

POS EXCEPTION Reporting The Benefits and ROI

By Walter E. Palmer, CFI, CPP, CFE

According to industry surveys as well as industry buzz, it's one of the hottest technologies in the retail loss prevention industry with users swearing by it and companies spending hundreds of thousands of dollars to implement it. What is all the excitement about? POS exception reporting systems.

This article will explore why the LP industry is so bullish on it, how it is providing results to loss prevention groups, and how the return-on-investment proposition works for retailers.

What is a POS Exception Reporting System?

“Exception reporting” is a term that is often bandied about with abandon, but what do we mean by it? Here we will specifically discuss POS exception reporting. However, the concepts of exception reporting apply in many different functional areas, such as accounts payable, new-hire screening, and physical security measures. For example, Joe Langford from Edge Information Systems, a background screening company, notes that they are incorporating exception reporting into their services to improve the value they bring to their clients.

Most commonly, though, when we refer to POS exception report systems, we are talking about software applications that take data from the retailer’s POS systems and analyze it against business rules developed by the loss prevention team to identify transactions that may indicate possible fraud or loss. These systems usually have several of the following features:

- A graphic user interface (GUI) or menu-driven structure designed around loss prevention concerns and issues
- The organization’s hierarchal structures for stores, districts, regional, and divisional reporting
- Data feeds from POS, sales audit, human resources systems, payroll, store demographics, and any other information that can be analyzed for fraud
- Predefined business rules, queries, and reports that can be run on a regular basis to identify high-risk transaction and associates
- “Drill-down” capabilities allowing the user to start at a summary level and then go into deeper detail down to the transaction or even SKU level
- Ad-hoc reporting capabilities to allow users to define new queries against the available data

These systems can be developed internally or purchased from third-party providers. They can be web, network, server, or single-client based. They can be as simple as data-mining systems with pre-saved queries and scripts, or

complex, robust systems specifically tailored and designed for loss prevention exceptions. There are examples of successful systems along each of these dimensions. Regardless of design, the bottom line question is, “What are the benefits that retailers are gaining from their use?”

Increased Internal Theft Case Resolution

The most immediate and obvious benefit from implementing a POS exception reporting system is the improved ability to resolve internal theft cases.

According to Cheryl Blake, vice president of loss prevention services for Aspect Loss Prevention, their clients experience

- An increase in dishonest associates cases of up to 50 percent over the previous year,
- They identify issues an average of 23 percent earlier,
- Their average case dollars for POS-related cases increase anywhere from 20 to 70 percent, and
- They recover increased restitution due to better documentation.

These benefits occur by using the systems in two directions: first, from the system generating leads to the investigator; and, second, from the investigator querying the system to support an investigation.

In the first case, internal theft activity that has not been identified at field level or that has just begun is flagged by the system’s analytics. Once identified, drill-down queries begin the process of case development prior to the case being assigned to a field loss prevention person.

In the second case, once a potential internal theft case is identified at field level through a tip, audit, or other means, the investigator can then have the system run queries and reports on the suspect associate. Oftentimes, what begins as a relatively small case develops into a significant investigation based on the wealth of information available through this process.

Linens ‘n Things, a user of Retail Expert’s NaviStor® system, saw total

cases rise 64 percent during the first year of implementation with the total dollar value of cases rising by 32 percent. In fact, the average case identified by the exception reporting system was 200 percent larger than those identified by other methods.

Prevention of Internal Theft

Due to the success of POS exception report systems in increasing internal theft resolution, many users find that it quickly becomes a prevention tool. In fact, while case results initially go up, many organizations find that over time, case results actually start to go down. By looking at a little criminology theory, the reason this occurs is clear.

Classic deterrence theory, such as discussed in *Crime & Human Nature* by James Q. Wilson and Richard J.

Herrnstein, identifies three necessary components that must be in place to deter an individual from criminal activity:

- *Severity*, or what are the consequences if I get caught?
- *Certainty*, or how likely is it that I will be caught?
- *Celerity*, or how quickly will I be caught and punished?

While we often focus on the severity of punishment (think capital punishment), the other two factors are just as important, if not more so, in affecting people’s behavior. Clearly, these exception reporting systems have a dramatic, positive impact on both certainty and celerity, thereby increasing deterrence and prevention.

In fact, many retailers “advertise” the capabilities of their system to educate associates and, hopefully, keep them from making a bad decision. Mike Smith, senior vice president of loss prevention at Finish Line, ensures that associates know about their exception reporting systems from new-hire orientation to regular meetings to bold lettering on the border of each register that reminds associates that every transaction is monitored.

“We clearly don’t hide the fact that we scrutinize all transactions,” says Smith. “We’d much rather deter fraud than lose profits, engage in

confrontations, and spend time investigating people.”

Overall Reduction of Loss

Shrink Results. Based on the increased apprehension rates and improved prevention, one would expect overall retail shrinkage to decrease after the implementation of a POS exception reporting system. While it is often hard to isolate how much this system contributes to a decrease in inventory shrink numbers, there does appear to be a correlation. “We are having customers tell us they are seeing a 10 to 30 percent decrease in shrinkage that they attribute to our system,” says Aspect’s Blake.

Addison Chan, vice president of business development for Triversity’s FraudWatch system, relates how one client installed their system in fifty stores out of 160 on a test basis. When store-by-store shrinkage results were analyzed eight months later, the stores using FraudWatch had 50 percent better results than the rest of the chain versus previous inventory results. “Obviously,” says Chan, “it was an easy decision for them to adopt the system across the enterprise.”

Cash Shortages. While most retail organizations already have some level of reporting on cash shortages, exception system users reported decreases in this area as well. This represents potential savings of hundreds of thousands of dollars, if not more, since one study showed cash shortages alone were 0.37 percent of sales in 2002.

Why the decrease in this area when reporting already existed? Often, it is because existing reporting did not have the depth and detail necessary to improve performance. For instance, the ability to see cash shortages by cashier, or by register drawer, over a period of time is critical for follow up and remediation. Additionally, the ability to associate other transaction data, such as no sales and voids, gives additional insight.

Credit and Gift Card Losses. Not

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exception \ik·sep´shan\ *noun*:
an instance that does not conform
to a rule or generalization

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only do credit card write-offs go down due to lower internal fraud and better compliance, but external credit card fraud can be impacted, as well. Bud Adrion, executive vice president for Retail Expert, says that several of their clients have used their NaviStor system to identify, track, and prosecute external fraudsters.

“One of our clients had a group using fraudulent cards up and down the east coast and was able to track them and have them arrested through the use of the exception reporting system,” says Adrion. “In fact, the FBI thought the reports alone constituted significant evidence in the case.”

At Circuit City, they have used their system from Aspect Loss Prevention to reduce losses where fraudulent credit card transactions are used to purchase gift cards. “By using ad hoc reports on a daily basis, we have been able to freeze gift cards purchased this way before they can be redeemed,” explains Wayne Davis, corporate investigator for Circuit City.

“We’ve been so successful with this and the dollars are so significant that we’ve added a line in our management reporting to reflect these savings.”

Time Savings and Efficiencies

A key issue for many users is the increased efficiency of POS exception reporting systems when compared to traditional methods they’ve used. In the past, investigations relied heavily on in-store media audit or time-consuming examination of detail or journal tapes. Once automated, these processes are streamlined in a dramatic manner.

One specialty chain who recently implemented a POS exception reporting system is experiencing a total savings of fifty-four hours a week in payroll from the efficiency of the reporting. Initially, that may not sound like a lot, but with a total payroll of only twelve positions in the loss prevention group, it is a significant savings of time that can be reinvested into key activities, not “busy work.”

Datavantage echoes that sentiment when they say their XBR system “eliminates hours of tedious manual review.” In fact, one study shows that only 8 percent of internal theft cases were identified in less than two weeks with their clients prior to implementation of the XBR system. However, that figure jumps to 35 percent of all cases after installation of the system.

“After all, isn’t this the rationale for exception report systems,” muses Jim O’Connor, director of loss prevention for Bed Bath & Beyond. “When we implemented XBR, one of my driving forces was to make my staff more effective by freeing them up to focus on the people, not the data.”

Training and Operational Improvements

In addition to the pure loss prevention results these systems generate, many users cite training and operational improvements as key wins from the implementation of these systems.

“Your employees are where it all starts...and ends,” says Larry Miller, president of Trax Retail Solutions. “Permanently changing their behavior is the ultimate key in preventing shrink and improving profitability.”

Among retailers who use the ShrinkTrax® system is Dan Faketty, vice president of loss prevention for Harris Teeter supermarkets. “Of course we use the system for loss prevention issues, but one of our biggest wins has been utilizing the same platform for operational issues and behavior modification.”

Faketty explains, “Our store management teams get weekly reports showing their lowest performing cashiers on a number of key performance indicators (KPIs). But even more importantly, they also receive a list of their three *top performing* cashiers.” This information is then used to recognize and reward these top performers in a public forum creating a positive environment where other

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cashiers strive for improved performance.

Calculating the ROI for POS Exception Reporting

Given all of the possible benefits that can be realized, how would one go about putting together a return-on-investment summary for one of these systems? We will not go into depth in this article on the technical aspects of calculating ROI, but we'll outline the general methodology one might follow for this process.

Identify Total Cost of Implementation. The first step to calculating ROI is to identify the total costs of implementing POS exception reporting.

If developing a system internally, it would include the following:

- All resource costs for the loss prevention team in developing the business and technical requirements necessary. This includes what queries, reports, and outputs are required from the system.
- All resource costs for IT personnel to develop the technical requirements based on the above and the management of the project plan.
- The equipment costs for servers, PCs, and data lines to run the system on.
- All costs for the actual programming and development of the application, data migration and integration from

external data streams, database administration and maintenance, quality assurance and testing, and technical support.

If purchasing an external system, additional considerations and trade-offs would include these items:

- The price of the software application, whether a one-time purchase, an annual license, an application server provider (ASP) model, or another purchase model.
- Annual maintenance or support contracts.
- Installation costs and training fees.
- Many of the internal resources costs will be lower than an internally developed system, but there will still be loss prevention and IT costs for project management and integration of the system into existing IT structures.

Identify Incremental Benefits from Implementation. "Incremental" benefits simply means what impact is this system going to have? What will be different as a result?

In order to justify the expense, you will have to quantify these benefits in financial terms. To simply say, "It will save us time" has no real impact in justifying the expense unless you can quantify that saved time in terms of reduced payroll or reallocated time allotment that will have some other financial benefit to the organization.

In regards to the benefits listed previously, an organization has to make a primary decision—are they going to justify the system based on increased apprehensions and associated savings, or are they going to project a reduced shrinkage result? One has to be careful about using both figures because they are likely redundant (one could say "a double dip"), since increased case results would feed directly into reduced shrinkage results, at least in theory.

For instance, if a case is identified by the POS exception reporting system and the associate makes an admission to \$25,000 in theft and makes restitution to the company, your shrink for that location would be reduced by \$25,000. You can't count it again in shrink results.

However, if you use shrink reduction as an incremental benefit, you could also include other savings due to such things as credit card write-off, time savings, cash shortages, and operational improvements, since they are separate financial issues from shrink results.

The difficulty always comes down to estimating the benefits. How much will shrinkage go down? How many more cases will we resolve? How much time will be saved? How much will compliance improve?

The important issue is to have a reasonable basis for the estimates and

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the method most often used is to benchmark what other organizations have experienced when they have implemented a system.

This is the reason that presentations on POS exception reporting systems are usually well-attended at professional conferences. Everyone wants to hear about the experience other organizations have had and how they have best utilized their systems to determine if it would benefit their own. Therefore, benchmark data continues to be the best source for estimating the incremental benefits of implementation.

Analyze the Financial ROI. Once total costs are identified and incremental financial benefits estimated, a financial analysis can be calculated. The first level of analysis is simply common sense: "Do the total benefits outweigh the costs?" Obviously, if you can't answer that question in the affirmative, the expense doesn't make sense.

Assuming you pass that first test, the next question is, "How quickly will the system pay for itself?" This is called payback period and is calculated by dividing the total cost by the annual return (or savings) in dollars. It might look like this:

Total costs = \$500,000
Annual return = \$200,000
Payback period = 2.5 years

However, most third-party providers claim their clients see payback in a matter of months, not years. So, let's take the above example, but estimated the annual return at \$750,000. In that case, the payback period would be eight months. If you were to show this kind of result, it would not usually be necessary to go onto the more detailed analysis since a payback period under one year is easily approved in most organizations.

However, if you want to go into more detailed analysis, you can tackle an analysis of Net Present Value or Internal

Rate of Return. For more information on how to do these types of analysis and a more in-depth discussion of calculating ROI, go to www.PCGsolutions.com/Articles_Downloads/ROI_Article.pdf to read the article "ROI: Turning Accounting Rules into Management Tools" from the September 2001 issue of *LossPrevention* magazine.

The finance department can also be a great partner to help you understand how they evaluate projects for return on investment.

What Is the Future for Exception Reporting?

Integration. As we look down the road into the future, convergence of technologies represents a key opportunity. In fact, current exception reporting systems are already built upon data streams that existed prior to the implementation of exception reporting interface. POS, sales audit, human resources, and store demographic data streams are aggregated and analyzed within POS exception reporting systems.

Over the past two years, case management systems have increasingly been integrated into POS exception reporting systems to streamline work flows and increase the efficiency of the investigative team.

"This integration just makes sense," says Retail Expert's Adrion. "We are finding more and more of our clients recognizing the synergy by having their POS exception reporting system integrating to their case management system."

Now, businesses are looking to add additional data streams in order to better leverage these systems. EAS data, digital video, alarm monitoring data, loss prevention and operational audit information, and cycle counts results are some of the additional data streams that loss prevention executives say would be beneficial and providers are already integrating into their systems.

New Business Models.

Developments occurring outside the loss prevention world could also impact the future of POS exception reporting. A

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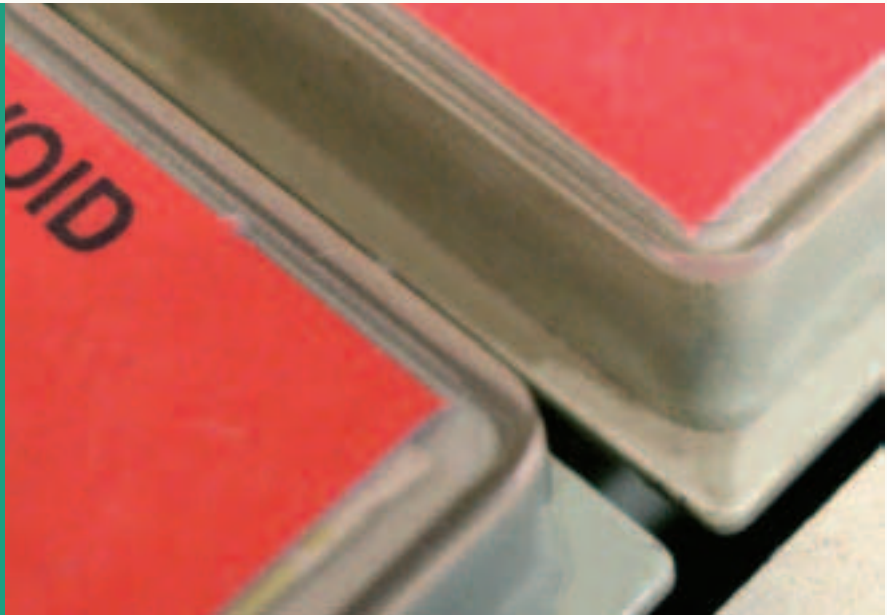
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recent study conducted by IBM and Microsoft shows that software utilization in the retail industry regardless of functional area was below 20 percent. This is causing many CIOs to look at new business models for utilization of software. Instead of paying an annual license fees, many organizations are now looking for “pay by utilization” models where they pay only for those features they use.

As a result, David Guttadauro, CEO of Security Source, says, “Loss prevention executives will need to look at the level of utilization they are able to get from their exception reporting applications. We are finding that most retailers are using five to ten standard reports, and only digging deeper into the data when there is an issue being investigated.”

Guttadauro adds, “In light of this, many CIOs are advocating that their LP departments purchase only what they are going to use, so we have

repositioned our software, VeriTraks, to allow a customer to do just that. Providing them with exactly what they are going to use, and charging them for usage only.”

Another interesting concept that might evolve in the upcoming years is the development of dialogue between the exception reporting system and the cashier who is actually creating the exception. Triversity’s Chan explains the possibility by comparing it to what organizations are doing with CRM (Customer Relationship Management).

“Companies are spending vast amounts of money on systems that will assist them in communicating directly with customers in a manner that is specific to that individual customer,” says Chan. This can even include allowing the customer to access certain data about their relationship with a company. “What would keep POS exception reporting systems from doing the same?” he asks.

“Imagine a system that actually communicates to the cashier in real-time when they are conducting a transaction,” Chan explains. “If it is simple cashier carelessness, the communication will focus them on the correct procedure. If it is a training issue, the system could walk them through the correct process. And, if it is a theft issue, wouldn’t this real-time communication have a chilling effect?”

If not real-time, still other possibilities are intriguing. Perhaps it is a message printed on the associate’s paycheck that is specific to their activity. Maybe it is an email to the associate highlighting their performance...good or bad.

With the current and future benefits of POS exception reporting systems, it is no wonder that the loss prevention industry is abuzz on this topic. ■



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