

Economic crime: people, culture & controls

The 4th biennial Global Economic Crime Survey
Retail and Consumer industry supplement



The retail and consumer industry is one of the sectors hardest hit by economic crime, with respondents reporting many more incidents than in other industries. In the retail sector, companies face a two-fold threat, from ‘shrinkage’ — theft of goods by both customers and employees — on the one side, to the broad spectrum of economic crimes such as accounting fraud, corruption and bribery, and intellectual property (IP) infringement on the other. The huge cost of shrinkage is no secret within this industry — one source estimated global shrinkage for 2007 at nearly US\$100 billion¹.

Counterfeiting in the retail and consumer industry is also a growing and expensive problem. It is estimated that international trade in illegitimate goods may have reached US\$200 billion annually in 2005 — and if domestically produced goods were included, the statistic would likely be substantially higher². In response to this emerging issue, US federal criminal statutes (e.g. Stop Counterfeiting in Manufactured Goods Act, 2007) and other pending US legislative initiatives have increased awareness of the problem and placed a greater emphasis on criminal, rather than civil, enforcement.

And while the direct financial costs of both shrinkage and other types of economic crime are substantial, the potential indirect impact to one of retail and consumer companies’ most valued assets — their reputation and brand — has even more

far-reaching negative consequences. Economic crime consists of more than just stealing goods — substituting inferior materials or knowingly failing to meet quality standards can be just as damaging. Consumer goods companies forced to recall products due to quality or safety issues have learned this lesson all too well. Similarly, IP infringement such as counterfeiting goods is becoming increasingly prevalent, and has serious repercussions on the long-term value of the brand.

In this retail and consumer industry supplement to *Economic crime: people, culture & controls: The 4th biennial Global Economic Crime Survey*³ we examine data from 371 retail and consumer companies in 39 countries and compare and contrast their views with those of executives across all industries. This special report highlights the importance of improved controls for fraud prevention and detection to retail and consumer industry executives, stimulate discussion, and assist in developing improved measures to combat economic crime.

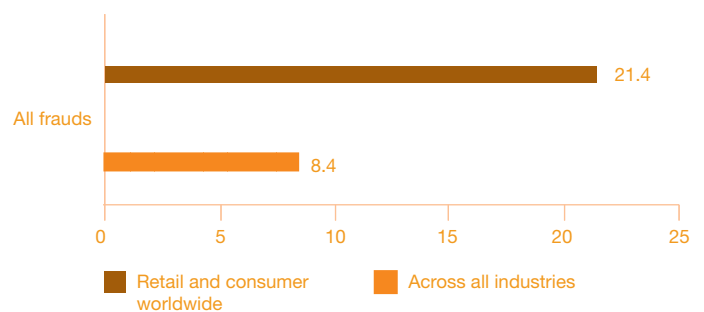
The prevalence and types of frauds

Economic crime is a serious problem in the retail and consumer industry. Nearly three-fifths (57%) of respondents reported that their company had been the victim of economic crime, compared to 43% of

respondents across all industries combined. The level of economic crime in North American retail and consumer companies was even higher at 62%. A look at the number of incidents of economic crime shows an even bleaker picture — retail and consumer companies reported nearly three times as many incidents per company as did respondents across all industries (retail and consumer mean: 21.4, versus 8.4 across all industries, see figure 1). However, these numbers do not reflect the full impact of shrinkage on retail and consumer organizations, since most losses due to shrink are not reportable “incidents.” All in all, the situation for retail and consumer companies is extremely serious.

While concerning, the higher rate of incidence within this sector may actually reflect a more developed control environment; once you start looking for fraud, you are more apt to find it. Despite having higher overall levels of control systems, retail and consumer companies reported slightly fewer types of preventive measures, including compliance programs (50% versus global all industries: 61%), ethical guidelines (74% versus 79%), and also anti-corruption programs (26% versus 32%). Further, the preventative control measures in place are often driven by legal regulations, rather than by a comprehensive approach at combating fraud.

1 Mean number of incidents of economic crime reported in the retail and consumer industry compared to all industries



1 Bamfield, J. (2007) *Global Retail Theft Barometer*, Nottingham: Centre for Retail Research
2 (2007) *The economic impact of counterfeiting and piracy: Part IV, Executive Summary*. Organisation for Economic Co-operation and Development (OECD)
3 *Economic crime: people, culture & controls: The 4th biennial Global Economic Crime Survey* is available for download at www.pwc.com/ca/crimesurvey
The global survey is based on interviews with executives responsible for detecting economic fraud in 5428 companies in 40 countries

Asset misappropriation stands out as the most pressing problem for retail and consumer companies. While this is the most common type of economic crime experienced in most sectors, the problem is particularly acute for retail and consumer companies, with 43% of respondents reporting cases, compared to 30% of respondents across all industries (see figure 2). Again, the situation was particularly dramatic in North America with 55% of respondents suffering from this type of economic crime.

In the retail sector, asset misappropriation losses are measured by shrinkage — theft of product in transit or at the point of sale, either by staff or by customers. As noted, shrinkage costs for the global retail community are enormous and many retailers are employing a number of well-established strategies for reducing this type of economic crime, including the use of CCTV, security tagging, RFID, and EPOS data mining. Strategic merchandising strategies — by making goods with high shrink rates less accessible to thieves — are also being used to deter crime. Many companies are also beginning to look further back in their supply chain to obtain a broader view of shrinkage. Stock file reviews, write-off volumes, carrier compliance audits, and vendor compliance agreements are some of the measures that are being employed to control shrink.

Other significant types of asset misappropriation include cash skimming — employee theft of cash through various schemes, including sales transactions, fictitious returns, or customer payments on accounts and accompanying account writeoffs. Cashiers at the point of sale can collude with criminals posing as customers, by failing to scan in all the items being taken from the store.

With the advancement of technology (i.e. advanced colour printing and imaging), the ability to create fictitious receipts, bar-coded merchandise tags and replica product packaging gives fraudsters highly advanced tools to commit return fraud — putting retailers at even greater risk.

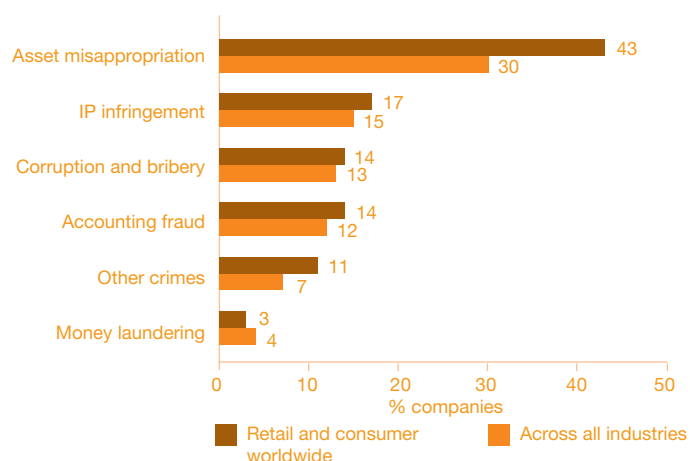
Sales and marketing fraud is another important area. This type of asset misappropriation refers to incidents where company sales and marketing personnel collude with customers to share rebates, promotions and discounts for personal benefit.

The Internet is becoming an increasingly important channel for retailers — and an increasingly lucrative avenue for enterprising fraudsters. The potential for economic crime in the e-tailing space includes dramatically increased rates of credit card fraud, as well as the risk of the

theft and inappropriate use of confidential customer information. Credit card fraud costs significantly less per incident, but numerous small thefts can add up to large numbers. It is currently being combated by techniques such as real-time verification of addresses from other public sources. Identity theft has far greater potential negative repercussions, both in terms of direct liability and damage to the brand. Initiatives such as the Payment Card Industry (PCI) Data Security Standard represent established protocols to mitigate these types of risks as much as possible.

The Internet is also providing lucrative opportunities for schemes which infringe upon IP, as the sale of counterfeit goods is often easier through Internet channels. IP infringement was the second most prevalent type of economic crime reported by retail and consumer survey respondents, with 17% of companies suffering from this type of fraud — primarily in the form of consumer goods counterfeiting. Counterfeit goods may pose serious safety hazards, for example over-the-counter medications produced to insufficient purity standards, and electrical goods which purport to be laboratory certified, but actually pose safety hazards. Further, profits from counterfeiting may support other types of criminal activities, such as organized crime or terrorism. Although retail and consumer

2 Percentage of companies surveyed reporting different types of economic crime



goods companies may not have produced faulty products, or sold them knowingly, their brands are nonetheless at risk.

Fourteen percent of respondents also reported incidents of accounting fraud over the past two years, a figure roughly in line with the trend across all industries (12%). In the retail and consumer sector, revenue recognition schemes such as trade loading/channel stuffing practices to boost sales at or close to the end of the period, and bill-and-hold transactions, where legitimate sales orders are received, processed, and readied for shipping, even though the customer is not ready, willing or able to accept delivery of the product at that time, are common. We provide more extensive information on how to identify, audit, and reduce risks of these types of economic crime in our report *A Deeper Dive: Protecting retail and consumer companies against fraud and misconduct at the business process level*, available for download at www.pwc.com/ca/retail-deeper.

The financial and collateral damage

Retail and consumer companies that are already taking measures to control their shrinkage losses may think this constitutes an adequate investment in

fighting economic crime, however other types of incidents can generate substantial costs, both direct and indirect. Our survey results highlighted cases of accounting fraud as particularly costly for the retail and consumer industry, to a greater extent than across all industries.

Further, economic crime costs substantially more than the losses directly generated by the crime. Companies also need to consider the costs of managing incidents. In terms of the concrete cost of managing economic crime, retail and consumer companies in North America reported higher expenses than did their peers in other regions, with particularly higher managing costs for corruption and bribery cases and other crimes.

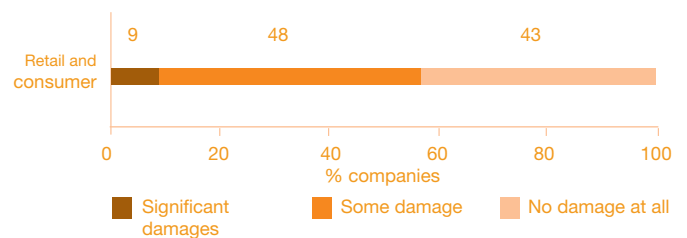
Perhaps even more potentially damaging than direct financial losses, are the types of losses which are difficult to quantify. Collateral damage can include damage to a company's brand or to its position with regulators. Staff morale may be impacted, with a resultant drop in productivity. Negative publicity from fraud can also affect a company's share price. Retail and consumer companies are built on the perceived market value of their brands and products — damage to these can therefore have far-reaching impacts within the market and the company impacted.

Survey responses indicated that retail and consumer companies are well aware of the collateral damage from economic crime. More than half of companies in the retail and consumer industry worldwide who detailed serious incidents of economic crime reported having suffered collateral damage from such incidents (57% versus all industries: 54%), and 9% reported having severe damage to the intangible elements of their organization (see figure 3). As was also true for most other industries, the most frequently cited intangible damages were 'significant management time distracted', 'significant financial/time expense involved in litigation', and 'decline of working morale' followed to a lesser extent by 'damage to company reputation' and 'impairment of business relations'.

The emerging markets

Global retail and consumer companies are continuously looking to emerging markets, both as a source of lower cost goods and as a key sourcing market that will become increasingly important as consumers in these regions gain more buying power. Of specific concern, are the emerging markets of the E7 (Brazil, China, India, Indonesia, Mexico, Russia, Turkey) — nearly three-fifths of retail and consumer companies (57%) report victimization in this region — a figure higher than that of

3 Estimates of the impact of intangible damage of the most serious incidents of economic crime



other industries, but in line with retail and consumer results globally.

IP infringement stands out as a particular problem in these emerging markets, with more than a quarter of respondents (26%) reporting incidents in the E7, compared to 17% of retail and consumer companies worldwide. Many consumer goods manufacturers have shifted large portions of their production activities to areas with low labour costs such as China. These types of moves, while they may be necessary to maintain competitiveness, also increase the risk of counterfeiting at remote production facilities.

Further, companies need to be sensitive to possible ethical issues at suppliers. A number of retailers have banded together to form the Supplier Ethical Data Exchange (SEDEX), an organization designed to help members share information on the ethical performance of their supply chains. These practices are not only good sustainable business practices, they help to ensure that suppliers are not violating any local laws, such as those banning the use of child labour.

The emerging markets are also the site of the majority of foreign offenders. Retail and consumer companies, like their peers in other industries, reported a large proportion of cases including offenders external to

the company, with 72% of the companies reporting at least one case. A quarter of these external offenders came from overseas they were most commonly involved in money laundering (54%), IP infringement (34%), and corruption and bribery (31%) offences. When foreign offenders were involved, they notably came most frequently from China (38%), Central & Eastern Europe (24%), and Russia (23%) in this industry.

Detection

A closer look at the primary methods of detection of the most serious incidents of economic crime reported by respondents in the retail and consumer industry reveals that a substantial number of these incidents (38%) are detected through chance mechanisms. Internal or external tip-offs, or accidental reviews uncover important facts pointing to the incidents – a finding consistent with results across all industries (see figure 4). It is important to note that the focus of this portion of our survey, is on most serious incidents precluding routine low-level shrinkage; detection of shrinkage would likely reflect a much higher rate of detection by means such as corporate security.

Internal audit measures detected another 20%, and whistle-blowing systems detected 10%. In North America, corporate

security measures proved to be effective as well, with 15% of crimes detected in this fashion, versus just 4% across all industries globally and 6% of retail and consumer companies across all regions.

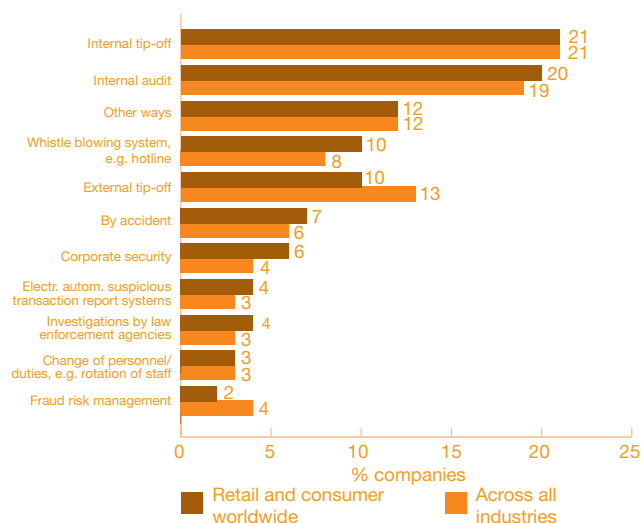
Reporting, investigations, and recovery of lost assets

Discovering fraud is only the first step. Companies also need to decide how to deal with the perpetrator and attempt to recover lost assets.

Upon the discovery of fraud, the most common response of retail and consumer organizations was to inform their boards of executive management, although they were somewhat less likely to do so than their peers in other sectors (74% versus 82% across all industries). The main burden of investigation into the offence was borne by internal departments. Nonetheless, respondents from the retail and consumer industry were more likely to report cases to law enforcement – 71% called in law enforcement officers, substantially more than peers in other industries (60% across all industries).

Retail and consumer respondents were also more likely to have pressed criminal charges against perpetrators of economic crime, with more than two-thirds of cases reported to the police (67% versus 50%

4 Top methods of detection of most serious incidents of economic crime



Note: categories with response rates of less than 2% have been omitted.

across all industries). The strongest reaction came from North American and Western European companies: 71% and 82% respectively reported offences to the police. Very few losses were recovered through insurance providers, however those companies which instigated court proceedings had a strong rate of recovery (73% versus global all industries 62%). This result is not surprising, as a substantial amount of asset misappropriation in the retail and consumer goods industry consists of fairly straightforward theft, a type of economic crime which is easier to prosecute than more complex fraud schemes.

Although slightly fewer retail and consumer respondents reported that their company's response was to do nothing compared to their peers across all industries, 14% still took no action following a serious incident of economic crime (versus 17% across all industries). We see this trend as meriting serious concern. Companies who do not respond rigorously to incidents of fraud run the risk of encouraging future fraudsters and increasing their future exposure to economic crime.

Management awareness

Like their peers in other industries, respondents in the retail and consumer industry tended to be optimistic regarding future economic crime. Although 57% of

respondents reported that their company had been the victim of economic crime in the last two years, only 14% expect that their company will be subjected to economic crime in the next two years (see figure 5).

So what are companies doing? Around 36% have strengthened existing control measures — strongly driven by pressures to comply with the Sarbanes-Oxley Act. Nearly half (49%) of North American companies reported having strengthened their control measures in recent years, and of those North American companies listed on a US stock exchange, a staggering 100% named the Sarbanes-Oxley Act as their motivation for doing so. In contrast, only around a quarter (27%) of companies in Western Europe have improved control measures recently.

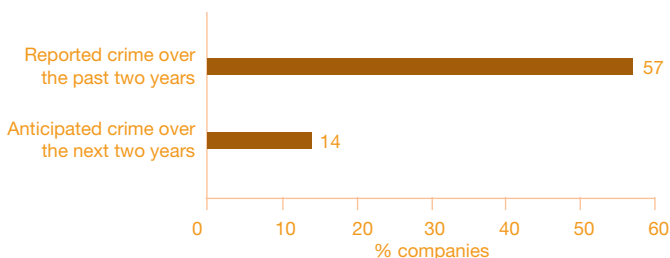
Issues such as counterfeiting need to be addressed not only by individual businesses, but by the industry as a whole. Various sub-sectors of the retail and consumer industry are banding together to make the consumer aware of the negative consequences of counterfeit goods — funding organized crime and terrorist organizations, unsafe and unhealthy consumer products, etc. Some sectors are enlisting consumer enforcement, such as setting up hotlines for customers to report potential counterfeit products.

The driver of fraud/fraud's perpetrator

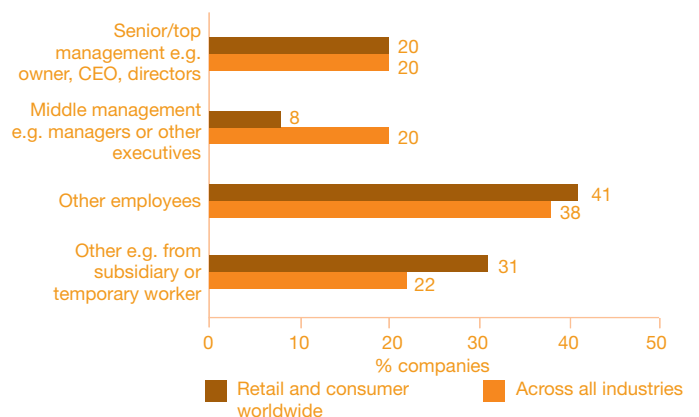
Just under half of those committing serious incidents of economic crime in the retail and consumer sector came from within the company, slightly less than the rate across all industries (46% versus 50% across all industries). Internal perpetrators of serious incidents were most likely to be either very senior, or junior/temporary employees (see figure 6). A substantial 20% of perpetrators came from the ranks of top/senior management, the same as the rate across all industries. This trend is cause for concern, as our global survey results indicate that fraud by senior managers is much more likely to negatively impact staff morale, particularly when top-ranking perpetrators are perceived to have been let off lightly.

A large proportion of offenders also came from workers at subsidiaries or temporary workers — 31%, compared to 22% across all industries. This result probably reflects the fact that the retail sector relies upon large numbers of temporary staff on evenings and weekends, as well as during peak periods such as the pre-Christmas season, when very busy stores may enhance opportunities for merchandise theft. More importantly, temporary stocking clerks or cashiers have access to goods to a far greater extent than in most other industries.

5 Retail and consumer executives' perception vs reality: Actual and anticipated levels of economic crime



6 Level of perpetrator of most serious incidents of economic crime



Middle managers in the retail and consumer industry are less likely to commit fraud — only 8% of economic crime was perpetrated by middle management, compared to 20% across all industries. Middle management in the retail sector may be less involved at the point of transaction than lower level staff and therefore have less opportunity to commit some types of economic crime such as asset misappropriation.

The demographics of the retail sector, which includes a large number of women and a younger employee base, were also visible in the profile of offenders of serious incidents of economic crime. These were more frequently less than 30 years old (42% versus global all industries: 21%) and had been employed by the company for a somewhat shorter average time worldwide (5-7 years), with the exception of North America (9 years). In comparison to other industries, offenders in the retail and consumer sector were also less well educated, and the proportion of men was less dominant (71%; across all industries: 85%).

Overall, individual causes of fraud were ranked more highly than corporate causes; the most frequently cited corporate causes included 'insufficient internal controls' or 'low commitment to the company', as was the case across industries. North American retail and consumer companies named individual causes with

an above-average frequency (e.g. denial of consequences, lacking awareness of values and wrongdoing), whereas in Western Europe, they reported 'expensive lifestyle' notably frequently.

Combating the fraud triangle

In our report *A Deeper Dive*, we looked at the fraud triangle. The three conditions fraud experts say are always present whenever fraud occurs:

- 1) Opportunity
- 2) Incentives or pressures
- 3) Justifications to commit fraud or rationalization

Addressing any one of these three areas can have significant benefits. Opportunity for fraud can be combated particularly well at the business process level, as we describe in detail in *A Deeper Dive*. Preventive systems such as ethical guidelines and anti-corruption programs⁴ can help combat the rationalizations perpetrators use to commit fraud. Attacking opportunity areas and offender justifications is an excellent start, however, retail and consumer companies also need to be aware of how increased pressures and incentives to commit fraud contribute to the structure of economic crime — a factor that will contribute significantly to the crime outlook for the industry.

Outlook and concluding thoughts

Retail and consumer companies are facing a number of challenges. Many consumer goods companies are managing rising input and skyrocketing fuel costs, while at the same time they are under pressure to hold down sales price increases to consumers. Retailers and consumer goods companies also need to respond to rising consumer demand for healthier and more sustainable products. These factors place further pressure on retail and consumer companies including their employees, and business partners within the supply chain — who may be faced with greater incentives to commit economic crime. At the store level, retailers looking to keep a tight control on salaries need to avoid increasing the incentive for employees to steal.

The industry is currently in the midst of a period of intense change. Companies are looking across the globe in order to focus on growth markets, placing an ever growing emphasis on electronic retail channels, and relocating production locations. One way that companies are looking to increase their presence in growth markets is via greater levels of product licensing, however risks exist that licensees may not employ the controls necessary to adequately control economic crimes such as counterfeiting. Retailers who are shifting sales to e-channels need to take measures

57% of retail and consumer companies have been the victim of economic crime in the last two years.

⁴ For more information on the efficacy and business case for anti-corruption programs, see our report, *Confronting corruption*^{*}, available for download at www.pwc.com/ca/confrontingcorruption.

to fight the new types of opportunities for economic crime these channels pose. Consumer goods companies sourcing in emerging markets need to monitor suppliers rigorously to prevent counterfeiting and catch other types of fraud such as the substitution of lower quality materials. More generally, significant corporate changes are known to increase the risk of economic crime, management should be aware — actions made to increase competitiveness also increases the risks of economic crime.

Companies need to correlate their market expansion strategies with the potential increased risk of economic crime. Retailers and consumer goods companies should shift away from a narrow focus on shrinkage and utilize a company-wide approach on monitoring, detection, and investigation. The expanded view will provide them with a better vision of the overall economic crime risks and enable appropriate management of such risks.

Who to call

Ian Booler
Retail and Consumer
514 205 5383
ian.booler@ca.pwc.com

Lino Casalino
Advisory Retail and Consumer Leader
416 815 5263
lino.casalino@ca.pwc.com

Steven Henderson
Investigations & Forensic Services
416 941 8328
steven.p.henderson@ca.pwc.com

Chris Kong
National Retail and Consumer Leader
416 869 8739
christopher.p.kong@ca.pwc.com

Sarah MacGregor
Investigations & Forensic Services
416 814 5763
sarah.e.macgregor@ca.pwc.com

Ross Sinclair
Assurance Retail and Consumer Leader
416 228 4000
ross.sinclair@ca.pwc.com