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Official Journal of the Ontario Insurance Adjusters Association

Vol. 71 • No. 2 • October 2006

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# A Forensic Accountant's Perspective on Inventory Losses: Why a Proper Post-Loss Inventory Count Is Critical

*By John-Paul Strasler, CA•IFA, Insignia Forensic Group Inc.*

*John-Paul Strasler*

It's Monday afternoon, and the forensic accountant receives a call from the adjuster:

*Adjuster*: Hi. I just received a claim for inventory that was stolen over the weekend. The company is a tobacco wholesaler, and they think they've lost about $250,000 of product.

*Forensic Accountant*: Have they counted the inventory remaining after the theft?

*Adjuster*: I think so, but not everything. The insured said they received a supplier shipment today and are trying to fill customer orders. Can you contact them and get out there as soon as possible?

*Forensic Accountant*: Sure.

And so begins another assignment.

Inventory losses can take many different forms. The inventory may be damaged, for instance by fire or water, and still be on hand, or it may have been stolen, or totally destroyed by the insured peril. The inventory may consist entirely of goods purchased in their finished state or, if the insured is a manufacturer, of raw materials, inventory in process and finished goods. In addition, the loss may relate to all or only a portion of the inventory.

In cases where the loss relates to damaged inventory that is still on hand, the inventory items can generally be easily identified, and the focus turns to valuing the loss pursuant to the policy wording. In scenarios like the one described above, however, the inventory lost obviously cannot be inspected. Accordingly, an analysis is required in order to corroborate the stolen inventory, with an essential compo-

nent of the analysis being the inventory remaining after the theft, as explained below.

The following are some key points that adjusters should keep in mind when handling inventory losses.

**Has an Inventory Count Been Performed?**

This is one of the first questions you should be asking insureds, and one that you can expect to be asked when retaining the services of a forensic accountant. If there is only one thing that you take away from this article, it should be the importance of a proper post-loss inventory count in order to verify the amount claimed. If the insured has not already performed a count, then one should be arranged as soon as possible after the loss is reported.

Validating a claim for stolen inventory requires the preparation of an inventory roll-forward in order to estimate the inventory theoretically on hand at the time of the loss. The starting point for a roll-forward is the opening inventory balance, usually at the date of the last full inventory count. Inventory purchases (net of returns to suppliers) are added, and goods sold (net of customer returns) are subtracted. Other reductions in the physical inventory due to shrinkage (normal shortages that arise when inventory is counted), perishable and/or damaged goods that have been discarded, etc., also need to be subtracted in the roll-forward calculation. This yields the inventory theoretically on hand at the time of the loss.

*If there is only one thing that you take away from this article, it should be the importance of a proper post-loss inventory count in order to verify the amount claimed. If the insured has not already performed a count, then one should be arranged as soon as possible after the loss is reported.*

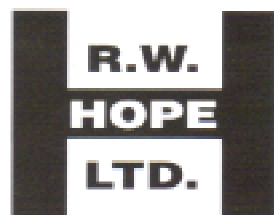
From this balance, the inventory remaining after the loss is then subtracted, with the difference representing the estimated inventory loss, which should equal or approximate the amount being claimed. Accordingly, without reliable information on the inventory remaining after the theft, the loss cannot be corroborated.

It should be noted that insureds will sometimes provide a listing of the stolen inventory, supported only by supplier invoices showing the purchase of the goods. As can been seen in the roll-forward calculation above, inventory purchases are but one part of the calculation and, on their own, do not corroborate the loss.

**Was the Inventory Count Performed Properly?**

It is important that the count be performed using appropriate procedures and that the results be independently verified. Otherwise, the count may not be accurate, and will therefore be of questionable reliability for both the adjuster and any forensic accountant who is brought in after the fact to investigate and opine as to the quantum of the loss.

In most cases, the insured performs some type of inventory count in order to determine what was lost. It may be a count of the entire remaining inventory or only of the particular inventory categories that appear to have been affected. In order to assess whether a proper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inventory count was performed, the following factors should be considered:

*Was the count adequately documented?*

Ensure that you request legible copies of the count documentation prepared by the insured, and instruct the insured to safeguard the original paper work. Do this immediately, as it sometimes happens that these records are not retained or are misplaced and can not be located.

These documents, however, will be of limited use if the descriptions of the goods counted by the insured do not contain enough details to tie back into the business's accounting records. For example, if the claim is for stolen clothing, a description of "25 leather coats" is not very useful if the business carries many different styles that range significantly in cost. If the insured is performing the count, the insured should be advised that complete details must be recorded, including the product code, product description, selling price, age and condition of each item.

*What procedures were followed?*

Ask what procedures were in place to ensure that all of the goods were counted and that the quantities and other details recorded are accurate. Finding out how often inventory is counted in the normal course of business, whether the process is documented and what level of experience the staff involved have will provide an indication of how reliable the count is. For example, are pre-numbered tags affixed to inventory items, and

*"I make big batches and freeze it."*

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is a check done after the count is finished to ensure all inventory is tagged and all tags are accounted for? Are there multiple count teams that cross-check each other's work to ensure that the product descriptions, quantities, etc., are correct?

Inquire as to whether any inventory was received or shipped while the count was being performed, and if so, how it was controlled (e.g., segregated) and documented. This is vital, since the ending inventory balance, per the roll-forward calculation, which is based on the insured's accounting records, must be at the same point in time (cut-off date) as the inventory count. Otherwise, not all of the difference between the two balances will be as a result of the inventory stolen.

*The adjuster, forensic accountant or other independent expert should supervise the count to ensure that it is conducted properly, monitor any inventory receipts or shipments and perform test counts, so that the results can be relied upon.*

*Does the business have inventory at any other locations?*

Depending on the nature of the business and type of inventory, inventory may be stored in a trailer, an off-site warehouse or storage facility, the owner's vehicle or garage, etc. If this is the case, this inventory must also be identified and counted after the loss, as it forms part of the remaining inventory that is deducted in the roll-forward calculation.

In addition, any inventory in transit or on consignment (from or to suppliers and customers) needs to be identified and considered.

*Does the business buy from or sell to related businesses?*

If so, the accounting records and inventories of the related parties will likely need to be inspected as part of the process of verifying the inventory purchases and sales of the insured business and the inventory remaining after the loss. In situations where inventory transactions with related parties are significant, failing to identify this at the earliest stage of a claim can impact the forensic accountant's ability to corroborate the claim with objective documentary evidence.

*When was the count performed?*

Ideally, the count should be performed as soon as the loss is discovered. By so doing, an accurate figure for the inventory remaining after the loss can be ascertained, prior to post-loss purchases, sales, etc. In addition, since the roll-forward calculation needs to be performed to the date of the count, delaying the count extends the roll-forward period.

*Was the count independently verified?*

The adjuster, forensic accountant or other independent expert should supervise the count to ensure that it is conducted properly, monitor any inventory receipts or shipments and perform test counts, so that the results can be relied upon.

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If this does not occur, then the test counts should be performed as soon as possible after the insured's count. The test count quantities will then have to be rolled back to the date of the insured's count, by accounting for all purchases, sales, etc., during the intervening period. This is generally appropriate where inquiry and a review of the documents indicate that the count appears to have been performed properly and not a lot of time has elapsed since the count. The alternative is to redo the inventory count in full and bring the roll-forward calculation up to that point in time.

If neither of these occurs, then the insured's count will need to be accepted, unless, of course, other analysis contradicts this.

### How Does the Business Keep Track of Inventory?

Many businesses use what is called a perpetual inventory system, which tracks the activity for each specific product such that at any point in time, the quantities reported by the system should equal those physically on hand. If this is the case, request a printout of the inventory at the time of the loss, which can then be compared to the results of the inventory roll-forward calculation discussed above. Be aware that some perpetual systems do not provide historical information, so the printout should be requested at the first opportunity.

Also keep in mind that there is usually a normal error rate in the perpetual records, which may be significant, depending upon factors such as the type of inventory, number of different product types, volume of transactions, existence and

effectiveness of internal controls and normal inventory shrinkage. These errors are corrected when the business performs a physical inventory count. Therefore, if relying on perpetual records, it is important to find out when the inventory was last counted and the normal level of adjustments that are made, in order to assess the potential error in the perpetual records being used.

**Conclusion**

While some inventory claims are relatively straightforward, others can be quite complex. The intent of this article is to explain the importance of a proper post-loss inventory count in verifying a claim for lost inventory. By asking the right questions and taking the right steps, you can obtain the information needed to properly evaluate the loss in an expeditious manner, thereby facilitating the claims process and allowing the claim to be paid with confidence.

*John-Paul Strasler, CA•IFA, is the principal of Insignia Forensic Group Inc. and has specialized in insurance claims quantification and forensic accounting for over 11 years. He is designated by the Canadian Institute of Chartered Accountants as a specialist in investigative and forensic accounting.*

*If you have any questions on this article, or to request an Inventory Loss Checklist for Adjusters, please contact John-Paul Strasler at 416.626.9688 or jpstrasler@ExpertClaimsAnalysis.com.*

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