An Adjusters Guide to Stock Reconciliation

By the CILA Business Interruption SIG

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Background

This paper was originally prepared by John Ball in the 1990s and has remained as an acknowledged "how to" guide ever since. The processes and steps outlined represent a "gold standard" that is unlikely to be carried out in full except in exceptional cases due to the time and expense involved. The principles remain valid, however, and an understanding of why each step may be carried out, and the possible effects on the claim amount if they are not carried out, is essential for those adjusters dealing with a claim by way of stock reconciliation.

The paper dealt with a largely manual system of stocks, purchases and sales etc. that is unlikely to be encountered in today's world. Accordingly, it has been updated to include some of the benefits and challenges provided by the computerised accounting systems now in place.

This paper is designed to be a basic guide to the stock reconciliation process and concentrates on wholesale or retail rather than manufacturing concerns. Measuring the value of work in progress and finished goods in a manufacturing business is much more complicated and outside the scope of this paper.

For insurance claims purposes, a stock reconciliation may be defined as:

"A method of establishing the theoretical value of stock at or shortly before the date of the loss from which is deducted the value of the stock remaining (if any) to produce a net loss figure".

Given the theoretical nature of the answer, it is important for adjusters to recognise that a stock reconciliation should be used as a method of the last resort for assessing the value of a stock loss. A stock reconciliation provides scope for the less scrupulous policyholder (or his advisers) to manipulate figures to their advantage. It should therefore only be used where it is not possible to undertake a complete and accurate physical count to determine the stock loss (e.g. following theft or a major fire).

A stock reconciliation has a number of disadvantages, including the following:

- It is likely to be less accurate than a physical count
- It relies on the accuracy (or otherwise) of the policyholder's records
- It is easily manipulated and is open to abuse
- It is inexact
- It can be time consuming
- It has an air of being scientific, and this can sometimes serve to obscure the inaccuracies that can inadvertently be incorporated in the calculations

Fortunately, there are also some advantages:

- It is a widely accepted method of calculating the stock loss
- It can be difficult for the policyholder to dispute (especially if undertaken carefully)
- The work undertaken in the context of a stock reconciliation can also be of value in assessing the value at risk and in connection with any BI claim

Computerised accounting systems

In practice, most computerised accounting systems (ranging from large systems such as SAP or SAGE down to Quickbooks etc.) can produce "book stock" figures almost at the press of a button and certainly periodically at month end. However, losses may inconveniently not occur at midnight on the last day of the month, and thus a stock reconciliation may need to occur.

Whilst the discussion / methodology that now follows does not specifically mention computerised records, the principles have not changed. For instance, whilst in a manual system it may be appropriate to review paper copies of invoices to see when goods were delivered (or sold, if sales invoices) this can now be done by looking at digital images. The level of detailed work undertaken (for instance review of invoices) has to be assessed in terms of materiality and proximity to the critical dates – i.e. the last pre-loss stock count date and the date of the loss itself. There is probably little to be gained from inspecting lots of sales invoices from a sales day book for months that are not the month after the last pre-loss stock count or the last month or two before the loss. It may well be that, following querying the operation of the accounting system, the stock reconciliation only takes place in detail for the period from the previous month–end prior to the loss to the date of the loss itself.

Preliminary action

If a stock reconciliation is to have any validity, it needs to be undertaken at the earliest opportunity. The following immediate steps should be taken:

- A full count of all remaining stock at all locations. Damaged as well as undamaged stock should be recorded. Do not overlook stock in transit. To avoid the possibility of miscounting due to stock movements when there is more than one location, it may be necessary for more than one adjuster to be involved so that the count is literally simultaneous.
- Protect undamaged stock and damaged stock that may have a salvage value.
- Enquire as to whether some of the stock is customer returns, supplier returns not yet sent back, items under quality inspection / rejection / re-working etc.
- Control the movement of undamaged stock (anything not physically counted will automatically increase the claim). It may be necessary to isolate the area in question

- Establish the policyholder's stock control system.
- If in any doubt about the claim take statements from staff, neighbours, suppliers and customers concentrating on unusual stock movements as well as establishing the usual routine.
- Take photographs
- Obtain a location plan of the stock, including accurate measurements of the volume of the area containing the stock
- Sift debris for evidence of stock quantities. Some parts of stock may not be completely destroyed and with careful work may be capable of evaluation
- Establish what stock records have survived and secure them. If destroyed, it may be necessary for them to be recreated via suppliers, customers, auditors and the policyholder's bank. Whilst this may be time consuming, there is often no alternative
- Obtain the latest audited accounts including the (non-statutory) detailed trading and profit and loss accounts. Establish the date of the last physical stock count and the methodology used
- Obtain monthly management accounts (if maintained by the Insured) for the last two years prior to the last audited accounts and for the months after the last audited accounts until the most recent month pre-loss
- There may be advantage in seeking the policyholder's initial assessment of the value of the stock loss. This may later highlight the need for double checking if there are significant discrepancies.

The stock reconciliation calculation

Once the physical count has been completed and agreed (a joint count with the policyholder sharing the results at the end is best to avoid subsequent potential problems) there is no reason why disposal of the debris and salvaging should not proceed.

The adjuster will then need to commence enquiries with a view to completing the stock reconciliation calculation, which is fairly simple:

Opening stock		£______
Plus purchases		£______
Deduct sales (A)	£______	
Less profit in sales (B)	£______	
Deduct sales at cost (i.e. A – B)		£______
Theoretical stock value @ cost price		£______
Less stock remaining		£______
Theoretical stock loss		£______

However, the theoretical stock loss calculated may not necessarily be the sum to be paid by insurers. The figure may require adjustment for shrinkage and/or obsolescence. Application of the policy conditions may also result in adjustments.

It should also be remembered that the stock loss identified is theoretical and the fact that the figure has been produced at the end of a detailed analysis and lengthy calculations does not necessarily mean that it is accurate and should be used for the purpose of the calculation of the sum payable under the policy. Do not automatically accept the figure as the right answer without considering whether it is a realistic figure. How does it compare with the policyholder's initial assessment? How does it compare with the normal level of stock holdings? This is not to suggest that the whole exercise is a waste of time. However, the adjuster should examine the result in order to be satisfied that it is realistic.

If at all possible, the theoretical value should be verified in whatever way might be possible, including reference to items recovered in the stock sifting exercise or by volume checks. Could the stock have been contained within the area in question?

Opening stock

Careful consideration must be given to the opening stock figure. It is likely to be the closing stock figure from the last audited accounts or the most recent physical count if later. However, where there was no audit then the opening stock figure, even if included in a set of financial accounts, may be unreliable.

It is essential to establish the methodology of the calculation of the opening stock figure:

- Were the auditors in attendance throughout the count or at all?
- Are the count sheets still available for examination?
- What is the basis of value of the opening stock? Is it at cost net of VAT (if the policyholder is registered for VAT)?
- Have suppliers' discounts been taken into account?
- Have adjustments been made for obsolete or slow moving stock?

If the opening stock figure in the stock reconciliation has not been calculated strictly in accordance with the method adopted for the last physical count or audit, the adjuster should undertake detailed enquiries to establish why not.

Purchases

When examining the policyholder's purchase records, the adjuster must always have in mind that the object of the exercise is to track the movement of stock between the last physical count and the date of the loss. If the policyholder maintains a sequentially numbered goods inward recording system, ensure that every invoice has been included. The adjuster should then examine the invoices in order to be satisfied on the following points:

- Is the invoice for stock or some other purchase? If not relating to stock, it should be excluded from the calculation.
- Were the goods delivered to the policyholder? If there is any doubt, enquiries may have to be made with suppliers. If not delivered to the policyholder, they should be excluded.

- Have discounts been taken into account? If not, the value of the purchases will be artificially inflated.
- Has VAT been excluded (for a VAT registered business)? VAT should be ignored throughout the stock reconciliation exercise, if the business is registered for VAT.
- Have returns to suppliers been taken into account? Does the policyholder maintain a returns register? The reason for the return should be established. It may highlight problems that would affect the value of the destroyed/stolen stock. In appropriate cases, it may be necessary to undertake enquiries with suppliers. Short payments or credits could highlight the possibility of returns or deliveries not matching with invoices. If returns are not eliminated from the calculation, the value of the stock will be overstated.
- Goods inwards records should be checked to ensure that deliveries match with the invoices. This is not always the case, especially if deliveries are sent in batches. Packing errors also arise from time to time.
- Invoices for goods delivered before the last count but invoiced subsequently should be excluded as they have been included in the opening stock already.
- Goods invoiced before the last count but delivered subsequently should be added to the purchases figure.
- Goods invoiced to the policyholder before the loss but for delivery subsequently should be excluded. They were - obviously - not present at the time of the loss.
- Goods delivered after the last physical count, but before the loss and invoiced subsequent to the loss should be added to the purchases figure.

In most computerised systems the matching of invoices with stock records etc. is automatic. Where the system records any of the above circumstances, a difference account is usually generated – such as “accrual for goods received not invoiced” etc.

Particular problems can arise when stock is purchased from abroad. The effect of currency fluctuations must be taken into account. Remember the purpose of the exercise is to track stock movements, not cash movements.

Attention should be paid to goods supplied to the policyholder on "sale or return". Have the goods been returned if not sold?

Sales

A similar exercise should be undertaken with the sales invoices. Again it must be borne in mind that the purpose of the exercise is to track stock movements between the last physical count and the date of the loss. Sales day book information can be used to check that all relevant invoices are deducted. It is more likely that the policyholder will maintain a sequentially numbered invoicing system. Both this and despatch records should be examined to ensure that every invoice has been included. If there are no sequentially numbered records, check that the level of sales is in line with turnover in previous periods.

The adjuster should then examine the invoices/despatch notes in order to be satisfied on the following points:

- Have discounts been taken into account? Unusual discounts should be investigated. They may highlight problems affecting the value of the destroyed/stolen stock.
- Has VAT been excluded (for a VAT registered business)?
- Have returns to the policyholder been taken into account? Does the policyholder maintain a returns register? The reason for the return should be established. It may highlight problems that would affect the value of the destroyed/stolen stock. In appropriate cases, it may be necessary to undertake enquiries with customers. Check all credit notes. Watch for an increase in the number of credit notes immediately prior to the loss (if an increase occurs, this reduces the sales figure and therefore increases the calculated stock value). The cause of any departure from the normal pattern should be investigated. Are all the credit notes correct?
- Despatch records should be checked to ensure the deliveries match with the invoices.
- Goods despatched before the last count but invoiced subsequently should be excluded. Their removal from stock has already been accounted for in the opening stock figure.
- Goods invoiced before the loss but for despatch subsequently should be excluded from the sales figure. They were still in stock at the time of the loss.

- Goods invoiced before the last count but delivered subsequently should be included in the sales figure. They have been removed from stock in the period between the last count and the date of the loss.
- Goods despatched before the loss but invoiced to customers subsequently should be included in the sales figures. They - obviously - represent a reduction in the stock holding prior to the loss.

Particular attention should be paid to cash sales. Are there any? How are they recorded?

It should always be remembered that any sums incorrectly omitted from the sales item (or incorrectly included in the purchases item) will increase the claim pound for pound (subject to the rate of gross profit).

Gross Profit

Most policyholders will maintain their records on the basis of purchases at cost and sales at retail. If the stock reconciliation is to be accurate, all the figures must be consistent. The object of the exercise is not to track movements of money, but movements of stock. If all the figures are not on an identical basis, the result will be nonsense. Accordingly, it is necessary to reduce the retail value of sales to cost. This is most easily achieved by identifying the rate of gross profit and deducting it from the value of sales.

However, considerable care needs to be taken in identifying the rate of gross profit to be applied. Whilst the last audited accounts is a good starting point, the adjuster should not stop there. A review of the last three years' accounts might reveal a trend in the rate of gross profit, warranting further investigation to establish whether it is appropriate to use that figure in the stock reconciliation calculation.

In addition, where - as is almost inevitably going to be the case - the period between the last physical count and the date of the loss does not coincide with the policyholder's financial year, it is necessary to consider any cyclical factors that impact on mark up and therefore the rate of gross profit. For example, if the period for which the reconciliation is being drawn up includes the policyholder's annual (or an extraordinary) sale, the rate of gross profit is likely to be significantly different from a period not encompassing a sale. If there has been any extraordinary discounting - for example a sale when there would not normally be one - this would be cause to initiate further enquiries.

If different stock lines are sold at different times of the year, adjustments to the rate of gross profit may be required.

The adjuster should not automatically accept the rate of gross profit, even adjusted for the factors outlined above. Consideration should be given to the general business environment (for example, does the economy permit increases in prices to match increases in costs) and changes in the nature of the business (is the business precisely the same at the date of the loss as it was when the various accounts were prepared). Is the gross profit percentage still appropriate? Scrutiny of monthly management accounts, giving more detail than annual financial accounts, is likely to be of help in determining whether or not a particular percentage should be used.

The crux of agreeing a claim by way of a stock reconciliation is establishing the correct rate of gross profit to be deducted from the sales. This is an area open to abuse and manipulation. It needs the most careful investigation. If in doubt, the adjuster should seek advice from a suitably experienced accountant.

Further adjustments

Completion of the mechanical calculation of opening stock, plus purchases, less sales (at cost price) produces the theoretical stock holding at the date of the loss. Deduction of any stock remaining results in the theoretical value of the stock lost or destroyed. Adjustments should then be made to calculate the value of the stock for consideration by insurers.

Adjusters should consider whether any of the following adjustments are relevant:

- Adjustments for obsolete or slow moving stock. Clues will have been provided during the examination of the previous stock taking records. If the policyholder has consistently made such adjustments in the past, it is likely that similar adjustments will need to be made now. Even if no adjustments have been made in the past, they may still be appropriate. Examination of purchase invoices may reveal items that have been in stock for many years. If they could never have been sold or only sold at a discount to less than the purchase price, an adjustment must be made (N.B. discounts that do not reduce the sales value below cost are, of course, irrelevant as the stock figure calculated is already at cost). Examination of sales invoices might show regular sales of certain stock lines that suddenly dried up or the loss of a regular customer. Any remaining items of such stock could well be redundant.
- Adjustments for pilferage, shop-soiling, breakages, etc. ("shrinkage"). Most trades have a fairly good idea of the normal level of shrinkage. The percentage is always based on turnover, not on stock levels. Accordingly the percentage deduction to be made here should not be based on the theoretical stock holding figure just produced, but on the turnover in the period between the last physical count and the date of the loss.
- Physical verification. Is the theoretical figure consistent with what the area could have contained? Is it consistent with any physical evidence obtained from the sifting of debris? Is it consistent with the policyholder's initial assessment? If it is possible to verify any part of the claim, efforts should be made to do so.
- Adjustments for price fluctuations after the loss, but before replacement. In particular, because the policyholder is replacing the whole of the stock, rather than making smaller regular purchases, bulk purchase discounts might be available. However, do not always assume that price fluctuations will always be downwards. In the event of a major loss involving (for example) commodities, the loss itself might cause prices to rise (but check the Policy wording, the indemnity for stock is often not on a reinstatement basis)
- Stock on approval or in trust. The existence of stock in these categories ought to be detected during the examination of purchase records. If not already taken into account, they should be considered here. They may not be the policyholder's property or responsibility, in which case they should be eliminated.

Having reached an acceptable value for the stock loss, it only remains for the policy conditions in so far as they relate to the value of the loss to be taken into account. Do not overlook:

- Salvage realisation
- Policy limits
- Average
- Excesses