WHITE PAPER

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Calculating Your Real Return Rate
Miscalculations Impact Omnichannel Retailers Worldwide

Consumer behavior has changed dramatically as ecommerce has grown. The influx of returns this triggered has called attention to the need to recalculate the return rate to represent the true cost to the organization.

Many retailers are unaware of their real return and exchange rates because those rates are not identified in standard point-of-sale (POS), ecommerce, and retail enterprise resource planning (ERP) reporting systems, which tend to miss key components in identifying the true impact of merchandise returns on a retailer's business. Omnichannel processes like buy-online-return-in-store add complexity that can cause inaccuracies or hide what is really happening.

By correctly valuing their return and exchange rates, retailers can understand the impact returns have on profitability, and thereby improve their net sales, gross margins, and profits.

Knowing their real return rate, they can pursue their optimal return rate. This occurs when a retailer creates an environment that encourages consumers to purchase with confidence yet prevents problematic returns. This optimal level accepts all legitimate returns and strikes the right balance between a situation that permits too many returns that lead to net losses or fraud, and a situation that allows so few returns that it limits consumers' desire to make purchases, leading to lower revenue. The essential first step is to accurately calculate the return rate.

The Old Return Rate

Calculating return rates seems like straightforward math, but many commerce systems greatly oversimplify the formula as:

Pure Return Transactions ÷ Net Sales = Return Rate

The problem is, this formula often overlooks exchanges, and therefore understates the value and quantity of merchandise returning to the store from any channel. Items that get returned within exchange transactions are unexpectedly hidden, masking your opportunities to rescue sales, provide better consumer service, prevent loss, and more.

The Real Return Rate Includes Exchange Transactions

Today omnichannel retailers think of returns as merchandise that flows back into the brand and gross sales as merchandise that flows out of the brand. The outbound transactions are very different from the inbound, and the metrics you use should not obscure that fact by netting out the individual pieces, as often happens in exchange transactions.

Definitions

Purchase – This is a transaction that only includes purchased items and no items are returned or exchanged. The consumer will owe money to the store in this type of transaction.

Pure Return (Return) – This is a transaction that only includes returned items and no items are purchased or exchanged. The consumer will receive money back in this type of transaction.

Even Exchange – This is a trans action that includes returned items and purchased items that are exactly equal in value so that the total transaction amount is $0.00. No money will be exchanged in this type of transaction.

Negative Exchange – This is a transaction that includes returned items and purchased items where the dollar amount of the returned items exceeds the dollar amount of the purchased items. The consumer will receive money back in this type of transaction.

Positive Exchange – This is a trans action that includes returned items and purchased items where the dollar amount of the purchased items exceeds the dollar amount of the returned items. The consumer will owe money to the store in this type of transaction.

When our retailer customers measure return rate, they include the total dollars from pure returns and the total dollars from all returned items involved in exchange transactions (positive, negative, and even exchanges). If return rate is not calculated this way, a large portion of the merchandise returns are completely ignored. The logic behind this is pretty simple: Every item returned is added cost and lost revenue.

For example, under the old way, a retailer with 100% of its returns being exchange transactions would have a return rate of 0%! Instead, since it's clear that there is return activity in its stores, shouldn't a different formula be utilized to more accurately reflect reality? Please see a simplified calculation example below.

Example Calculations

SIMPLIFIED CALCULATION OF RETURN RATE						
Trans Type	Trans ID	Line Item	SKU	List Price	Discounts	Extended Amount
Purchase	00001	001	1234567	$29.99	$0.00	$29.99
		002	1234567	$33.33	$0.00	$33.33
		003	2345555	$59.99	$0.00	$55.99
		004	1111111	$24.99	–$10.00	$14.99
Positive exchange	00002	001	444444	–$29.99	$0.00	–$29.99
		002	555555	–$21.99	$3.00	–$18.99
		003	444444	$29.99	$0.00	$29.99
		004	555555	$21.99	$0.00	$21.99
Purchase	00003	001	1234567	$89.99	$0.00	$89.99
		002	2345555	$59.99	$0.00	$55.99
Positive exchange	00004	001	1111112	–$9.99	$1.99	–$8.00
		002	2222222	$12.99	$3.00	$15.99
		003	3333333	$19.99	$3.00	$22.99
		004	4444444	$29.99	$3.00	$32.99
Return	00005	001	9999999	–$19.99	$0.00	–$19.99
		002	8888888	–$7.99	$0.00	–$7.99

OLD RETURN RATE CALCULATION		
Total Pure Returns	–$27.98	← Total of only return transactions (exchanges excluded)
Net Sales	$319.27	← Net total of all transactions
Old Return Rate	8.76%	← Total Pure Returns divided by Net Sales

REAL RETURN RATE CALCULATION		
Total Returns	–$84.96	← Total of all negative extended amounts
Gross Sales	$404.23	← Total of all positive extended amounts
Net Sales	$319.27	← Total of all extended amounts (Gross Sales + Total Returns)
Real Return Rate	21.02%	← Total Returns divided by Gross Sales

This simplified example underscores the significant differences in return rate calculations, and how the real return rate provides a clearer snapshot of what is happening in your stores or online.

What Is Return Fraud?

A recent survey by the National Retail Federation found that return abuse and fraud costs retailers $25 billion annually. This includes "wardrobing" schemes in which people buy a product for the day and then return it the next, and "price arbitrage" schemes in which boxes or items within boxes are switched around so people can buy higher-end products for low-end prices. In some cases, people forge or steal receipts to "shoplist" (e.g. shoplifting to match specific items on a receipt) for goods and then "return" those items at the checkout for cash; or they might just bypass the receipts completely, steal the goods and "return" them without a receipt for a refund or exchange.

The Impact on Your Omnichannel Business

When this emergent approach of measuring returns as all merchandise that flows back into your brand is compared to previous calculations, most retailers see a return rate increase of 50% to 150%! By viewing returns in a broader light, you receive:

- More visibility into item return trends and patterns, creating better merchandise and consumer service intelligence.
- Greater understanding of consumer behavior, enhancing CRM analysis.
- Stronger ability to spot and prevent return loss, fraud, and abuse.
- Improved capability to reduce return rate and thereby keep more revenue (net sales) in your company.

Our retail customers see fraud and abuse issues in both exchange and return transactions; in fact, exchanges are very popular among suspected fraudsters since exchanges are often scrutinized less (under the old return rate method which presumed exchanges were "safer" transactions than returns). Since return loss can be perpetrated in many transactions, the loss prevention tools you use and the method by which you calculate return rate must account for exchanges, too. Appriss® Verify return authorization accounts for exchanges and helps you prevent fraud and abuse in merchandise returns of all types, keeping sales revenue from flowing out of your brand.

Example of the Hidden Cost of Returns

One footwear retailer, for example, realized that the company was losing 1% of sales each year to fraudulent and abusive merchandise returns. Executives saw an opportunity to improve overall profitability by tracking return transactions, reducing refund amounts, creating incremental revenue, and delivering a positive consumer experience during returns.

Think of it this way: A consumer brings back one pair of shoes that have been worn and are not defective, and the consumer demands a refund. The selling price of the pair of shoes was $100; the cost of the shoes was $60; the gross margin was $40; and the net profit was $10. The store must write off this pair of shoes. How many new pairs of shoes do you think that retailer will have to sell to make up for the loss on the write off of the return? The answer is 10. The revenue on 10 pairs would be $1,000, which would cover the cost of the shoes ($600) plus the lost margin of $400 and the operating expenses ($300) and yield the original 10% net profit.

The vast majority of all returns are initiated by good consumers who repeatedly shop at a given store or outlet. In fact, more than 75% of all shoppers never even return purchases. However, the remaining 25% of legitimate returns can be costly. Assuming a 40% gross margin and a $100 item retail price for 20 items, a retailer will achieve zero profit at a 20% return rate. The problem, for most retailers, is that their current accounting programs do not accurately reflect their real return rates.

The optimal return rate occurs when a retailer creates an environment that encourages consumers to purchase with confidence yet prevents problematic returns. This optimal level accepts all legitimate returns and strikes the right balance between a situation that permits too many returns that lead to net losses or fraud, and a situation that allows so few returns that it limits consumers' desire to make purchases, leading to lower revenue.

Analysis of Ten Major Retailers

Appriss Retail recently tallied up real return rates for 10 different omnichannel retailers (using aggregated and anonymized data). All retailers in the study were found to be underestimating their return rate— one by as much as 150%, with an average return rate discrepancy of more than 80% (see table below), resulting in additional costs of over $462 million to a retailer doing $10 billion in annual revenue. The problem was in using flawed math..

Anonymous Retailer	Real Return Rate Calculation	Old Return Rate Calculation	Difference
#1	7.2%	4.2%	69%
#2	15.3%	8.6%	79%
#3	8.1%	5.4%	49%
#4	13.2%	9.5%	39%
#5	6.8%	3.7%	85%
#6	4.5%	2.5%	79%
#7	9.4%	4.7%	100%
#8	19.9%	11.7%	71%
#9	8.2%	3.7%	118%
#10	9.3%	3.7%	149%

Using the old method of calculating return rates, retailers were excluding exchanges from their calculations. This method often understates the value and quantity of merchandise being returned. Using this old methodology, retailers mistakenly assume that exchanges show no impact on their business because no money changes hands and, on the surface, they have no apparent effect on net sales. In reality, every item returned represents an added cost and a loss of revenue. Exchanges cost money in restocking fees, in employee time, and in possible damage to goods. The new "real return rate" method of calculating return rates includes the dollar value impact from pure returns, as well as the total dollar value impact from all exchange transactions, whether they are positive exchanges, negative exchanges, or even exchanges. From an operational point of view, this makes much more sense because it more precisely quantifies the impact of all returns on the retailer's business.

Knowing Accurate Return Rate Leads to Better Consumer Experience

In short, while the effect of returns on retailer financial statements may seem negligible according to traditional methods, they are anything but insignificant. Failure to accurately account for returns using a consumer-based, operational perspective can have dramatic consequences in terms of the financial repercussions of underestimating costs and in terms of the marketing repercussions of failing to maintain or grow a loyal consumer base. To improve store performance, retailers need to have a clear picture their true profits and losses.

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