Inventory Fraud: Detecting, Preventing & Prosecuting

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Fraud against a business includes the theft of physical assets including cash (particularly in a retail setting) or inventory. The theft of inventory is typically perpetrated by an employee and can be discovered rather quickly in an environment where there are strong internal controls.

There are essentially two types of inventory fraud: actual physical loss and financial statement fraud.

Employee Theft

Theft by employees results in an actual loss of inventory. This is rather common in a retail setting, in which an employee steals business inventory for personal use, such as consumer goods that are small and easy to hide. Some employees also steal inventory for resale, which can happen any number of ways, from receiving clerks to night-crew stockers.

Signs that employees may be stealing inventory include:

- Missing documents (packing slips, shipping receipts, etc.)
- Employees living above their means
- Complaints by employees or customers that personal effects are being lost or stolen
- Unhappy employees who feel they deserve more in either salary or benefits
- Employees who refuse to go on vacation for fear of their substitute catching the theft
- Excessive loitering by off duty employees, ex-employees or friends
- Frequent shortcuts in security procedures in order to hasten deliveries
- Bringing baggage to/from work
- Signing another employee's name or signing illegibly on inventory documents
- Frequent cash shortages or overages on the same employee's shift
- Unusually high number of "no sale" transactions

Companies take various measures to detect and catch inventory theft by employees, including video surveillance, random audits, cash control, employee rewards for reporting theft, employee background checks, secret shoppers, and trash control.

Financial Fraud

Inventory fraud can be committed through financial statement manipulation. This includes timing schemes, expenses recorded as inventory, and valuation schemes. This type of fraud is usually implemented by senior management and is motivated by the need to attain some financial goal or benchmark.

Inventory overstatement is the most common type of inventory related fraud. Management may be motivated to report high earnings to either satisfy stockholders, achieve compensation targets, or maintain bank lending covenants. One way to inflate income is to overstate inventory. This was the type of fraud in some of the most famous and significant public company frauds in recent history. Cost of Goods sold is calculated by subtracting the increase in inventory from purchases. Therefore, overstating ending inventory (increase in inventory) understates cost of goods sold and has the effect of reporting higher profit.

Alternatively, management is sometimes motivated to report lower profit in order to limit the amount of taxes. This is particularly prevalent in small closely-held businesses. In this case, understating inventory accomplishes the overstatement of cost of goods sold and, as a result, net income.

Warning Signs
It is not unusual to find that a business is the victim of both types of fraud (theft and financial statement fraud) simultaneously since the occurrence of either indicates lax internal controls.

Whether inventory is being stolen or the financial statements are being manipulated for some reason, there are several warning signs that indicate that there may be a problem. These include:

- The inventory asset value does not change for several periods, or the change is minimal
- The gross profit percentage never changes from period to period
- Inventory values are increasing at a faster rate than sales
- Dramatic changes to the inventory turnover ratios
- Shipping costs as a percentage of inventory changing dramatically
- Low inventory valuation even though the warehouse is full of inventory
- High inventory valuation even when the warehouse is empty
- Shipping invoices that cannot be traced to purchases or sales
- Standard costs per unit vary widely from actual costs per unit for an extended period of time
- Inventory counts vary widely from quantities recorded in the perpetual inventory system
- Shipping invoices with strange or unauthorized delivery addresses

Note that there can be reasonable explanations for these but such evidence should be reviewed objectively and analytically. Additional information may be needed to arrive at a conclusion.

Prevention
Some simple steps can be taken to safeguard physical inventory and prevent financial statement fraud:

- All shipping invoices should be physically attached to either purchase invoices (freight in) or sales invoices (freight out). Shipping invoices that cannot be traced to either may indicate that inventory is being shipped to an authorized person or business.
- A surprise inventory count should be performed at infrequent intervals to test the accuracy of the perpetual accounting system. This step would also set an expectation among employees that someone is checking the numbers.
- Shipping and receiving duties should be separated from those who have the responsibility to issue invoices or pay bills if at all possible. This separation of function will serve to enhance the paperwork controls that require all shipping invoices to be matched up with either a sales invoice or a purchase invoice.
- Write-offs for obsolescent or spoiled goods should be examined for validity.
- Financial statements can be analyzed to compare prior and current periods and to review changes in inventory ratios over time. Industry norms can be compared to your company's figures. Variances from expectations should be investigated and explained.

Litigation Implications

Inventory fraud occurs in companies of all sizes, from small distributors or retailers to major Fortune 500 companies. A noted case in the last few years involved two former executives of the Bristol-Myers Squibb Company who were accused of conspiracy and securities fraud charges related to a wholesale inventory manipulation that artificially inflated company revenues by millions of dollars. The executives misled investors by concealing the excess inventory held, a result of an aggressive program of rebates and discounts offered by the company to meet its sales targets. Bristol-Myers Squid paid over $800 million to shareholders and others financially harmed by the manipulation.

When inventory fraud occurs, recovery of any financial loss can result in litigation. As mentioned a public company can be sued by shareholders. The individual perpetrators can be sued or an insurance carrier might be sued if they questions the validity of the loss or refuse appropriate compensation.

In such cases, **Arxis Financial's** "Litigation Consulting" practice is available to assist in determining the extent of monetary loss or damages and to help uncover how the loss occurred. Our professionals utilize various investigative and analytical procedures to support criminal or civil actions against an individual(s) or provide evidence for insurance claims. We assist attorneys in interpreting the data and help counsel to understand and analyze events or issues as they develop the case and prepare discovery.

<u>**About the author:**</u>

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