# First Friday Fraud Facts+

August 1, 2014

***The Idaho State Controller's Office distributes this newsletter as a cost-effective method of increasing awareness about ways to detect and prevent fraud, waste, and abuse in government.***

Welcome to First Friday Fraud Facts+ (F4+). This edition will discuss inventory fraud.

Inventory fraud is an ongoing concern with huge impacts on consumers at all levels. Unfortunately, entities must combat inventory fraud both on the front end and on the back end. Not only do they have to worry about shoplifters taking inventory off the shelves, but they also must focus on inventory walking out the back door with the help of their own employees. According to one survey, 24 major retailers reported that shoplifters and dishonest employees stole more than $6 billion in 2011 (yes, that is *billion*).[1]

Typically, a person might think of inventory as a consumable or sellable item. Most government entities do not engage in product sales. However, that does not mean governments do not have inventory. That computer system on your desk is (or at least should be) on an inventory list. That state-owned vehicle you drive and that office chair you sit on are all inventoried items. Unfortunately, inventory fraud also takes place in government workplaces.

## Types of Inventory Fraud

### Theft

Theft involves appropriating inventory for personal use and can occur in various forms. Collusion is a common scheme. One example of collusion is when a receiving clerk signs for fewer items than were received. The items not signed for are then sold to someone else and the parties involved pocket the money. In one instance, a dock worker and route driver stole $300,000 worth of inventory in six months by not completing load sheets correctly or accurately.[2]

#### Red Flags of Theft

- Missing documents.
- Employees living beyond their means.
- Employees who never take vacation for fear their substitutes will discover their schemes.

**Questions or Comments:**

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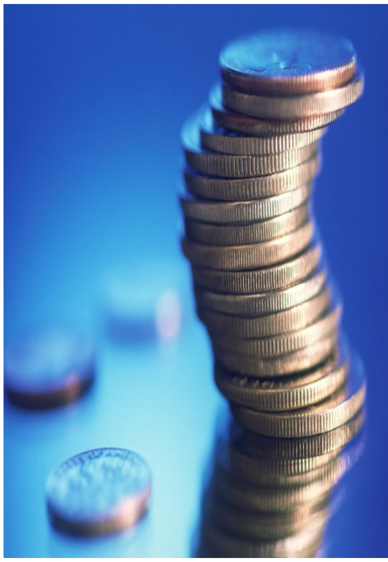

- Excessive loitering by off-duty employees.
- Bringing baggage to/from work.

Financial Fraud
Inventory fraud can also take place by manipulating financial statements. Typically, financial fraud is implemented by senior management in order to meet financial goals or benchmarks. Examples include timing schemes, expenses recorded as inventory, and valuation schemes.

### Red Flags of Financial Fraud

- Inventory asset value does not change for several periods.
- Gross profit percentage never changes from period to period.
- Dramatic changes to inventory turnover ratios.
- Shipping invoices cannot be traced to purchases or sales.
- Shipping invoices with unauthorized delivery addresses.

## PREVENTION

Inventory fraud can be very difficult to detect. However, controls can be implemented to help reduce the possibility of fraud:

- Implement proper inventory counting procedures. Split responsibilities to ensure the same person does not receive and control access to inventory.
- Do not rely solely on an asset management system. Get out there and perform a physical count. Conduct scheduled and unscheduled physical counts, and inform your employees that these counts will take place.
- Attach shipping invoices to purchase or sales invoices.
- Examine write-offs for validity.
- Compare current and prior period financial statements for unusual inventory variations.[3]

## CASE STUDY

The following case is one of the most famous in modern finance.

In 1960, Tino De Angelis borrowed $200 million on behalf of a large salad oil company over which he was CEO. The loan was secured by large tanks of salad oil. What the creditors did not know, however, was that De Angelis had significantly overstated the company's oil inventory.

Forty-foot tanks were filled with 37 feet of seawater. The remaining three feet contained salad oil that floated on top of the seawater. When the creditors examined the tanks, they saw three feet of oil and assumed each tank was completely full.

The company's inventory listed more oil tanks than actually existed. After the creditors examined the tanks, De Angelis had his men repaint different numbers on the tanks and fooled the creditors into “seeing” all the tanks listed on the company’s inventory.

Finally, De Angelis had underground pipes built to transfer oil from one tank to another. As the creditors examined one tank and moved to another, the oil would move right along with them and fill the next tank.

Today, this case will elicit a couple of chuckles from the reader. But once De Angelis’ scheme was discovered, the creditors lost $200 million and De Angelis was sent to jail for seven years.[4]

[1] $6 Billion Mystery Reveals Shoplifting Epidemic, http://www.businessnewsdaily.com/2635-shoplifting-employee-theft.html. Accessed March 12, 2014.

[2] Focus on Employee Fraud—Inventory Theft, http://www.mcgoverngreene.com/archives/archive_articles/Craig_Greene_Archives/Focus-Employee_Frauds-Invent.html. Accessed March 12, 2014.

[3] Inventory Fraud: Detecting, Preventing & Prosecuting. Chris Hamilton, CPA, CFE, CVA, DABFA.

[4] Ghost Goods: How to Spot Phantom Inventory. Joseph T. Wells.