WHITE PAPER

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Return Rate Miscalculations Impact Retail Chains Nationwide

Calculating Your Real Return Rate

Today's business environment underscores the necessity of accurately monitoring finances and implementing programs that will give meaningful numbers in terms of actual operations as well as accounting documents. For example, even though retail sales fluctuate every year, whether those sales actually generate margin dollars and profits after discounts, promotions, returns and exchanges are taken into consideration remains to be seen. Many stores may never know their real return or exchange rates because those rates are not identified in standard point-of-sale (POS) and retail enterprise resource planning (ERP) reporting systems, which tend to miss key components in identifying the true dollar impact of merchandise returns on a retailer's business.

However, retailers in growing numbers are beginning to examine their return rates from an operational point of view in order to more accurately quantify the impact returns are having on their businesses. These retailers realize that by correctly calculating their return and exchange rates, they are better able to understand the impact returns have on profitability, and thereby improve their net sales, gross margins, and profits.

With knowledge of 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 POS and retail ERP reporting systems greatly oversimplify the formula.

The old method for calculating return rate is to add up all pure return transactions and divide that negative number into net sales. This formula often overlooks exchanges, and therefore understates the value and quantity of merchandise returning to the store. Items that get returned within exchange transactions are unexpectedly hidden, masking your opportunities to rescue sales, provide better customer service, prevent loss, and more.

The Real Return Rate Includes Exchange Transactions

Considering a bigger picture, more retailers today are thinking of returns as merchandise that flows back into the store and gross sales as merchandise that flows out of the store. 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 transaction 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 transaction 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 clients 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.

What Is Return Fraud?

A recent survey by the National Retail Federation found that return abuse and fraud costs retailers $17–22 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 Business

When this emergent approach of measuring returns as all merchandise that flows back into your store 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 customer service intelligence.
- Greater understanding of shopper behavior, enhancing CRM analysis.
- Stronger ability to spot and prevent return fraud and abuse.
- Improved capability to reduce return rate and thereby keep more revenue (net sales dollars) in-store.

Our retail clients see fraud and abuse issues in both exchange and return transactions; in fact, exchanges are very popular among fraudsters since exchanges are often scrutinized less (under the old return rate method which presumed exchanges were "safer" transactions than returns). Since return fraud can be perpetrated in many transactions, the fraud prevention tools you use and the method by which you calculate return rate must account for exchanges, too. Appriss Retail's Verify® return authorization and Receipt Verification™ solutions do account for exchanges and help prevent fraud and abuse in merchandise returns of all types, keeping sales dollars from flowing out of your store.

Example of the Hidden Cost of Returns

One footwear retailer, for example, realized that the company was losing one percent 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 positive customer service 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 shoes was $100 per pair; the cost of the shoes was $60 per pair; the gross margin was $40 per pair; and the net profit was $10 per pair. The store has to 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 (i.e. $600) plus the lost margin of $400 and the operating expenses (i.e. $300) and yield the original 10 percent net profit.

The vast majority of all returns are initiated by good consumers who repeatedly shop at a given store or outlet. In fact, over 75 percent of all shoppers never even return purchases. However, the remaining 25 percent of "good" returns can be costly. Assuming a 40 percent gross margin and a $100 item retail price for 20 items, a retailer will achieve zero profit at a 20 percent 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 retailers. Of the retail clients under study, all were found to be underestimating their return rate—one by as much as 150 percent, with an average return rate discrepancy of over 80 percent (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 Client	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 calculation. 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, however, 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 Decisions

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. In order to improve store performance, retailers need to have a clear picture their true profits and losses.

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