For those in the accounting industry, “accounting fraud” tends to conjure images of money-hungry employees siphoning off cash to buy luxury cars or trips to Europe. While embezzlement makes for attention-grabbing headlines, the real threat to companies’ bottom line may be far more damaging, hard to detect and often committed for corporate rather than personal gain: inventory valuation fraud.

Perhaps the most famous example of inventory valuation fraud is the Great Salad Oil Swindle of 1962 that nearly crippled the New York Stock Exchange. The story goes that a New Jersey-based wholesaler and commodities trader, Tino De Angelis, realized an opportunity to corner the soybean oil market through soybean futures contracts and loans on overvalued inventory obtained by diluting soybean oil with water. Ultimately, the scandal caused over $1.1 billion (in today’s dollars) in financial losses to the companies involved, including American Express, Bank of America and Bank Leumi.

As this case illustrates, inventory valuation fraud may have a crippling effect on a company. Unfortunately, many companies are ill-prepared to spot the signs of

Why inventory valuation fraud goes undetected, what motivates employees to commit this fraud, the most common methods and what companies can do to mitigate their risk.

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inventory valuation fraud. This article will explain why inventory valuation fraud goes undetected, what motivates employees to commit this fraud, the most common methods and what companies can do to mitigate their risk.

Going Undetected

While embezzlement can be committed by nearly any employee, inventory valuation fraud is more complicated and requires direct access to a company’s accounting functions. Also, the valuation of inventory often demands several assumptions, which leaves room for interpretation and manipulation.

Changing one assumption or inflating one component of the calculation of finished goods can make a significant impact on a company’s financial statements. Increasing the value of inventory is, in some way, going to increase net income, since the adjustment (credit) will likely either report an increase to revenue or a decrease to expense.

Given the number of variables and assumptions used in inventory valuation, it is not surprising that inappropriate inventory valuation is more difficult to detect. It is far more difficult to identify inventory being carried at an inaccurate value than it is to detect that it does not exist.

What Motivates Valuation Fraud?

There are countless reasons why employees might commit valuation fraud, but personal financial gain is not chief among them. Certainly, personal gain can be a side effect of valuation fraud, as in the case of performance bonuses tied to meeting projections or benchmarks – but typically motivations are grounded in corporate gains.

When people steal inventory, it is because the inventory holds some intrinsic value. The motivations for valuation fraud are usually tied to corporate gain, e.g., meeting internal benchmarks, projecting financial stability ahead of a major transaction, meeting bank covenants or, as in the case of Salad Oil, to secure lending.

**Pressure to meet projections** should be of concern to publicly-traded companies, where earnings projections are a key factor in the value of company stock. For private companies, it could be as simple as trying to achieve a certain net income number for bonus and profit sharing contributions to be paid.

**Bank covenants** often contain financial agreements requiring minimum net income, minimum tangible net worth and debt service coverage. Journal entries to increase the value of inventory, and in turn net income, is one way to meet a covenant. A failure to meet bank covenants could be as simple as obtaining a bank waiver. However, the bank may conclude the loans are too risky and call the debt in full, which could have consequences serious enough to motivate a valuation fraud scheme.

**Inflated assets and earnings** are key to watch for ahead of a merger or acquisition. Increasing the value of the
company’s assets and inflating earnings is accomplished by increasing the value of the inventory on hand or decreasing necessary reserves to increase earnings projections. However, most companies keep mergers or acquisitions under tight wraps until they are ready to announce, so detecting inflated assets or earnings ahead of time may be challenging.

Asset-based lending can be a major motivator behind valuation fraud. Banks frequently loan money to companies based on the value of certain assets, including inventory. Improperly inflating the value of inventory could also extend the amount of available credit for borrowing.

Meeting performance-based compensation targets is a more self-serving motivator. As mentioned earlier, some financial benchmarks could be tied to a bonus program benefiting employees, especially senior management. Manipulating inventory values will have corresponding effects on net income, which could be used to meet this self-serving goal.

How is Valuation Fraud Committed?

There are several primary methods for perpetrating inventory valuation fraud:

- Capitalizing selling, general and administrative costs as inventory is perhaps the easiest way to commit inventory valuation fraud. However, it also the easiest to identify due to standard procedures. By increasing inventory and reducing expenses recorded in the income statement, accountants are effectively capitalizing costs, which should instead reduce net income.

- Manipulation of estimates is somewhat easy to accomplish if you can justify a change in your methodology or assumptions used in the calculation of an inventory valuation allowance. In the case of Point Blank Solutions, the company failed to report millions of obsolete inventory which would have required an adjustment to earnings of almost $13 million.

- Journal entries are the Hail Mary of inventory valuation fraud: when all else fails, post an entry to make the results what you want them to be. Alternatively, journal entries can be recorded to offset any system-generated entry recording cost of goods sold when inventory is credited once sold.

What Can Be Done?

There are many ways companies can mitigate fraud risk by developing simple, yet impactful, internal control practices. A strong internal control environment will increase the chances of detecting fraud, and act as an obstacle to a would-be fraudster.

Maintain strong analytics. Auditors and managers should look at several behaviors in inventory and cost of goods sold, including changes

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in estimates of obsolete inventory, shrinkage and profit margins. Increased write-offs directly to cost of goods sold may be an indication of an insufficient reserve. Other relationships to evaluate are shipping costs to raw material inventory, turnover ratios, inventory growth compared to sales growth and gross margin by product line fluctuations. These analytics require strong expectations, so avoid mistakenly overlooking flat margins when you expect improvements.

Carefully review journal entries. Research shows there is a direct correlation between the level of authority of a perpetrator and the magnitude of the fraud. Reviewing the journal entries posted by key individuals, especially if they have a large profit/loss impact, could be a fruitful exercise. Journal entries to manipulate inventory values are likely to be posted manually. Reviewing manual journal entries; a standard audit step thanks to Enron, WorldCom and Tyco, is a good starting point.

Understand the assumptions. Knowing the assumptions involved in the valuation of inventory, and having the will to challenge them, is helpful in identifying potential valuation fraud. In the well-known Walmart shrink scandal, a change in approach to recording shrinkage allowed the company to report inflated earnings. Addressing this fraud involved a change in culture, specifically how people viewed the topic, which is why it went undetected for so long.

Scrutinize overhead. The application of overhead to inventory is an area where large differences can be realized by changing a production efficiency assumption or inflating the cost pool. In this case, the assumptions built into the overhead application need to be closely evaluated and challenged. A close review of the cost pools to determine if all costs are related to the manufacturing of the inventory is necessary to ensure disguised Selling, Generated and Administrative (SG&A) costs are not included to inflate earnings.

Foster a culture of accountability. There are several ways to address these risks from both a proactive and detective standpoint. A manager or auditor should be asking: What can go wrong? Where are opportunities and what are the motivations? They should be proactively reviewing internal controls to ensure the appropriate checks and balances are operating as designed. From a detective standpoint, they should be using the tools above to make sure that results make sense given all other known variables.

What’s the Big Deal?

Why worry about manipulating inventory values if the adjustments will work themselves out in a future period? Never forget: knowingly misrepresenting financial results to people who use that information to make decisions is prosecutable fraud. Similar allegations for this type of conduct would be breaching fiduciary responsibilities and abusing one’s position to override controls.

At minimum, valuation fraud presents great personal risk to one’s employment, and could even result in civil or criminal charges. At maximum, valuation fraud places the financial stability and reputation of a company at serious risk of regulatory action, lost investment opportunities, lost customers and other devastating financial and reputational impacts. Learning how to mitigate the risk of valuation fraud by spotting the signs early on should be a priority for every company’s internal controls.

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