Perpetual Inventory White Paper & Example Procedure
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Introduction

Inventory accuracy is a critical and highly sensitive area affecting all businesses. Perpetual Inventory/Cycle counting can increase inventory accuracy to levels of 96% and better, while offering significant cost saving when compared to physical inventory counting. Inventory record accuracy has a significant impact in increasing levels of customer service, reducing costs, and increasing productivity. Small businesses stock is a buffer for variation in demand. When inventory is located correctly and warehouse pickers do not have to search for items, productivity is increased. Customer service increases due to more accurate stock information, less backordering, and fewer stock-outs.

The physical inventory process is one of the most widely used and commonly accepted practices to account for inventory. This process does have some drawbacks:

1. The process is un-automated and is prone to errors due to the amount of paperwork involved.
2. Operations typically must be shut down for a physical inventory.
3. Personnel used to take a physical count are often not trained and are unaware of stock locations and product ID increasing room for error in the count.

Temporary help (and overtime help) sometimes must be hired in order to get the physical inventory count completed within a specific time frame.

Cycle counting is the process of counting inventory items throughout the year on a schedule so that all items are counted at least once a year. The primary focus is on items that move more frequently, with less attention given to items that move less frequently. This process is more efficient than a physical inventory process. It utilizes employees that are familiar with inventory and warehouse locations, and can uncover processes that produce inventory inaccuracies.

Cycle counters perform counts of SKU’s (Stock Keeping Units) and record the information. This count is then checked, based on the actual record, to see if there is a discrepancy between the two counts. A tolerance level is used to see how much above or below the actual count is when compared to the record count. This tolerance level is low for fast-moving items and higher for slower moving items. When a count is taken that is outside of the tolerance level, and examination is undertaken to understand the root cause of the error so that the source of the error can be eliminated. This process has an impact on inventory records for all items through repairing the process that accounted for the inaccurate information. Under the physical inventory process, this type of investigation is impossible, and process errors are never repaired.
Cost of Inaccurate Records
There are built-in inefficiencies and hidden costs directly and indirectly related to inaccurate inventory records. Two of the major cost are “Holding Cost” and “ordering or setup cost”

Excess Inventory Levels
When inventory records are inaccurate, additional purchases will oversupply the warehouse resulting in excess inventory and a lower annual turnover rate. This excess inventory increases annual carrying cost and increases the chance of product obsolescence.

Lower Productivity Levels
Warehouse productivity levels can be decreased substantially when pickers have to search for products instead of getting them from prime pick locations. When records are inaccurate, shortages occur. Therefore, inventory is not where warehouse-tracking systems think it should be.

Expending Orders
When inventory records are not accurate, product transit needs to be expedited so that sales are not missed. This process takes a considerable amount of time of purchasers, receivers, and supervisors to update records, order the product, and receive the product. These types of orders are also very expensive on both ends of the supply chain based on time and excess freight costs from expediting smaller orders.

Lost Sales
When inventory records are inaccurate, the promised stock for customers may not be available at all, or shortages in orders may occur. These customers will either have to wait for an order to come in or get the product from a competitor, resulting in lost sales and potential loss of accounts.

Two approaches: Periodic and Cycle
There are two approaches to maintaining inventory records: periodic physical inventory and cycle counting.

Periodic Physical Inventory
This is typically referred to as the annual physical inventory method. This approach is the counting of all SKU’s within a short time frame and is typically done once a year. It usually requires a large number of employees and cannot be done while the business is operating. Some problems with this approach are:

1. Inefficient use of employees; temporary help is usually required.
2. Errors cannot be tracked and fixed because of time constraints.
3. The operation typically must be shut down for a physical inventory to be taken.
4. There is little, if any, increase in record accuracy.
Cy[cle Counting

The cycle counting approach is a technique that segments inventory based on an ABC analysis and sets up a time schedule for when items should be counted throughout the year so that when the time frame of one year passes, all SKU’s have been counted at least one time per year, with the faster moving SKU’s being counted multiple times per year. This program uses people who are familiar with the warehouse, locations of SKU’s, and the activities surrounded by inventory management. It is also these employees’ responsibility to define inconsistencies in inventory record and troubleshoots the processes causing the errors. Cycle counting has the following benefits:

1. Few mistakes in item identification.
2. The ability to identify and correct record errors.
3. The operation does not have to be shut down during a cycle count.
4. Fewer, more experienced people are used to perform a cycle count.
5. There is a systematic improvement in the processes that dictate inaccurate records.

In order for a cycle counting process to be implemented, the first action to be taken is to assign a count frequency based on an inventory ABC analysis.

ABC Inventory Analysis

ABC analysis is a method of assigning and classifying SKU’s. For the cycle counting procedure, SKU’s are ranked from highest to lowest based on the annual sales volume at cost. The idea behind this ranking is based on the 80/20 rule, where 80% of the volume in the warehouse comes from only 20% of the SKU’s. Table B is an example of an ABC analysis. “A” items account for the top 80% of sales, while “B” items account for the next 15% of sales, and “C” items account for the last 5% of sales. Typically, more than half of the items are “c” items. Understanding this analysis shows that 80% of sales or volume comes from a very small percentage of items.

ABC Calculations

Putting together an ABC analysis is really quite simple as long as the date is in a format that can be manipulated on a computer. The requirements are SKU Numbers, Units On Hand, and Unit Sales for a 12-Month Period, and Last Cost per Unit. As long as this data is available, inventory on hand and annual sales can be follow these steps:

1. Calculate annual usage, in dollars, for each SKU
2. Rank (sort) the SKU’s descending order based on annual dollar usage
3. Assign ABC classifications based on the criteria described above
The following table B is an example of an ABC ranking and classification:

<table>
<thead>
<tr>
<th>Item Number</th>
<th>SKU Number</th>
<th>Cumulative Percent of Items</th>
<th>Item Unit Cost</th>
<th>Quantity On Hand</th>
<th>Inventory Dollars</th>
<th>Annual Unit Sales</th>
<th>Annual Sales Dollars</th>
<th>Percent of Total Sales</th>
<th>Cumulative Percent of Total Sales</th>
<th>ABC</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10950220</td>
<td>3.33%</td>
<td>$54.15</td>
<td>5,500</td>
<td>$297,825</td>
<td>$61,040</td>
<td>$3,305,316.00</td>
<td>29.16%</td>
<td>29.16%</td>
<td>A</td>
</tr>
<tr>
<td>2</td>
<td>10657000</td>
<td>6.57%</td>
<td>$13.50</td>
<td>10,625</td>
<td>$148,575</td>
<td>$130,060</td>
<td>$1,755,810.00</td>
<td>15.43%</td>
<td>44.65%</td>
<td>A</td>
</tr>
<tr>
<td>3</td>
<td>10217000</td>
<td>10.00%</td>
<td>$16.60</td>
<td>4,563</td>
<td>$75,746</td>
<td>$98,322</td>
<td>$1,652,145.20</td>
<td>14.40%</td>
<td>59.05%</td>
<td>A</td>
</tr>
<tr>
<td>4</td>
<td>10110200</td>
<td>13.33%</td>
<td>$16.60</td>
<td>4,563</td>
<td>$112,455</td>
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<td>$1,439,550.00</td>
<td>12.70%</td>
<td>71.75%</td>
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<td>11093000</td>
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<td>7,128</td>
<td>$139,930</td>
<td>$57,022</td>
<td>$1,071,443.38</td>
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<td>81.20%</td>
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<td>6</td>
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<td>$89.60</td>
<td>85</td>
<td>$76,296</td>
<td>$1,008</td>
<td>$904,780.80</td>
<td>7.08%</td>
<td>89.18%</td>
<td>B</td>
</tr>
<tr>
<td>7</td>
<td>10157000</td>
<td>23.33%</td>
<td>$205.70</td>
<td>206</td>
<td>$52,659</td>
<td>$2,450</td>
<td>$503,965.00</td>
<td>4.45%</td>
<td>93.63%</td>
<td>B</td>
</tr>
<tr>
<td>8</td>
<td>11069000</td>
<td>25.67%</td>
<td>$10.52</td>
<td>1,078</td>
<td>$11,341</td>
<td>$14,140</td>
<td>$148,752.80</td>
<td>1.31%</td>
<td>94.94%</td>
<td>B</td>
</tr>
<tr>
<td>9</td>
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<td>30.00%</td>
<td>$2.91</td>
<td>5,016</td>
<td>$11,587</td>
<td>$46,242</td>
<td>$106,919.02</td>
<td>0.94%</td>
<td>95.88%</td>
<td>C</td>
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<tr>
<td>10</td>
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<td>33.33%</td>
<td>$67.80</td>
<td>510</td>
<td>$34,578</td>
<td>$1,134</td>
<td>$76,885.20</td>
<td>0.68%</td>
<td>96.56%</td>
<td>C</td>
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<td>36.57%</td>
<td>$26.70</td>
<td>365</td>
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<td>97.24%</td>
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<td>$16.28</td>
<td>245</td>
<td>$3,089</td>
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<td>97.56%</td>
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<td>97.80%</td>
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<td>192</td>
<td>$3,609</td>
<td>$770</td>
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<td>0.14%</td>
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<td>50.00%</td>
<td>$3.60</td>
<td>310</td>
<td>$1,178</td>
<td>$4,116</td>
<td>$15,367.10</td>
<td>0.14%</td>
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</tr>
<tr>
<td>16</td>
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<td>53.33%</td>
<td>$85.00</td>
<td>19</td>
<td>$1,615</td>
<td>$182</td>
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<td>0.14%</td>
<td>98.21%</td>
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<tr>
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<td>$1.00</td>
<td>1,256</td>
<td>$1,265</td>
<td>$15,442</td>
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<td>52</td>
<td>$1,492</td>
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<td>19</td>
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<td>$2.27</td>
<td>450</td>
<td>$1,022</td>
<td>$6,678</td>
<td>$15,159.06</td>
<td>0.13%</td>
<td>98.61%</td>
<td>C</td>
</tr>
<tr>
<td>20</td>
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<td>$35.53</td>
<td>35</td>
<td>$1,244</td>
<td>$416</td>
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<td>0.13%</td>
<td>98.78%</td>
<td>C</td>
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<tr>
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<td>70.00%</td>
<td>$7.48</td>
<td>37</td>
<td>$1,387</td>
<td>$392</td>
<td>$14,089.16</td>
<td>0.13%</td>
<td>98.87%</td>
<td>C</td>
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<tr>
<td>22</td>
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<td>73.33%</td>
<td>$29.00</td>
<td>29</td>
<td>$8,41</td>
<td>$504</td>
<td>$14,616.00</td>
<td>0.13%</td>
<td>99.00%</td>
<td>C</td>
</tr>
<tr>
<td>23</td>
<td>10553000</td>
<td>76.57%</td>
<td>$40.06</td>
<td>29</td>
<td>$1,162</td>
<td>$364</td>
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<td>99.13%</td>
<td>C</td>
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<tr>
<td>24</td>
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<td>$20.73</td>
<td>55</td>
<td>$1,140</td>
<td>$700</td>
<td>$14,511.00</td>
<td>0.13%</td>
<td>99.26%</td>
<td>C</td>
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<td>$33.58</td>
<td>30</td>
<td>$1,007</td>
<td>$420</td>
<td>$14,103.60</td>
<td>0.12%</td>
<td>99.38%</td>
<td>C</td>
</tr>
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<td>26</td>
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<td>$111.45</td>
<td>15</td>
<td>$1,672</td>
<td>$126</td>
<td>$14,042.70</td>
<td>0.12%</td>
<td>99.51%</td>
<td>C</td>
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<td>27</td>
<td>11165000</td>
<td>90.00%</td>
<td>$20.41</td>
<td>86</td>
<td>$1,750</td>
<td>$686</td>
<td>$14,001.26</td>
<td>0.12%</td>
<td>99.63%</td>
<td>C</td>
</tr>
<tr>
<td>28</td>
<td>10433000</td>
<td>93.33%</td>
<td>$45.25</td>
<td>22</td>
<td>$996</td>
<td>$308</td>
<td>$13,937.00</td>
<td>0.12%</td>
<td>99.76%</td>
<td>C</td>
</tr>
<tr>
<td>29</td>
<td>10193000</td>
<td>96.57%</td>
<td>$39.69</td>
<td>20</td>
<td>$794</td>
<td>$350</td>
<td>$13,891.50</td>
<td>0.12%</td>
<td>99.88%</td>
<td>C</td>
</tr>
<tr>
<td>30</td>
<td>10757000</td>
<td>100.00%</td>
<td>$39.40</td>
<td>150</td>
<td>$5,310</td>
<td>$392</td>
<td>$13,875.80</td>
<td>0.12%</td>
<td>100.00%</td>
<td>C</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>100.00%</td>
<td>$40,847</td>
<td>$1,007,652</td>
<td>$451,218</td>
<td>$11,355,086.93</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Extension of the ABC Analysis
The ABC analysis can be taken one step further to designate items with $0 or less sales with a “D.” These are items that neither have nor moved in a year’s time, and inventory managers should give consideration as to whether these items should be stocked, or what can be done to get rid of them.

Count Frequency
The true goal of implementing a cycle counting procedure is to gain better control over the inventory. Through the identification of the select few items that really count toward the majority of annual volume, it is easy to see that these items are the ones that needs to have the fewest possible errors in inventory records so that when orders are received for these items, there is always enough on hand to completely fill an order. The real driver to counting frequency is to subject the “A” items to more counts than the “B” items, with the “C” items to be counted the least frequently of all. Here is an example of how to calculate the frequency of counts:

- There are 2,000 “A” items that must be counted 4 times each per year, resulting in 8,000 counts per year.
- There are 3,000 “B” items that must be counted 3 times each per year, resulting in 9,000 counts per year.
- There are 5,000 “C” items that must be counted 2 times each per year, resulting in 10,000 counts per year.
- There are 400 “D” items that must be counted 1 time each per year, resulting in 400 counts per year.

Therefore, there are a total of 27,400 counts to be made each year, or (27,400/260) = 105 per day. Most experienced cycle counters can count 100 – 130 items per hour. The cycle counter must have sufficient time to be able to examine the variances in actual count versus the records to be able to pinpoint problems.

Implementing a Cycle Count Process
The best way to start a cycle counting process is to begin with a small number, or sample, of SKU’s that can be monitored for results (Control Group). After selecting the sample, perform cycle counts frequently to allow counters to become familiar with the process. When discrepancies are identified, have the counters identify the root causes and rectify the problem area. As accuracy increases, and employees become more familiar and productive with this process, expand the sample until the entire inventory is included in the process.
Accuracy
A tolerance level for each ABC classification should be defined. These tolerances should be based on the expected inventory accuracy levels. An example would be to allow a 1% tolerance level for “A” items, a 2-5% tolerance level for “B” items and a 5-10% tolerance level for “C” items. The larger the tolerance allowed, the lower the overall inventory accuracy achieved.

When to Count
It is best to perform a cycle count prior to any days inventory transactions, at the end the days inventory transactions (inventory freeze) or real-time based on scanner gun technology:

Causes of inventory Accuracy Errors
The real issues that cycle counting discover are errors, the causes of inaccurate records, and the elimination of systematic processes in materials movement and transactions. Finding errors during a cycle count identifies the process, so repairing the errors for a single item has a cascading effect on all SKU’s. Here are some causes of inventory errors that a good cycle counting procedure can discover:

1. Poor training of people in materials movement
2. Bad units of measurement
3. Theft
4. Obsolescence
5. Poor security
6. Item identification
7. Adequate storage space
8. Locator system problems
9. Timely reporting of transactions

Summary
An effective cycle counting program has many benefits. Properly implementing a program can have a positive effect on the entire organization through uncovering process errors and inefficiencies, increasing inventory accuracy, and improving productivity. The customers also benefit because of increased record accuracy and items being in stock when they are ordered.
Example Cycle Count Procedure

Cycle count
All businesses where manufacturing and/or warehousing activities take place, will implement and maintain a perpetual inventory record process in order to accurately report inventory valuation at any point in time. This perpetual inventory system uses transactions to adjust on-hand balances to coincide with physical activities that are occurring. The gap between the action and transaction is minimized by posting transactions to the financial or operating inventory system as they occur. Cycle counting shall be performed in order to measure the accuracy of the perpetual inventory systems and processes. Below is the recommended process.

Inventory Systems of Record (Example Operating Systems)
1. MS Dynamics Navision
2. Epicor
3. MAS 200
4. SAP
5. Oracle
6. Local Operating System (approved by Finance)

Inventory Profile
ABC analysis will be used to determine:

1. How often to count
2. Rules for recounts
3. Determining Item Count Accuracy measure

An ABC analysis of all items (cost x annual usage) will be conducted at the beginning of each quarter.

1. A = 70% Cost
2. B = 20% Cost
3. C = 10% Cost

***The item record will be updated with the correct designation.

***When an item is designated an A, B, or C, it must be labeled by that profile in all Warehouses within that operating system.

The accepted rule for how often items will be counted is:

1. A items = 4 times per year
2. B items = 2 times per year
3. C items = 1 time per year

***The Item record will be updated with correct designation.
**Counting**

A report – Cycle Count Record, will be generated daily from the operating system (manual method used where no system exists) listing all items separated in A, B, or C categories with the last day counted for each item. The prescribed number of counts for A, B, and C items will be selected and transferred to the count sheet.

When an item is selected for the daily count it will be counted in all parent and child warehouses physically at that location. Every effort will be made to store all of one item in a single location (one to one vs. one to many). Unused locations will be purged from the item’s location list.

Two methods will be employed to ensure all items are counted:

1. ABC counting emphasizing A and B items and capturing any uncounted C items
2. Bin or Row counting emphasizing C items and capturing items in the undocumented locations.
3. Weighing of high volume items is authorized & preferred for counting

**ABC Counting**

Count Sheets will be generated by the operating system or the manual method of transferring data from the system. Blind Count Method will be utilized (counter will have no knowledge of system on the count sheet). Count sheets will consist of the following data:

1. Item Number
2. ABC Code
3. Unit Cost
4. Bin Locations
5. Signature Block for Counter
6. Date of Count
7. Warehouse Location #

Count sheets will be distributed by cycle count leader and counts performed at each identified location. Upon count completion count sheets must be signed and dated. The count sheets must be tallied and entered into the system by the cycle count leader. It is critical that the counts be tallied and entered into the system by someone other than a cycle counter. This is needed to maintain the integrity of the process. System reconciliation must be performed on the count accuracy by comparing actual count to the system of record quantity on hand. If the reconciliation is a match, the count will be accepted. If the reconciliation yields a mismatch, then recount according to the following:

1. A items = Automatic recount
2. B items = Automatic recount
3. C items = Recount if error >5% on item count

When recounting focus on the following:

a) Counting errors
b) Similar part numbers
c) Other WH locations  
d) Many to one locations

After the count reenter the follow-up count and accept the results of the recount.

**Bin Counting**

Bin Counting will proceed in the same manner, after the initial selection of items to be counted. For bin counting the bin is selected by the cycle count leader. The count sheet is generated from a list of items in that bin.

**Reconciliation**

1. After the recount is confirmed  
2. Check inventory transaction history report  
3. Look for obvious errors  
4. Look for transaction lag time  
5. Perform necessary inventory transaction identified by counts

**Inventory Adjustments**

Whenever inventory is counted and found to be out of sync with the operational system tally, the inventory must be adjusted to the actual count. This is accomplished with a variance report and inventory adjustment. The Delegate of Authority (DOA) must be adhered to prior to making the transactional system adjustments. Records of the DOA sign acknowledgment must be maintained locally or electronically for audit purposes.

**Measurement**

The three main measures of each inventory counting event are:

1. Net Variance  
2. Absolute Variance  
3. Items Count Accuracy

These calculations are logged at the end of each count event to establish monthly and annual rates in the Cycle Count Outcomes Log. This log is the data for the control range chart.

Additional reports may be formulated to report results by cause of variance or ABC accuracy as deemed necessary for process improvement.

**Variances**

Variances outside of the process control range will trigger immediate remedial action. The control range for variances is:

1. Absolute value($) of variance – Target = less than 2%, Range = +/- 2%  
2. Net value($) of variance – Target = less than .5%, Range = +/- .5%  
3. Item count(#) Accuracy – Target = 97%, Range = +/- 3%
The variance report is presented to the inventory manager along with supporting material for authorization according to the DOA. The count is entered to update the system. A summary report (Cycle Count Daily Metric) of the cycle activity is recorded and presented along with the variance. This is used to determine if the process is in the Control Range.

**Remediation**

**Remedial Control Lot Counting**
When the cycle count metrics fall out of the control range, the facility reverts to Control Group Counting to identify and correct process issues. This is necessary to avoid the practice of offsetting variances from count to count. When the measurements again fall within the control range, regular cycle counting is commenced. The number of counts needed in each cycle is adjusted for the remaining count days in the year.

**Control Group Counting:**

1. Select control group
   a) Small number of parts
   b) Represents overall inventory
2. Count the control group repeatedly
3. Identify process issues
4. Correct process issues
5. Expand to other items
6. Continue to resolve process issues

***It is crucial that root cause be determined on Control Group Transactions that have failed.***

At any point that the Operations/Finance team deem the inventory cycle count process has failed, an end of period physical inventory must be performed. The operations cycle count team must be retrained on this procedure.

**Internal Audit**
The controllers will establish audit procedures to assure the integrity of the count processes and results.