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Strategies for Reducing Retail Shrink During Challenging Times

Internal Audit, Risk, Business & Technology Consulting

Shrink has long represented a significant challenge for retailers. Unfortunately, during a time of tightening margins and declining sales, the issue shows no signs of withering away.

According to the 2020 National Retail Security Survey of the National Retail Federation (NRF), shrink is at an all-time high. In 2019, it accounted for an average rate of 1.62% of inventory, calculated at retail, costing the industry a record $61.7 billion. Moreover, the issue is remarkably widespread, with seven in 10 retailers reporting shrink rates above 1%.[1]

Aside from the massive financial impact to retailers' bottom lines, shrink impacts retailers in other, less visible ways.

The inaccurate accounting for missing, lost or stolen inventory can decrease customer service levels and hurt a retailer's brand reputation. For example, if a store is out of a particular stock-keeping unit (SKU), the inventory management system may show the item available at a nearby store location. If a sales clerk promises a customer that item will be shipped to their home or nearest store in two days, but the physical item has disappeared from inventory, the result may be delays in delivery and, perhaps, a lost sale.

In the same way, high shrink negatively impacts employee morale, and will eventually hurt a retailer's market share, as disgruntled employees and dissatisfied customers begin to migrate elsewhere.

This white paper will discuss the major types and causes of shrink, along with best practices and emerging trends in loss prevention and shrink mitigation.

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A Diverse Problem With Many Causes

To understand the scope of the shrink problem, one must first understand the subtle differences between shrink and damages. Retailers often lump these two issues into a single category; however, they should be tracked and addressed separately.

In the simplest terms, *shrink* refers to any unaccounted for loss of inventory. *Damages*, on the other hand, refers to any loss of inventory that can be explained. Examples include returned, broken or damaged items, or stale merchandise that has reached a state of obsolescence. Retailers should treat shrink and damages differently from both an accounting and mitigation standpoint.

[1] *2020 National Retail Security Survey*, National Retail Federation, July 2020: https://cdn.nrf.com/sites/default/files/2020-07/RS-105905_2020_NationalRetailSecuritySurvey.pdf.

The root causes of shrink are myriad, but they generally fall into six major categories that closely track the inventory life cycle: receiving discrepancies, misreporting damages, cashier inaccuracies, internal/external theft, improper physical counts and inaccurate price changes. Following is a deeper discussion of each:

- **Receiving Discrepancies —** Shrink can occur at the moment a shipment of merchandise is received (or not received) by the retailer. For instance, if a store or warehouse is expecting receipt of 100 pieces of an item, but physically receives only 95, that discrepancy must be recorded to ensure that the retailer receives credit for the missing merchandise. If such discrepancies are not tracked accurately, those pieces will be lost to shrink before they ever hit the showroom floor.
- **Misreporting Damages —** One of the most common areas of shrink occurs with broken or damaged merchandise, or items that have reached the end of their useful life through the natural cycle of obsolescence. If the item is not recorded accurately as damaged — if it is simply thrown away — it will remain in the retail inventory management system, resulting in a lost piece of merchandise.

  The problem of misreported or unrecorded damages may also become a procurement and potential customer service issue, as sales associates must rely on the accuracy of the system to locate a shopper's desired item based on SKU, sizing, color and other attributes.
- **Cashier Inaccuracies —** Human error at the point of sale is another common source of shrink. If a checkout associate accidentally fails to scan an item, or inaccurately registers multiple items with different SKUs as a group of identical items, the result is an inaccurate item count in the store's inventory tracking system.
- **Internal/External Theft —** Of course, the highest profile cause of shrink is outright theft. It is important to consider internal and external theft as two separate challenges, as both represent significant sources of loss.

  To illustrate the massive scope of internal theft, a recent survey reported that retailers apprehended one out of every 50 employees nationwide for theft in 2019 and recovered over $45 million in inventory, an increase of nearly 8% over 2018.[2] Likewise, external theft in the form of shoplifting accounts for 30 to 40% of total retail shrink.[3]

[2] *32nd Annual Retail Theft Survey*, Jack L. Hayes International, 2020: http://hayesinternational.com/news/annual-retail-theft-survey.

[3] Ibid.

As with quarantine, goods in transit to a store or warehouse must be isolated prior to a scheduled physical inventory count.

- **Improper Physical Counts —** Shrink can also occur in a warehouse, a distribution center, a store or even in transit if personnel do not perform physical merchandise counts correctly.

  Shrink from inaccurate physical merchandise inventory counts may occur during two common scenarios:

  - **Quarantine —** When a physical inventory count is being conducted, any new deliveries of merchandise to that store or warehouse must be physically separated from the merchandise already on-site until the count is completed. Otherwise, this new merchandise would be included in the physical count of product on hand, resulting in an artificial inflation of inventory (referred to as "inventory swell" or "positive shrink").

    The received inventory would then be input to the system, resulting in a double counting of the same merchandise. During the next physical count the following cycle, this merchandise will appear as inventory shrink. It's important to note that such lax inventory management practices often result in poor customer service, as previously described in this paper.

  - **In Transit —** As with quarantine, goods in transit to a store or warehouse must be isolated prior to a scheduled physical inventory count. Retailers use two methods of accounting for goods in transit: free-on-board (FOB) shipping point or FOB destination. These terms refer to the point in time when a shipment is counted in the retailer's inventory and are dependent on the retailer's contract with its vendor. To minimize opportunities for shrink while goods are in transit using one of these two methods, retailers generally don't allow any receipt of new goods within a window of one to two days before a physical count.

- **Inaccurate Price Changes —** For stores that use the retail inventory method for determining their ending inventory balance, incorrect price changes can result in shrink caused by accounting errors. For example, if an item is marked down by $5, the price change must be recorded for every piece in inventory. If the employee responsible for markdowns misses a piece, which is later sold at the current, marked-down price, it will result in a $5 shrink loss in the inventory system.

  Price changes do not affect retailers that use the cost inventory method.

According to the latest NRF survey, over 95% of retailers discuss loss prevention during the new-hire orientation (up from 82.5% in 2018), nearly 93% include it in the code of conduct and over 91% promote mitigation practices via bulletin board notices and posters.

Combatting Shrink at the Source

To tackle the complex problem of shrink, retailers should take a multidimensional approach to loss prevention. One of the most critical strategies loss prevention professionals should take is to employ a robust program of employee awareness. Most retail employees have a sense of pride in their work and will do all they can to prevent physical losses. But to be successful, teams need to be up to date on their employers' most pressing areas of risk.

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Loss prevention departments can begin by developing and distributing literature designed to educate staff on the most coveted merchandise, current risks and best practices. The organization can easily outsource the creation of customized literature to specialized third-party firms.

Each store should also develop its own shrink plan, customized to address the top five or 10 inventory items, vendors or merchandise classes that experienced the highest loss in the most recent inventory cycle. These plans should also include concrete mitigation steps and should be communicated storewide with all staff.

For example, if a big-box home improvement store was experiencing higher-than-average shrink related to a specific light bulb product, the store might decide to assign a manager to oversee loss mitigation for that product SKU and related items. Alternatively, the store manager or loss prevention executive could oversee that process or conduct an audit to address it.

Field support is another way to bolster shrink mitigation efforts. This may consist of dedicated oversight of high-shrink stores or mitigation efforts focused on a specific department or merchandise category. If the issue is internal or external theft, field support may include undercover loss prevention officers.

[4] *2020 National Retail Security Survey*.

According to the NRF, in 2019, over 78% of retailers deployed live customer-visible CCTV in stores, a 16.4 percentage point increase over 2018.

Technology Takes Center Stage

Store audits are another way to ensure that proper mitigation processes are being followed consistently. Traditionally, retail store audits were time- and resource-intensive endeavors. They often included a visit from internal auditors or loss prevention personnel and the development of a formal audit work plan, resulting in a deluge of paperwork. The subsequent transfer of hand-collected data or documentation into analysis tools often resulted in a substantial time lag between the audit and reporting of findings to management, slowing the decision process and resulting in missed opportunities to implement timely corrective action.

Today, the loss prevention field has benefited from technological innovations like mobile, cloud-based audit technology deployed via smartphones and tablets. Married with big data analytics, this aids retailers by enhancing audit productivity, increasing operational effectiveness and improving reporting capabilities.

Even with these technological advances, periodic physical inventory counts are still a critical piece of the loss prevention puzzle. Protiviti recommends performing annual physical counts in all stores and distribution centers, and at least twice per year at high-shrink locations. As for higher-risk merchandise, it is best practice to perform periodic cycle counts as well.

Cycle counts are another way to mitigate shrink throughout the year and should be conducted at a regular cadence. Many retailers do them weekly. The items counted in cycle counts vary each week and are either selected by the loss prevention department or systematically. Every SKU in the store or warehouse should be cycle counted at least once per year, with higher-risk items (e.g., expensive merchandise or items experiencing high volumes of loss) counted on a more frequent cycle, such as monthly. Beyond their shrink mitigation benefits, cycle counts also ensure an accurate accounting of items in-store, alleviating the customer service issues previously described.

Beyond audits and inventory tracking, technology serves other important roles in loss prevention.

Although best known for securing clothing, EAS (electronic article surveillance) tags have long been used in retail to prevent shrink caused by external theft. The hard tags are commonly used on many types of high-value and easily concealable merchandise, including high-theft items like power tools and electronics.

Similarly, CCTV (closed circuit television) is another popular technology for deterring both internal and external theft. The cameras are generally placed in high-risk or hard-to-monitor areas of the merchandising floor and may either be obvious to customers or hidden. Some retailers also install CCTV cameras that integrate with point-of-sale (POS) systems to help research exception-based reporting and catch employee theft. According to the NRF, in 2019, over 78% of retailers deployed live customer-visible CCTV in stores, a 16.4 percentage point increase over 2018.[5]

[5] Ibid.

Beyond these classic loss prevention technologies, new solutions have emerged in recent years, including biometrics, facial-recognition tools, AI and machine learning. Retailers deploying POS facial-recognition technology report a 34% decrease in shoplifting.[6] Additionally, one in 10 retailers have, or plan to implement in 2020, POS fingerprint-recognition technology.[7]

Overall shrink has been rising in recent years, and in fiscal year 2019, it hit a high of 1.62% of inventory, calculated at retail.

Limit the Loss With Standard Operating Procedures

Of course, all the technology in the world is worthless without standard operating procedures (SOPs) that are simple and well considered and that address the most urgent areas of loss risk. Loss prevention professionals should update SOPs often based on the latest shrink metrics and ensure regular and timely communication to management and staff.

Retailers should also establish strict policies and procedures around exception reporting, which may be implemented at the store level or corporatewide. At a minimum, loss prevention executives should place special focus on fraudulent returns of high-shrink items at the point of sale, including fraudulent post-void transactions, which result in total loss of a legitimate purchase.

Retailers should also closely track empty packages found in the store, as they are powerful indicators of high-shrink merchandise and emerging loss trends. Stores should have documented processes to code the packages and track by SKU. Retailers may wish to consider EAS tagging or locking these items to reduce shrinkage, if warranted.

So-called grab-and-runs, where a prospective thief targets high-value or high-volume merchandise located close to the store entrance, offer a similar opportunity for trend identification and mitigation. It’s important for loss prevention personnel to track theft patterns and consider securing or relocating the most frequently stolen items to a less vulnerable area of the floor.

Last, data analysis and benchmarking are sophisticated, powerful tools for reducing shrink risk and losses. Although retailers recognize that a certain level of shrink is simply a cost of doing business, a focus on comparative industry benchmarks, coupled with intensive mitigation efforts focused on high-shrink stores and merchandise, can offer an effective one-two punch in reducing shrink’s impact on the bottom line.

As mentioned earlier in this paper, overall shrink has been rising in recent years, and in fiscal year 2019, it hit a high of 1.62% of inventory, calculated at retail. This figure can be used as a benchmark average, or retailers can more finely tune their benchmark rate to account for their retail category, geographic locations, merchandise types or other factors.

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[6] Facefirst: www.facefirst.com/blog/retail-loss-prevention-and-violent-crime-statistics.

[7] *2020 National Retail Security Survey*.

Respondents to the 2020 National Retail Security Survey called out analytical (75.4%), computer (36.2%) and cybersecurity (31.9%) skills as specific areas of need in order to support the continued growth and success of loss prevention programs throughout the industry.

Shrink Is Growing Online

E-commerce is a burgeoning shopping channel that has shown exponential growth during the COVID-19 crisis. According to a report from Adobe, total online spending in May 2020 was $82.5 billion, an increase of 77% over the prior year.[8]

Online shopping is also an ecosystem ripe for fraud. According to the *2020 National Retail Security Survey*, 26.1% of respondents saw the greatest increase in fraud occurring within online sales, and another 18.8% saw fraud increasing most dramatically within multichannel sales, including shoppers that buy online and pick up in-store.[9]

For online retailers, the highest risks of losses generally fall into three broad areas: fraudulent purchases and returns (including scenarios where a fraudster returns a lower-value item than originally purchased for a full refund), shipping errors (including an invalid or incorrect shipping address, sending the wrong merchandise and shipping the wrong quantity), and poor or inconsistent quality of goods sold.

To address these challenges, loss prevention specialists can employ a number of mitigation techniques:

- Ensure the accurate recording and validation of the shopper's shipping address at time of purchase
- Implement and communicate a clear and consistent returns policy prior to purchase
- Implement a robust cybersecurity program that monitors and proactively identifies threats and their potential impacts to the organization
- Use data analysis and threat intelligence to anticipate emerging fraud and cybercrime trends

Shrink in online shopping is recognized as an emerging challenge, and one that will demand loss prevention professionals with highly specialized skills. Respondents to the *2020 National Retail Security Survey* called out analytical (75.4%), computer (36.2%) and cybersecurity (31.9%) skills as specific areas of need in order to support the continued growth and success of loss prevention programs throughout the industry.

[8] "COVID-19 Accelerated E-Commerce Growth '4 to 6 Years,'" *Forbes*, June 12, 2020: www.forbes.com/sites/johnkoetsier/2020/06/12/covid-19-accelerated-e-commerce-growth-4-to-6-years/#18cab37c600f.

[9] *2020 National Retail Security Survey*.

Addressing the Challenges With Long-Term Strategies

Shrink is a growing problem, and one that is compressing retailers' ever-tightening bottom line. Fortunately, loss prevention experts are seeing success in a multipronged approach to combating shrink. By implementing a comprehensive, commonsense mitigation program, which includes staff awareness, field support, and the application of POS technology like biometrics, CCTV and mobile automated real-time audits, retailers can get to the root of the problem and address it effectively within the highest-risk areas.

Data analysis and benchmarking are also long-term strategies for recognizing areas of emerging risk and mitigating them before they get out of hand. This is where outsourcing or co-sourcing the loss prevention function can help, especially during times of tightening budgets and stretched resources.

By tracking the latest shrink trends inside and outside the organization, implementing swift and effective mitigation techniques where needed most, and getting outside help when warranted, retailers can take on this daunting challenge and reap the benefits of controlling shrink.

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