WHITE PAPER

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Return Risk and Abuse: How to Protect Profits

The top 1% of consumers making the most returns in any channel are draining $25+ billion annually from US retailers' coffers and costing them an average of $5.90 per $100 in returns[1]. Ecommerce and omnichannel returns skew higher. Executives and employees recognize their dilemma, but they have needed a means to address the problem directly while still providing an outstanding consumer experience to the other 99% of consumers.

Approximately 6–10% of all returns in the US are transacted dishonestly, a staggering proportion. Discovering that these returns occur under their current return policies, many retailers seek new profit protection tactics. What some find is that new, consumer-based return authorization systems help them to distinguish and deter these consumers before they have the opportunity to initiate a risky or abusive return.

Return Fraud and Abuse Schemes

Although fraudulent and abusive return procedures are myriad, some schemes are more commonly used than others. Understanding these schemes, despite their ever-evolving nature, is the first step toward choosing the best defense.

RECEIPT MANIPULATION

Some consumers forge ecommerce or store receipts using computers and color printers. Sophisticated practitioners may obtain the retailer's paper stock from store contacts or paper suppliers to enhance the appearance of the counterfeit receipt. Others simply find receipts in store trash receptacles, shopping carts, or discarded shopping bags. Internet-savvy individuals may visit questionable web sites that purchase or re-create legitimate receipts and sell them to criminals who need a receipt for a particular item.

Regardless of how the receipt is acquired, it can be used for a type of loss scheme called shoplisting because it works much like a shopping list. The consumer enters a store with the receipt in hand and proceeds with one of two scenarios: 1) Pick up the items(s) listed on the paper and head to the returns counter, or 2) shoplift the items(s) and come back at another time to conduct the loss-inducing return.

Shoplisting enables the consumer to eliminate the middleman, someone who will buy the stolen merchandise. Instead, this consumer essentially sells the product back to its owner, the retailer. This method bestows the aura of innocence through some quick computer work and a daylight trip to the store.

PRICE ARBITRAGE

Consumers with working capital can engage in several types of price manipulation. One example occurs when a consumer purchases two similar items with different retail prices and potentially in different channels. By repackaging the cheaper item in the expensive item's box and returning it for a full refund, the consumer has basically stolen the better item. This is particularly effective with electronics because cheap units often resemble expensive ones. Subsequently selling the more expensive item online, even at a discount, adds revenue to the consumer's pocketbook.

Return Risk and Abuse Schemes

- Receipt manipulation
- Price arbitrage
- Wardrobing/renting
- Check loss
- Returning stolen merchandise
- Employee collusion

Other forms of price arbitrage include switching boxes in the store to purchase a higher-priced item for less or purchasing an item at a discount and returning it for a full price refund. Regardless of the consumer's approach, the retailer pays the difference.

One magazine article describes a price arbitrage scheme thought to be committed by one group at a big box chain that cost a retailer $400,000[2]. The group attached homemade bar codes for inexpensive products and attached them to more valuable products when purchasing items. Then the group removed the phony bar code and returned the item to obtain the full price as store credit, cash, or a gift card.

RENTING/WARDROBING

Renting/wardrobing begins with a legitimate merchandise purchase. The item is then used once or twice and returned as new. The classic example is the purchase of an expensive cocktail dress for Instagram photos or a special event. The consumer simply tucks the tags into the garment in an inconspicuous manner, dazzles everyone with her finery, and then returns the dress for a full refund the following day, in essence having "rented" it for free. This technique has spread to other valuable merchandise. When consumers buy durable goods, such as a ceramic tile cutter to finish home improvement project or a trendy watch to accessorize a job interview suit, and then return the items after using them, they are violating a retailer's traditional return policies. Unfortunately, the widespread notion that this is an acceptable behavior has only exacerbated its effects.

ILLEGITIMATE CHECKS

Consumers who practice theft for a living are drawn to the world of bank accounts, preferably a false one—or perhaps yours. They purchase merchandise with an illegitimate check or with one backed by insufficient funds and then return the merchandise before the check clears the bank. Here the retailer is simply handing over its profits to the unscrupulous among us.

RETURNING STOLEN MERCHANDISE

Profiting from stolen merchandise has many faces. Some may steal merchandise themselves or buy it directly from someone who has stolen it already. Then they return it to the store for a full cash refund, either with a forged, found, or purchased receipt or without a receipt at all, depending on the store's return policy. More complex forms of this scenario entail stealing entire truckloads of merchandise and distributing them to accomplices who return the items to different retail outlets in a large geographic area. In essence, the store is buying the merchandise twice, first from the manufacturer and then from the "resellers."

A Washington Post article detailed a scheme in which shoplifters returned merchandise without a receipt, obtained store credit, and sold the store credit online for 76% of face value.

EMPLOYEE COLLUSION AND LOSS

Acting alone or in collusion, employees are uniquely positioned to cause significant financial damage in a relatively short period. Some employees act as facilitators, leaving back doors open or making loading docks accessible; some provide sales receipt paper stock; some actually execute the return transaction for their co-conspirators. The insidious nature of employee fraud can be debilitating if left unchecked.

Many Fronts of Return Loss and Abuse

The table below (Fig. 1) illustrates the NRF survey estimates of the frequency of various types of return loss and abuse from the 2020 Consumer Returns in the Retail Industry report.

Renting/wardrobing impacts retailers' profit margins. But each fraudulent or abusive return, regardless of its form, contributes to the substantial losses retailers sustain annually. The widespread nature of return loss and abuse reinforces the need for a focused defense strategy.

Fig. 1 – Example Return Fraud Retailers Experienced in the Past Year[1]

Response	Average
Returning Stolen Merchandise	54.8%
Employee Fraud/Collusion	37.1%
Renting/Wardrobing	33.9%
Receipt Fraud	22.6%
Returns Using E-Receipts	19.4%
Returns by ORC Groups	17.7%
Other/Unknown	6.5%

Traditional Return Policy vs. Consumer-Based Systems

Most traditional return policies do not consider who is making a return. Simple facts, such as the presence of a receipt, the age of the receipt, and the word of the consumer that the product is unused, are sufficient for a return. Some of the more advanced traditional systems check the validity of the receipt by using receipt reconciliation. Verifying the authenticity of the receipt, however, only reduces the problem of receipt forgery, which is estimated to be a smaller fraction of all return loss and abuse. Unfortunately, traditional systems do little or nothing to stop the loss and abuse schemes described in this white paper, hence, the emergence of consumer-based systems.

A consumer-based system tracks each consumer's behavior and identifies aberrant patterns to flag likely loss and abuse. Fraudulent and abusive returners make many returns, and the system detects them before they cause too much damage. This system typically helps a retailer feel confident in extending a more liberal return policy to most consumers but use a more focused policy for consumers who appear to be the sources of problems.

Profitability Is Connected to Return Rate

Clearly, returns cause the retailer to lose the profit margin earned on the original sale. The monetary drain, however, does not end there. Additional losses accrue when you factor in the time employees spend processing returns, evaluating the item's resale potential, and restocking the returns. When an item must be discounted or, even worse, discarded after a return, it further compounds the company's losses. Then, of course, there are the administrative expenses of accounting for returns and managing the entire return system. For mass merchandisers and nationwide chains, the industry-wide costs can reach hundreds of millions of dollars annually.

As a result of the aforementioned expenses, our experience indicates that an individual consumer with a long-term pattern of return rates greater than 20–30% negatively affects operating profit. The following tables (Fig. 2 and 3) illustrate our computation of these losses at four return rate levels when assuming a 40% gross margin and a $100 item retail price for 20 items.

Fig. 2 – Profit/Loss Calculations for Original Sale (without Returns)

Gross Sales	Gross Profit/(Loss) on Original Sale	Operating Expenses to Make Original Sale	Operating Profit/(Loss) on Sale
$2,000	$800	($550)	$250

Fig. 3 – Profit/Loss Calculations for Returns

Return Rate	Net Sales (After Returns)	Adjustment to Gross Profit/(Loss) (After Returns)	Additional Operating Expenses Incurred from Returns*	Contribution to Operating Profit/(Loss) After Returns Considered
100%	$0	($800)	($450)	($1,000)
50%	$1,000	($400)	($225)	($375)
20%	$1,600	($160)	($90)	$0
0%	$2,000	$0	$0	$250

*Expenses to process returns include sales staff time, markdowns, damaged goods, back office expenses, and other operating expenses related to processing returns.

Even at a 20% return rate, the retailer sees zero operating profit. In addition, as a retailer's gross margins fall, the break-even return rate also falls. The obvious implication is that profitability is directly connected to return rate.

Countering Return Loss

Return policies once were a point of differentiation—Nordstrom would take back any item at any time in any condition while a mom-and-pop operation said all sales were final—but with return loss and abuse reaching 5–10% of returned merchandise dollars, return policies need to be scrutinized. Curbing return loss can be critical to cutting expenses and improving net sales and the bottom line. The question is no longer *if*, but *how*.

The responsibility of managing the return policy for a retailer may not always be clearly defined. Different teams within the organization, each having separate goals, may share part of the responsibility. Centralizing the return authorization function within a consumer-based system, however, can assist in organizing the management of a return policy. Such a system can assist in quick ad-hoc analyses of the impact of any proposed changes on the consumer.

Computer technology can track consumer return behavior, using objective criteria. Working from a centralized location to recommend that returns be denied to systematic fraudsters is possible. For example, Appriss Retail uses a consumer ID or an identifying number from the original purchase receipt to help individual retailers collect information on the consumers within their own database.

When allowed by law, a retailer can also stop depending on a store associate to manually enter information, thus avoiding human error. Using the data collected, statistical loss detection models are developed to identify common patterns of loss and abuse. The models are consistently applied to every consumer, which helps to eliminate the variables of sales staff subjectivity and potential discrimination. Retailers can focus on specific outlier consumers to stop the financial drain.

When reviewing the common return loss and abuse schemes, most retailers discover that their current return policies do nothing to prevent them. For example, a consumer who purchases clothes every Sunday and returns them the following Sunday every week for a year is not violating most return policies. Retailers who wish to prevent this behavior must focus on the consumer's return patterns, i.e., pinpointing the consumer within the retailer's database to prevent what seems to be an abuive return transaction.

ALLAYING CONCERNS ABOUT A CONSUMER-FOCUSED STRATEGY

Management may voice concerns about replacing a traditional return policy with a consumer-level return authorization system. They may argue that tracking individual consumers within their own database, rather than using blanket return procedures, may drive consumers away. However, our research shows that approximately 75% of all shoppers never return purchases. Of the remaining 25% that do return items, only 1–2% behave in ways that appear to be risky or abusive. An effective return authorization system recommends denials of returns to only the outliers. The other 98–99% of consumers are unaffected. In contrast, most traditional return policies can adversely affect up to 15% of all return consumers.

The final question retailers pose is: "What happens to a consumer's shopping behavior following a retailer's denial?" Using a controlled, aggregated, and anonymized sample that analyzed shopping patterns before and after a retailer's denial on the same consumers, we found two significant facts:

1. The shopping patterns of 35-40% of consumers who experience a return denial are not affected afterward.

2. Within 60 days of a denial, on average, net sales for all denied consumers resume their pre-denial levels.

Ten Signals of Return Loss

RETURN POLICIES ARE AFFECTING YOUR COMPETITIVE POSITION IF YOUR . . .

1. Return rate is above the average return rate for your direct competitors.
2. Shrink rate is larger than the average shrink rate for your direct competitors.
3. Return rate has increased in two of the last three years.
4. Return policies are based on subjective intuition and do not measure the impact on consumers.
5. Return policies are arbitrary with respect to a consumer's loyalty or profitability.
6. Return policy has not been reviewed in the last 12 months.
7. Return policy has not changed significantly in the last three years.
8. Return policies are not enforced uniformly throughout the stores.
9. Average markdown rates following a return are increasing.
10. Percentage of returned merchandise you are able to resell has declined.

Thus, while denying a consumer may generate some short-term effects, eventually the consumer converts into a more profitable consumer, which is the desired end result. Another concern involves the privacy of the consumer's data; retailers think consumers might be leery of handing over personal information to facilitate a return. Retailers can allay these fears by instituting a formal privacy policy and setting up a call center that allows consumers to obtain a copy of their activity report and to correct inaccuracies.

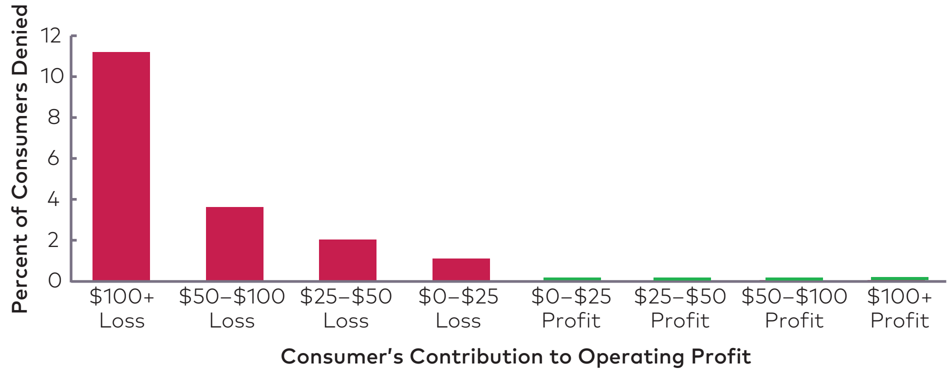
DETERRENCE

A consumer-based authorization system can also deter potentially fraudulent returners. Once return abusers realize that the retailer will not tolerate abusive or fraudulent return behavior, they will search for a softer target. In fact, return rates have dropped following installation of a prevention system but before the issuance of any denial recommendations. Would-be bad actors simply go elsewhere when they recognize that they cannot perpetrate loss-inducing schemes.

EFFICACY

The true test of a return authorization system is the number of unprofitable consumers it recommends be denied returns compared to the number of profitable consumers it recommends be allowed to make returns. The chart below (Fig. 4) illustrates a study of one large retailer (using anonymized data) following system implementation.

Fig. 4 – Denial Recommendation Rates by Profitability Group



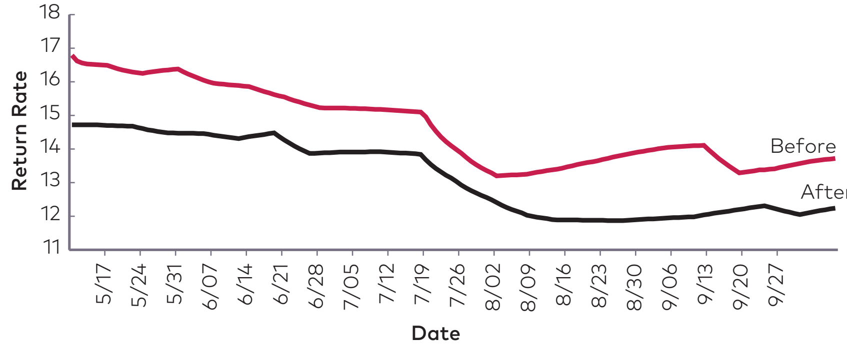
Note that as the consumer population approaches profitability for the retailer, there are fewer and fewer incidences of returns being recommended for denial, so that eventually only unprofitable consumers receive recommendations for denial of their abusive or potentially fraudulent returns. Reducing the number of unprofitable consumers leads to an improvement in a retailer's operating profits.

Benefits for Retailers and Consumers

Many retailers are moving toward a consumer-based return system as a way to dramatically improve their bottom line and improve performance. According to our internal studies, just a small improvement in the average retailer's return rate, e.g., falling from 10% to 9%, could mean an improvement in operating margins of between 4% and 6%. One retailer in particular demonstrated more than a 10% drop in return rates year-over-year using a consumer-based system (see Fig. 5).

APPRISS® RETAIL

Fig. 5 – Return Rate (Percent) Year-over-Year Comparison (Before and After Appriss® Verify)



Another study (using anonymized data) revealed a 15% reduction in shrink rates at a large retailer in the six months following implementation of our system. Arguably, few areas of retail diligence can bring such rapid financial improvement to the bottom line.

Return authorization provides additional benefits for retailers by allowing them to:

- Model consumer return behavior
- Change return policies according to the competitive environment
- Protect against fraudulent and abusive returns
- Deter employee-assisted inventory shrinkage
- Consistently apply operational procedures
- Utilize their data to make informed decisions

A fact-based return authorization system helps consumers as well as retailers. Consumers benefit from the objectivity of the system. They know the store's return policy is free from personal bias or preference. Furthermore, consumers enjoy more lenient return policies at retailers that target only fraudulent and abusive returns.

Strategy for the Future

Of course, management teams want to know the metrics derived from studies of a consumer-based return authorization system. They are:

- Decline in the return rate and total return dollars
- Increase in net sales and operating profit
- Decrease in inventory shrinkage

These metrics continue to show material, favorable movement in the battle against return loss. In short, a protection system makes it possible to deter return fraudsters who are shattering retailers' profit margins while supporting a pleasant and frictionless returns process for the other 98–99% of consumers.

This white paper originally appeared in the Texas A&M, Mays Business School, Center for Retailing Studies *Retailing Issues Letter,* volume 17, number 1. It is updated to reflect current statistics.

[1] National Retail Federation 2020 Returns Survey Oct-Nov 2020.

[2] https://losspreventionmedia.com/around-the-bay-area-orc-rings-have-raked-in-millions/

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