



Is Your Inventory Walking Out the Door?

United States companies lose an average of 6 percent of their total revenue to fraud by their own employees — a form of theft that costs \$400 billion every year, far more than armed robbery.

The usual suspects — aren't. Stereotypes notwithstanding, the typical perpetrator is a college-educated white male. And while rank-and-file employee fraud involves more people, losses from managerial fraud are four times higher, and those from executive fraud are 16 times higher.

Employees who commit fraud rationalize the crime in several ways: *It's only fair. Everybody else does it. No one will know. I'll repay it eventually.*

Some schemes are planned long in advance, by trusted employees whose position has acquainted them with a company's operations or brought them close to its suppliers and other key partners. Others arise *ad hoc*, aimed at low-hanging fruit made tempting by a company's own lax oversight.

Poor screening of new hires, failure to document disciplinary actions, inconsistent personnel policies, neglecting to inform employees about internal controls — these are all invitations to fraud. And internal controls, if they are insufficient or easily neutralized — or sometimes even *too* consistent — aren't much help.

The Caper Unfolds in Stages

Fraud schemes often begin with an intentional “accident” or anonymous small-scale theft. These are simply tests, designed to illuminate the terrain and provoke a company’s response for evaluation by the fraud planner. Then the plan develops, most often targeting one of the following areas:

- *Accounts Payable* can deliver kited or forged checks, kickbacks, rigged bids, transfers to fictitious payees and even paychecks to ghost employees.
- *Accounts Receivable* can permit lapping — the ongoing replacement of stolen receipts with subsequent thefts.
- *Expense accounts* can hide inflated — or invented — costs for travel, entertainment, supplies or seminars.
- *Inventory* is vulnerable to direct theft, diversion, overstatement, understatement, quality substitution, false weights and measures, short shipments or false valuation.

After the crime, a means of escape may be needed — depending on the chances of detection. If discovery is unlikely, perpetrators lie low; otherwise, they resign before the game is up.

Inventory Fraud by Rank-and-File Employees . . .

Production processes that involve complex accounting systems, numerous employees and large volumes of product make inventory fraud particularly difficult to detect and prevent. The most attractive inventory is either small and portable, very valuable, or easy to sell.

Common inventory fraud by employees includes direct theft, good inventory scrapped and sold, sales refund schemes, unauthorized outbound shipments and manipulation to conceal other frauds.

. . . And by Management

In manufacturing and retail, the largest expense for most firms is usually cost of goods sold. A dishonest manager may try to inflate inventory in order to misrepresent operational performance and earnings.

To do so, managers must manipulate either physical quantities or the values associated with them. And the means of doing so — empty boxes in a warehouse, bricks packaged as computer parts, tags altered after a count.

multiple counts of the same items, rigged barter transactions and bulk sales — are limited only by imagination. But understatement of inventory can serve a purpose, too. Minimizing stock-on-hand can be attractive to business owners who want to evade taxes or minimize their assets in anticipation of penalties arising from business or personal legal proceedings.

Detecting Inventory Fraud

The basic tools for uncovering inventory fraud are tests for quantities, compilation and valuation.

- *Testing quantities by physical count.* In normal times a company may employ various means to validate its inventory, including cycle counts or continuous updates, but a fraud investigation often requires a full physical count.

In these circumstances the company should consider contracting out inventory services — a CPA firm like ours can organize a count efficiently, accurately, with a minimum of notice and with its own count team (which, of course, won't include the fraud perpetrators).

In any case, investigators must carefully guard the integrity of the count — performing it outside the view of employees, if possible, and with strict controls over count sheets and tags, used or unused. The counters should examine inventory contents, with tests for purity and grade if appropriate — a lesson that creditors in one bankruptcy learned a bit late, when they discovered an oil tank filled 90 percent with water, a meager layer of fuel floating on top. And the counters should inspect records for goods received and shipped near the date of the inventory to see if they were properly included.

- *Testing inventory compilation.* Opportunities for manipulation arise between the counting and pricing of inventory, particularly when counts of the same items at various locations are aggregated into one list. An effective investigation requires inspection not just of the final list, but of every iteration that preceded it.

- *Testing inventory valuation.* Investigators should confirm that vendor invoices support the stated value of inventory on hand. If a company uses dollar-value, last-in first-out (LIFO) accounting, investigators should be alert to the manipulation of LIFO pools to inflate ending inventory. In an average-cost system, slow-moving items deserve particular scrutiny, which may require purchase and sales documents from several years.

Improperly valued items demand an explanation. Investigators should learn why they exist — and not be deterred by evasive responses or complex pricing formulas.

Next Steps

A manufacturing company, whose core business isn't policing or investigating, may need help when it faces the costly and complex challenges of inventory fraud. Fortunately, such help is readily available — from consultants and specialists like those at our firm, who are trained in company-wide risk assessment, computerized models for detecting suspicious patterns, physical inventory counts and financial statement analysis.

If you'd like suggestions or references for getting started in these areas, our firm can provide them. Please give us a call for assistance.

Some early warning signs of inventory fraud include:

- Unexpected shortages or fluctuations in inventory accounts
- Large adjustments to counts after a physical inventory
- Significant increases in cost of goods sold
- Significant decreases in gross margins
- Unusual or late journal entries

Objective analysis can expose these symptoms. Three ratios in particular — age of inventory, gross profit margins and inventory turnover — are revealing and should be calculated in detail regularly and in different quarters. However, these symptoms don't *necessarily* indicate fraud, because inventory is an area that's particularly susceptible to faulty record-keeping.