



SCMDOJO

GUIDE ON EXCESS AND OBSOLETE INVENTORY POLICY

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Revised & Updated

**ALLOWANCE FOR EXCESS,
OBSOLESCENCE, AND SHRINKAGE
INVENTORY**

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EXCESS AND OBSOLETE INVENTORY POLICY – ALLOWANCE FOR EXCESS, OBSOLESCENCE, AND SHRINKAGE INVENTORY.

Excess and obsolete inventory is an SCM (Supply Chain Management) issue that affects distributors, manufacturers, and retailers. The inventory signifies massive investment for any business, and if it is not traded for some reason, it consumes warehouse space and increases liability. Excess and an obsolete reserve is the inventory cost which is lesser than its possible disposition cost. Company financials are taken as an expense and can affect your ability to borrow.

Establish a methodology for proactively identifying, accounting for and resolving the disposition of excess and obsolete inventory. Also to assign the proper accountability for continuous improvement activities focused on reducing the occurrence of excess and obsolete inventory by identifying and addressing the related root causes

POLICY

The policy applied by any Company carries guidelines for adjustments, disposition, inventory valuation, and reserves. The accounts for inventory allowance also cover all operating units to include all excess, obsolescence, and shrinkage inventory. Policies implemented should offer:

- Inventory reserves evaluation to identify and review all inventory to proper estimations on a quarterly basis.
- Proper planning to ensure accuracy on all levels.

SCOPE

The scope of Excess and obsolete policy spread over all company inventory items. Such inventory items include

- Finished Goods
- Inventory at Subcontractors

- Raw Stock
- Work-In-Process (WIP)

Moreover, establish a methodology for proactively identifying, accounting for and resolving the disposition of excess and obsolete inventory. Also, to assign the proper accountability for continuous improvement activities focused on reducing the occurrence of excess and obsolete inventory by identifying and addressing the related root causes

WHEN INVENTORY IS CONSIDERED EXCESS AND OBSOLETE

In general, inventories are classified into excess, obsolete, or shrink inventory when a company still has goods that should have been sold. In the market, an inventory that cannot be sold drops significantly in value and could turn out useless in time. Allowance reserves are documented to cater for such inventory losses. Such inventory must be written down/off within the financial records in compliance with Generally Accepted Accounting Principles (GAAP).

A write-down is done whenever the inventory value falls below the reported cost of production. On the other hand, a write-off involves the complete takedown of such inventory off the books especially when it is confirmed to be valueless.

In cases of a decrease in value, the difference could be identified from charge to income during the period it happened.

UNDERSTANDING CONTRIBUTORS FOR EXCESS & OBSOLETE INVENTORY

Major contributors to excess or obsolete inventory are end items or components that are unique to a specific customer requirement. Operations and sales/marketing agree to stock at certain levels in order to meet a responsiveness requirement of the customer. There are five major reasons for significant demand changes these items

1.The Customer Pulls the Business

As a result, we need to identify the stranded inventory and present it to the customer per their contractual agreement. The inventory that remains must be tagged as obsolete and dealt with accordingly.

2. Design Change of Product

The customer has a design change that eliminates the requirement for some customer specific inventory/parts that are carrying. The action would be the same as in cause 1.

3. Significant Changes in Customer Demand

The customer has had a significant drop in requirements for their product which utilizes our customer specific products. Your action is to contact the customer to gain an understanding driving the change and its longevity. If the drop is determined to be long term, the inventory should be analyzed for potential excess.

A key assumption to all three of the above scenarios is that either the changes in conditions have been communicated or detected in a timely manner. You have to develop some sort of [ABC](#) or [ABC-XYZ Tool](#) to assist in this process.

4. New Products Introduction/ NPI Programs

These items, forecasted by engineering or product management. Generally a forecast and safety stock is agreed to with the commercial side of the business. Once product or programme is launched the parts should be analyzed using the standard classification process. Parts that have had normal demand will change to an “A or B” classification. Parts that have had poor demand, if any, are reviewed and disposition will be [determined then as C](#) or Excess or Obsolete

5. Low Volume, Highly Variable Demand Items

While the best strategy for these items is to manufacture them or purchase them as Made-to-order (MTO), this is not always possible as you have to keep them in stock as a part of product portfolio or catalogue launch.

In summary, your approach to limiting exposure to excess and obsolete inventory is highly dependent on early detection, analysis and disposition. Use this [Free ABC Analysis Tool](#) to enable proactive monitoring of the inventory activity profile and the establishment of a more sustainable and predictable inventory optimization and valuation approach.

INVENTORY ROOT CAUSE & DISPOSITION CODING

It is important to identify the major root cause or reasons for the excess or obsolete inventory as mentioned in the previous heading. Once this is done, you should give them a list of cause codes for the further deep-down analysis purpose so you can present which root cause is most contributing in terms of Pareto. The following list of cause codes are to be used in conjunction with the Inventory Monitor Tool:

- UR – Under review
- LB - Loss of business
- DC - Design change
- DR - Customer demand reduced drastically vs forecast
- NP - New product demand forecast that the demand did not happen as anticipated
- EC - Internal Engineering changes
- OP - Item over builds or buys to minimums or desired price breaks
- VC - Vendor/supplier change
- CO - Custom items – customer commitments outside of planning system

Once an item has been reviewed, a disposition code will be associated with the item in ERP system you are using to signify the resolution/disposition decision. I would also recommend to create

a simple Excel action register to identify the appropriate disposition of the item and assign the owner for the action and the date by which the action is to be taken.

The following list of disposition codes can be used in ERP System:

- S – Scrap
- C - Convert or use as substitute
- F - Sell through alternative means (fire sale promotion, discounts, etc.)
- A - Send to customer as per agreement (if any)
- R - Return to supplier
- D - Not ready for disposition
- N –Reviewed, no action required

GUIDELINES – SHRINKAGE

Inventory shrinkage is a loss identified when the number of products in stock is less than what was logged on the inventory list. These counts can be found using the program on ongoing cycle count and annual physical inventory. The loss may be from clerical errors, damaged goods, or theft.

When there is an inventory shrinkage, any inconsistencies should be addressed to resolve the records. Inventory shrinkage required an agreeing principle that should be added as an expense and recorded under the Cost of Goods Sold (COGS) account within the financial period it falls in for that year.

To account for Inventory Shrinkage via the perpetual accounting method would imply raising the cost of goods sold and decreasing inventory by the change recorded for that period. In the event of having a mixed history of pick-ups and write-offs and or history be present, evaluate other factors that designate the demand for shrinkage reserve and assess the required reserve where needed.

Inventory shrinkage can be managed by executing internal controls first. Below are other prevention techniques to apply:

- Anonymous Reporting
- Audits

- Education
- Monitor Trash Removal Process
- Reduce Temptation
- Separation of Duties
- Surveillance.

After yearly physical inventory alteration is documented, the shrinkage section for the monthly increase should be revised and adjusted to reflect the best estimate for future losses due to Inventory shrinkage.

GUIDELINES – OBSOLESCENCE

Inventory obsolescence is inventoried that are unsellable and valueless. It is defined as inventory that has stretched past its useful life as a finished product. Inventory obsolescence may arise for several reasons dependent on the industry and these includes:

- Finished goods in a saleable condition that remain unsold due to the absence of market demand.
- Raw materials and Work-In-Process (WIP) that cannot be used to create marketable goods or no conceivable use.

The amount for obsolescence reserve should be evaluated yearly, and an entry recorded created immediately to fine-tune the obsolescence inventory allowance. After yearly evaluation, the general ledger should hold a record of monthly accrual from obsolescence component. Track Inventory Levels in Real-Time would involve the use of a cloud-based inventory management system. Necessary adjustment and review should be made to reflect the best estimate for future losses. A basic formula to begin with is:

$$\begin{aligned} & \text{(Average Daily Unit Sales * Average Lead Time in Days) + Safety Stock} \\ & \quad = \text{Reorder Point} \end{aligned}$$

Creation of Obsolescence Reserve comprises of inventory list that seems obsolete should be developed and maintained based on both:

- Qualitative Inputs: No market demand/technological obsolescence created from sales input, supply chain team.
- Quantitative Inputs: No consistent usage within a time frame, except inventory, is held from resulting contractual obligation with the customer(s).

Account	Debit	Credit
Allowance for Obsolete Inventory	5,400	
Inventory Obsolescence	2,600	
Inventory		8,000

Recording Obsolescence Reserve is determined over the first eleven months for a year. The records should consist of two parts:

- Debiting an expense account: This includes Cost of goods sold, inventory write-downs, and obsolescence.
- Crediting an asset account: This includes obsolete inventory Allowance and Reserve.

[To Get Rid of Obsolete Inventory](#) to avoid hurting your business, you can apply the following steps:

- Bundle Products
- Donate Obsolete Inventory for Tax Deductions
- Liquidate Your Items
- Remarket Items
- Sell at a Discount
- Write-Off Obsolete Inventory

GUIDELINES – EXCESS INVENTORY

Excess inventory is the outcome of poor management of material flow or stock demand. Excessive Inventory is also linked with revenue loss, and it remains a threat to your business bottom line. Excessive Inventory levels feature various cost considerations that include revenue loss from products with less demand and costs associated with storing inventory (carrying costs). These costs add up rapidly across many factors. If not managed appropriately, the best case for any business is to sell off excess stock to break even and only lose a small percentage of profit.

There are different approaches to precisely detect excess inventory with reserve recorded together with forecasted demand. The total for any excess inventory should be determined yearly and an entry logged at year end to regulate any excess inventory grant. The Excess Inventory Allowance should equal 50% as a minimum for excess inventory.

After your yearly adjustment is logged, the monthly addition from excess inventory should be revised and attuned to echo the best evaluation to cover impending losses. Also, logging of Excess Inventory Reserve should be determined in steps.

Determining Inventory Turnover Ratio (ITR) would avail business the idea of which products reduce cash flows and account for excessive carrying cost. To do this, you use to apply the formula below

$$ITR = \text{Cost of Goods Sold} / \text{Average Inventory}$$

A more straightforward approach to calculating your average inventory is through the addition of beginning and ending inventory cost divided by two. A higher ratio usually denotes better performance. No business is perfect. Recognising these and applying corrective actions to this issue can turn out to be the best step in making a more profitable venture.

QUARTERLY MODIFICATIONS TO INVENTORY RESERVE

An inventory reserve is an accounting number applied in lessening the balance of a business inventory value to its market value. In most businesses, the inventory will precisely be detected when it becomes added to the reserve. The excess, obsolescence, and shrinkage inventory reserves

mandate quarterly assessment in determining if present business conditions designate historic trends or other factors have turned out to be invalid, necessitating modification to the reserves.

A minor or more significant excess or obsolescence inventory reserve is required to be documented, aligning with management ruling/considerations. The risks are meant to be less contemplated especially when calculations (from V and VI) are applied. With different forecasted demand and product life cycles, you will be able to designate the reserve that would not be adequately stated deprived of these considerations.

An adjustment ought to be recorded If your quarterly valuation shows that the excess, obsolescence, or shrinkage inventory reserve(s) are overly accumulated or under. Reserve(s) within such period needs to be well stated at the end of the quarter in addition to a monthly reflection of all the accumulated rate in the coming months.

ANNUAL MAINTENANCE OF RESERVE

Businesses are required to issue disclosures that notify shareholders of the usage of the reserve. Shareholders naturally request such data on why such reserve is set aside from operational usage. The annual maintenance can report the required reserve set aside monthly and the final use of such funds. The techniques for integrating and managing the yearly maintenance of reserve can be included in disclosure declaration. At the beginning of a new business year, every ledger should be the reverse of the preceding year's write-off and modification accounts to the linked allowance account. Such reports should include:

- Excess Write-offs reversed for Excess Inventory
- Obsolete Write-offs reversed for Obsolescence Inventory
- Periodic Cycle Count and Physical Inventory Modifications reversed for Shrinkage

DEBIT BALANCES IN RESERVE ACCOUNTS

A reserve account contains data relating to certain cash balances. This account is distinct from other business operating cash balances. The importance of the reserve account is intended to keep back money not used for regular business operations. Debit balances in reserve accounts may be typical for large businesses having multiple loans that necessitate outflows.

Reserves are famous for businesses to retain cash for future goals. Debit balances in inventory reserve accounts need to be adequately inspected, recorded, and appropriately modified.

RESPONSIBILITIES

Supply Chain Manager / Materials Manager

Coordinate and manage the establishment and ongoing activities of the Excess and Obsolete Inventory and manage the inventory coding process noted in Section INVENTORY ROOT CAUSE & DISPOSITION CODING.

Financial Controller / Finance Manager

Actively participate in the Excess and Obsolete Inventory review process, approve reserve amounts and related dispositions of excess and obsolete inventory, and confirm that the reserve approved by and agreed in the companies' financial statements in the period of determination. The financial controller / finance manager should also confirm the consistency of application of the reserve methodology and maintain all supporting documentation.

Facility Manager / Plant Manager

Review and approve the actions of the Excess and Obsolete Inventory review process on a quarterly basis and confirm that actions are being taken in a timely manner.

DEFINITIONS

Carrying cost of inventory: It implies a fixed fraction of inventory value indicating business cost incurred over a given time frame. It can include depreciation, employee costs, insurance, taxes, opportunity cost, storage cost, and overall capital cost for the whole business.

Excess Inventory: It implies inventory that surpasses projected demand due to the real amount, regarding raw materials, finished goods, is more than what is required to complete future orders.

Inventory Shrinkage: This represents Inventory losses identified through the difference between physical counting of inventory to records obtainable in general ledger within a given time frame.

Obsolete Inventory: It stands for physical Inventory which turns out to be outdated. It is the total of Raw materials, WIP that become unusable, and unsold finished goods due to less market demand.