The impact of return policies on the profitability of online retailers

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Abstract:
This paper gives an overview of our Phd thesis which aims to contribute to the lack of empirical research in the area of customer returns. The purpose of our thesis is to investigate how different return policies impact the long term profitability of an e-commerce and the buying behavior of a customer. We will first introduce the subject of research and define the research problem and objective. Then, we will discuss the literature and the terminologies related to the subject of research. The end goal of our thesis is to help managers decide whether to adopt a flexible (lenient) return policy, or to segment customers and propose differentiated return policies, or to implement a different return policy for each category of products.

Key Words: Reverse logistics, customer returns, return policy, profitability, e-commerce

Résumé:
Cet article donne un aperçu de notre thèse de doctorat qui vise à contribuer au manque de recherche empirique dans le domaine des retours clients. L'objectif de notre thèse est d'étudier l'impact de différentes politiques de retour sur la rentabilité à long terme d'un commerce en ligne et sur le comportement d'achat d'un client. Nous allons introduire le sujet de la recherche en premier lieu et définir la problématique et l'objectif de la recherche par la suite. Ensuite, nous discuterons de la littérature et des terminologies liées au sujet de la recherche. L'objectif final de notre thèse est d'aider les managers à décider s'ils doivent adopter une politique de retour flexible (indulgente), ou segmenter les clients et proposer des politiques de retour différenciées, ou encore mettre en place une politique de retour différente pour chaque catégorie de produits.

Mot clés: Logistique inverse, retours clients, politique de retour, rentabilité, e-commerce.
INTRODUCTION

The high volume of products returned by customers represents a major logistical and financial challenge for online businesses (Wood 2001). Thanks to the law of return, many companies have developed a return policy allowing customers to return their purchased products within a specific period of time. In 2007, the electronics industry in the United States spent $13.8 billion on returned products, of which only 5% were defective (Ketzenberg, 2009). The percentage of customers who return one or more purchased items tripled between 2016 and 2017 in France (Dévalée, 2017). Reverse logistics is even more relevant in e-commerce since 24% of the products purchased on e-commerce sites are returned by customers generating 4% of the total logistics costs, or 35 to 42 billion dollars per year (FEVAD, 2018). Because of a lenient return policy, the business retailer Zalando suffers from a 50% return rate of their overall shipments. Returned products are the outcome of a commercial agreement or a legal obligation between the consumer and the retailer called the return policy.

From a consumers’ perspective, the return policy is considered as a criterion that facilitates their online purchases and influences their buying behavior. Reducing purchase risks and lowering transaction costs by providing return services to the consumer may increase customer value (Chircu et al. 2006). Another study demonstrates that retailers can increase customers’ confidence by realizing a series of successful transactions, which includes returns service (Hjort, 2016). Ketzenberg (2009) confirms that online consumers tend to make their buying decision based on the flexibility of the return policy and choose the one that allows delay of irreversible decisions. However, according to Ketzenberg (2009), implementing liberal policies result in consumers’ abuse. Woods (2001) highlights some cases of consumer abuse of return policies such as the return of TV sets after watching Super Bowl in the United states, the return of camcorders after a wedding, or the return of wardrobe after using them during special occasions.

On the other side, the return policy is considered by some companies as a necessary evil (Petersen and Kumar, 2009), by others as a weapon of battle and differentiation in a competitive market (Padmanabhan, 2004). The purpose of implementing a flexible return policy is to create marketing incentive to attract customers and gain their loyalty (Hjort, 2016). However, with a return rate exceeding 30% and a total market size in US online apparel retails of over $40 billion in 2013, one can conclude that the management of returns represents is a real logistical, financial and commercial challenge for online businesses (De Leew, 2016). According to Ketzenber (2009), managers face a real dilemma while setting a return policy that is adequate for their
business. The preceding discussion explicitly shows that consumers’ returns are no longer a small part of the business process and are worth investigating.

1. RESEARCH PROBLEM

Minimizing return rates by restricting return policies is obviously beneficial for an e-commerce; meanwhile, allowing return policies increase consumer satisfaction which leads to a potential increase in sales. The analysis of trade-offs between avoiding returns as much as possible versus facilitating returns to increase sales revenue versus keeping costs of processing returns down is the key objective of our research. We aim to identify which returns practices online apparel retailers employ and why, and what is their impact on the profitability of an online retail. Our research question is:

What is the impact of different return policies on the profitability of online retailers?

This study should respond to all the following sub questions:

How sensitive are consumers to return policies? What are the implications of a return policy from an e-retailer’s and consumer’s perspective?

What is the optimal return policy that create a balance between both consumers’ and retailers’ satisfaction?

How should the retailer design the customer returns policies? Based on customer or product segmentation?

How should the positive and negative effects of customer returns be traded off to yield greater profits?

What are the marketing strategies that an e-commerce could implement to minimize returns?

2. HYPOTHESIS:

Null Hypothesis:

Ho: Return policies do not impact the long-term profitability of online retailers.

Research Hypothesis:

H1: Return policies impact negatively the long-term profitability of online retailers.
3. RESEARCH OBJECTIVES

Minimizing return rates by restricting return policies is obviously beneficial for an e-commerce; meanwhile, allowing lenient return policies increase consumer satisfaction which leads to a potential increase in sales. The key objective of our research is to examine trade-offs between minimizing returns and cutting off the costs by limiting the return policy versus encouraging returns to increase the customer satisfaction and raise sales by employing a flexible return policy.

First, we will investigate different return policies from relevant online businesses and analyze the customer-retailer relationship tied by the return policy agreement. Then, we will study the real impact of return policies on the profitability of an e-commerce. The purpose is to find the return balance that satisfies both the customer and the retailer. In parallel, we would like to explore the possibility of employing marketing activities to reduce the return rate.

A search with keywords “consumer return” and (“b2c” and “return”) in November 2014 rendered only 29 hits on ISI Web of Knowledge, of which 25 were related to supply chain management in the broadest sense (De Leew et al. 2016). This means that research in this field is scare, especially from a marketing perspective. There is a need for more empirical research in this particular area, which makes this research subject worth investigating.

4. LITERATURE AND TERMINOLOGIES

It is surprising to see that with the increasing rate of consumers’ returns, the research in this field is very limited. In this section, different terminologies related to this research subject will be explained based on a selection of pre-reviewed research articles.

4.1. REVERSE LOGISTICS

Reverse logistics is characterized by the flow of goods from the customer to the supplier. It is the upward process of the traditional logistical chain. Indeed, reverse logistics is solicited when the customer makes a return of previously purchased goods. Customer returns could have several reasons among these, one finds: error of the choice of the product ordered by the customer, an error during the preparation of the order or an error of labeling; the absence of the customer at the time of delivery, the refusal of the product by the customer following an excessive delivery delay, an error in the delivery note, a deterioration or breakage of the product following a mistake during delivery, a manufacturing or assembly defect; or a cancellation of the order after the period allowed by the law or by the marketing policy of the supplier (Harris,
As a result, the flow of reverse logistics turns out to be complex in the majority of cases, especially for retailers that have not actively invest on the necessary human and material resources to manage these returns. Customers’ returns need to be re-integrated into the stock to be resold, returned to the customer or integrated into a resale network of returned products. The non-optimized returns with the absence of corrective actions raise the costs of the supply chain and ultimately weigh on the net results and long term profits (Harris, 2010). Consequently, the poor management of returned products ends up affecting the quality of the after-sales service valued by the customer and which directly conditions the image of the e-commerce.

The return rate varies from one industry to another. According to Ketzenberg (2009), the return rate is 8.5% in consumer electronics, 19.4% in apparel, and 40% for online apparel.

### 4.2. RETURN POLICIES

Returned products are the outcome of a legal document or an agreement made by the retailer called the return policy. A return policy represents a set of rules that the company establish to manage the process by which consumers return or exchange purchased products (USLegal, 2006). Nowadays, consumers are experiencing more liberal return policies that go beyond the law imposed by governments leading to high return rates (Ketzenberg, 2009). The liberalization of return policies is mainly due to the importance that consumers grant to being able to return purchased product; especially in e-commerce businesses (Ketzenberg, 2009). According to Batarfi (2017), the implementation of a flexible return policy in which consumers could return goods and benefit from a full or partial refund is used as an effective marketing tool and a competitive strategy to potentially increase consumers’ satisfaction and improve the company’s sales. Online consumers tend to make their buying decision based on the flexibility of the return policy and choose the one that allows delay of irreversible decisions (Ketzenberg, 2009).

A study realized by Harris Interactive demonstrates that 90% of the consumers surveyed check the return policy before purchasing the product for the first time from an online retailer and base their buying decision on the flexibility of the return policy (Market Wire 2007). Furthermore, the results of the same study indicate that 70% of the respondents confirmed that they would avoid to shop from an online retailer that has an inconvenient return process (Ketzenberg 2009).
Based on the literature, the type of return policy adopted by the company varies according to the type of business, the type of industry, and the type of retail (online or physical). We can classify return policies into different categories such as: Full refund of the selling price, partial refund of the selling price, exchange of the product with no possible refund, full or partial refund on a certain category of products, and no refund or exchange whatsoever (Batarfi, 2017). Other authors classify return policies based on the five dimensions of leniency: time, money, effort, scope, and exchange (Janakiraman et al. (2005). If we take for example the computer manufacturing industry, Dell opts for a return policy where the customer is refunded the full amount of the selling price for both regular and customized products. On the other hand, Apple has developed a return policy where customized products and special orders cannot be refunded (Batarfi, 2017). If we take the case of Amazon, the cost of returning the product is deducted from the customer’s refund if the error is not due to Amazon (Liu et al. 2014). A popular website, consumerworld.com, compares different existing return policies among leading online businesses. This comparison will be used later in a separate section of the research paper.

4.3. THE LAW OF RETURN

The law of return has been implemented by the governments of some countries to give customers the right to return or exchange purchased products. This law does not exist in all countries. The European law allows consumers to return their products, and in some countries such as Germany and Finland, customers didn’t have to pay for the cost of return (Hjort, 2016). In 2014, all members of the European Union have decided to implement a new directive allowing retailers to decide whether to charge customers for returns or not (Hjort, 2016). Nowadays, companies have the freedom to decide to shift the cost of returns to consumers, yet a large number of online retailers prefer not to charge their customers in order to survive in a very competitive market.

In Morocco, the law of return is not clear and explicit, which makes it worth investigating.

4.4. PROFITABILITY

Companies that develop flexible return policies to attract consumers and stay competitive in the market need to recognize first its impact on the profitability. According to Ketzenberg (2009), handling product returns can be costly for the company ranging between 2% to 50% of the total sales. The reverse marketing manager for UPS, Jim Brill, affirms that the cost of processing returns ranges from 20% to 65% of the cost of sold goods (Li et al. 2019).
Hjort (2016) has conducted a research study on the impact of return policies on profitability of a fashion online retailer. He analyzed the transactional data of online customers for a specific Swedish fashion e-commerce. The results of his regression analysis demonstrated that lenient return policies that do not partially or fully charge the customer for returned products do not benefit retailers in terms of long-term profitability. In parallel, Bower et al. (2012) have concluded in their research that the implementation of return policies for short-term gain have long-term negative impact on the online business. We use this as our theoretical starting point and aim to identify how choices in the design of return policies can contribute to both profit maximization and cost minimization.

5. METHODOLOGY

First, we will collect all the existing theories about return policies in order to deeply analyze each type of a return policy. Then, data will be collected from relevant Moroccan online retailers using a qualitative approach. The data collected will be used in mathematical model that we will develop in the purpose of creating a balanced equation that will maximize long term profit, minimize the cost of returns, and keep customer’s satisfaction.

6. PRACTICAL AND SOCIAL IMPLICATIONS

The end goal of this research is to help managers decide whether to adopt a flexible (lenient) return policy, or to segment customers and propose differentiated return policies, or to implement a different return policy for each category of products.

Meanwhile, reducing the flow of returns can have significant social and environmental impacts by reducing transport and handling process.

7. RESEARCH LIMITATION

This study will be limited to online businesses only, and will not include physical stores. Also, the collect of quantitative and qualitative data will focus on online retailers located in Morocco only.
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