



## Inventory Losses – When to Hire a Forensic Accountant

by Chris Hamilton, CPA, CFE, CVA, DABFA

Inventory losses never seem to strike at an opportune time. Whether from water damage, theft, obsolete merchandise or other unpredictable damages, these situations can cause a significant financial impact upon a business, as well as untold customer relationship headaches. As such, it is imperative for both the insurer and the insured to quickly involve a forensic accountant to assess the damages and develop estimates of the loss.

### Types of inventory losses

As one of the most important and constantly changing current assets, inventory is a critical component for many business types. This can lead to all types of illegal practices, so virtually any insurance claim for inventory losses is a red flag for insurance investigators.

Here are some of the most common inventory loss situations:

- **Theft** - Employee theft can take many forms, from physically taking items of relatively small face value to embezzlement, fraud and theft of information. When such costly crimes are detected, litigation may be necessary for recovery of losses. Forensic accountants can be brought in to quantify the monetary loss or damages and to identify the thief or thieves. *Arxis Financial* utilizes various investigative and analytical procedures to support criminal or civil actions against an individual(s), form a basis for termination of a dishonest employee, and provide evidence for insurance claims.
- **Fire or Water** – Fire and water damage is a relatively common class of inventory loss. Investigators will apply valuation and forensic accounting techniques to determine the value of the destroyed or damaged inventory, as well as unsold inventory. Of course, the insurance company will also employ the use of criminal investigators as necessary if intentional damage is suspected.
- **Financial manipulation** – Managers and supervisors will sometimes alter inventory records to cover theft or to improve their performance ratings so that they can receive higher bonuses. Forensic investigators can utilize a number of techniques to uncover these fraudulent practices, such as uncovering accounting aberrations that infer a higher than warranted loss amount. Of course, forensic accounting techniques for valuing inventory losses are impacted by the quality and availability of records maintained by management.
- **Loss of future earnings** - The loss of inventory is only one aspect of the profit chain. A company can sometimes inflate the impact of a loss event on its profitability, or in some cases, undervalue it if it fails to include key factors in its estimates. As such, typically the engagement of a forensic accountant also involves calculating loss of future earnings.
- **Insurance fraud** - Insurers often engage forensic accountants to confirm and measure inventory loss claims. For example, since obsolete inventory can be a fraction of the original value, it encourages unethical management practices. Some companies overstate inventory by maintaining obsolete inventory on their balance sheets at full value, instead of writing it down. If this escapes auditors, through various deceptive means, a later insurance claim event (such as a disaster) can be used to recognize the overstated value of the inventory. A forensic investigator can look for industry standards and internal procedures that are used to identify obsolete inventory, which among other techniques, can help to uncover the fraudulent practices.



### **Recent losses**

In the case of recent inventory losses, typically a forensic accountant will research the industry and type of inventory, and then assist in an on-site count. In some circumstances, others will conduct the count, and then the forensic accountant will statistically sample items to verify the work. Of course, if the inventory has been partially or completely destroyed, financial and other records are largely relied upon to develop a valuation. These can include prior physical inventory records, inventory transactions (e.g., purchases, work-in-progress reports, sales records, etc.) up to the date of loss, projecting as accurately as possible the inventory value at time of the loss. A skilled forensic accountant utilizes a combination of knowledge, experience and investigative accounting skills to determine value.

There are numerous facets that impact how inventory losses will be valued. In the case of disasters (such as floods, rain damage or fire), inventory may be heavily damaged and unusable. In such cases, the forensic investigation will assess the damaged inventory, replacement costs, obsolete inventory, and sales documentation to develop a loss estimate. One of the key valuation factors is to determined value for slow-turnover or obsolete inventory, which can be a point of contention. Another difficult situation is valuing materials that are work-in-progress and the value-added at each stage in production to the original "raw" inventory value.

### **What about analysis after-the-fact?**

Sometimes inventory losses are questioned by insurance adjusters but it has been a substantial time since the physical inventory was reported or the loss occurred. Generally accepted accounting principles (GAAP) include various write-offs of assets to the income account. Forensic accountants look beyond the face value of the reported financial statements to determine if fraud has taken place.

From an accounting perspective, there is a distinction between normal and abnormal, ordinary and extraordinary, recurring and nonrecurring business conditions. Forensic accountants are trained to spot factors such as manipulated practices that impact earnings, which may be done in cases such as insurance fraud. The method of accounting for inventory losses, in and of itself, can be an indication of whether inventory fraud took place by management.

### **Experts Can Make or Break Your Case**

As noted above, accurate and relevant estimates of damages are based on reliable historical accounting information. Additionally, the use of an experienced forensic accountant and valuation expert is required to properly use the historical information as a basis to value the damages caused by the inventory loss. **Arxis Financial, Inc.** has significant expertise in forensic accounting services for inventory losses. Please contact us with your questions.

### **About the author:**

*Chris Hamilton is a partner with the CPA firm of Arxis Financial, Inc., in Simi Valley. He is a member of the California Society of Certified Public Accountants (Litigation Services Committee), and the American Institute of Certified Public Accountants. Mr. Hamilton is a Certified Public Accountant, a Certified Fraud Examiner, a Certified Valuation Analyst, and a Diplomat of the American Board of Forensic Accounting. He can be reached at ph. 805-306-7890 or [chamilton@arxisgroup.com](mailto:chamilton@arxisgroup.com).*