CLIENT STORY

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Global Business Consulting

A national retailer takes on inventory shrink to improve margins

At a price tag of almost $50 billion per year,[1] retail industry losses due to inventory shrinkage are significant. Measuring inventory shrink is a must because it directly impacts gross profit and businesses cannot improve on what they cannot or do not measure — and inventory is no different.

Measuring shrink is challenging, particularly if inventory processes lack transparency or the data being used is not complete, accurate or timely. Such was the situation that a large North American retailer faced. As part of an enterprisewide effort to increase profitability and improve inventory performance, the organization's management noticed that although their "reported" inventory shrink percentages were lower than the industry average, the low percentage did not align with their "real world" view, nor the reduced profit margin results they were experiencing.

Disjointed, undocumented processes and holes in data hurt margins

Through some of its own research and investigation, the retailer discovered that its inventory management and supply chain practices lacked consistency and standardization, and on top of this, they were siloed between distribution center operations and back-of-the-store operations. Inventory control was compromised because the company's distribution centers were not aligned with their retail stores, with significant "blind spots" of "in transit" inventory back-and-forth that were never reconciled. The numbers were skewed as a result of how they were classified and reported by stores. As a result, upper management did not have access to a holistic end-to-end view of inventory performance and shrink.

At the time, the company culture supported employee decisions and actions that often were undocumented and not based on formal inventory policy or process. For example, sales staff had the latitude to mark down products in retail locations by virtually any percentage, even 100%, which in turn skewed inventory data. Clearly, changes in policy and process were needed in order to establish better control and tracking of inventory, including but not limited to shrink.

The company set out to understand how to address these issues in order to more accurately report inventory shrink, identify and resolve root causes, and ultimately reduce shrink to increase profit margins. Gaining a clearer understanding

[1] "Inventory Shrink Cost The US Retail Industry $46.8 Billion," TJ McCue, *Forbes*, January 31, 2019: www.forbes.com/sites/tjmccue/2019/01/31/inventory-shrink-cost-the-us-retail-industry-46-8-billion/?sh=273d32286b70.

was going to require documenting and standardizing end-to-end inventory processes, performing analysis to identify and quantify the sources of loss, mitigating detrimental actions on inventory to stop undocumented losses, and resetting expectations for future inventory management.

Making a commitment to gain control of its inventory, the retailer turned to Protiviti for assistance. The company worked with Protiviti to conduct a comprehensive supply chain assessment in the following areas:

Distribution center processes	• Distribution center receiving and put away • Distribution center picking and fulfillment (store and e-commerce) • Physical storage	• Cycle counts and inventory management • Item return receiving (damages, return to vendor, distressed inventory) • Physical inventory and shrink reporting
Store processes	• Receiving from distribution center • Receiving direct to store • Receiving store to store • Manual markdowns	• Return processes • Custom orders • Customer-owned goods • Physical inventory and shrink reporting
Additional processes	• E-commerce • Customer service orders	• Loyalty and reward programs • Fraud and theft analysis
Data analysis	• Examined historical shrinkage and factors affecting reported shrinkage • Performed data analysis of manual markdowns and damaged inventory to identify trends and anomalies • Reviewed customer loyalty program metrics to identify high transaction activity by associate, dollar volume, loyalty points and unvalidated address information	• Quantified total loss, which adjusts reported shrinkage for excess damages and manual markdowns • Developed recommendations to enhance oversight and accuracy and reliability of reporting

An end-to-end process flow was developed to track the inventory supply chain from receipt at distribution centers through usage at retail locations. This holistic view produced a comprehensive story for the movement of inventory.

Process mapping leads to a path for inventory control

In many respects, the company was starting from scratch, as it lacked comprehensive documentation of its supply chain and only certain people in some groups could explain particular portions of how inventory flowed. It did not have clear, end-to-end documentation that illustrated the movement of inventory from vendors through distribution centers, as well as the back and forth from the retail locations and inventory hubs.

Protiviti interviewed the organization’s leadership team and visited multiple distribution centers and retail locations to map the entire inventory process. An end-to-end process flow was developed to track the inventory supply chain from receipt at distribution centers through usage at retail locations. This holistic view produced a comprehensive story for the movement of inventory — from the time it arrives in the United States to its transport to and sorting at the organization’s distribution centers, where it is then sent to stores and also returned from stores. This mapping enabled management to gain a clearer understanding of the flow of inventory from start to finish, where and how inventory movements are recorded, as well as the potential loss/shrink points.

After the process was documented, the Protiviti team utilized insights gleaned from store and distribution center employees and management, along with our knowledge of leading practices, to identify gaps and areas for improvement. With transparency into end-to-end inventory management, Protiviti made recommendations to address the gaps and tighten the retailer’s inventory control system.

A deep dive on data brings clarity

Next, the retailer worked with Protiviti to create a methodology for calculating “total loss” inclusive of inventory shrink, damages and excessive manual markdowns. A view of total loss offers a far more comprehensive picture than the sum of individual losses from shrinkage, damages and markdowns — it also includes all day-to-day factors that impact inventory.

A data deep dive was performed to look at different elements of sales, markdowns and shrink data. Analyzing specific regions and stores, the Protiviti team identified those that had either higher or lower than normal outliers — using indicators such as “highest shrink variance” and “highest overage.” Then, to more accurately calculate total loss, the team conducted statistical analyses of shrink, damages and manual markdowns organizationwide, enabling it to arrive at a “total loss calculation.”

Impact analysis of process recommendations

● High ● Medium ● Low

	Relative impact on:					
Recommendation	**Loss prevention**	**Inventory control**	**Store ops change mgmt.**	**DC change mgmt.**	**Current systems**	**Customer experience**
Manual markdown data enhancement	High	Low	High	NA	Medium	Low
POS control of miscellaneous and aged returns	High	Low	Low	NA	High	High
Strengthen store receiving controls	Medium	High	High	Low	Low	Low
Detail receive inventory returned to DC	Medium	High	Low	High	Low	NA
Implement store cycle counting	Medium	High	High	NA	High	NA
Systematic traceability of customer-owned goods	Medium	Low	Low	NA	High	Low
Damaged inventory disposition	Medium	Low	Medium	Medium	High	NA
Store inventory accuracy reporting	Low	High	Low	NA	Low	NA
Redesign customer reorder process	Medium	Medium	High	NA	Low	Low
Increased analysis of MMD data	High	Low	High	NA	Medium	NA

The policies and process recommendations Protiviti delivered to the retailer enabled management to bridge and align inventory data and process with profitability.

Lastly, recommendations based on dollar impact to the retail chain were made to address the observations and identify gaps or losses. These observations brought clarity to key stakeholders who could then apply Protiviti's recommendations and access higher-quality data to optimize decision-making for their business.

Addressing inventory turbocharges informed decision-making

Protiviti's recommendations gave the organization the ability to access and understand critical data and key performance indicators to understand the reality of inventory performance, monitor compliance with internal policies and drive opportunities to reduce shrink.

A summary of 15 process and data analytics recommendations was provided to the retailer's management for implementation. The benefits of each recommendation, the impact each recommendation has on inventory and the action steps required to implement them were outlined. The inventory process and data analytics recommendations were also prioritized based on relative difficulty as well as impact on:

- Loss prevention
- Inventory control
- Store operations change management
- Distribution center change management
- Current systems
- Customer experience

The policies and process recommendations Protiviti delivered to the retailer enabled management to bridge and align inventory data and process with profitability. Further, with a holistic and more accurate view of their data, together with enhanced data analytics, the organization was able to leverage a standard, reliable calculation that provided a clearer view of inventory shrinkage over time.

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