technology in the inventory verification process will help identify the deviations, if any, faster, with improved efficiency and on a sustainable basis.

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