

The economics of the money-back guarantee

Written by The Conversation

“Returning the product to Amazon ASAP!” [complained one disgruntled](#) Amazon customer as they gave a one-star review for a digital camera on the company’s site. This is despite the same product having an average rating of four-and-a-half stars out of five from 242 other customers.

Companies like Amazon aren’t just ignoring these disgruntled customers and their product-returning ways. In fact, retailers are increasingly offering extra services such as warranty plans, free shipping and guarantees to reassure them. Selling with the “money-back guarantee” is a prime example of this.

This is because the economics of the money-back guarantee can work for retailers. These businesses allow customers to return products that do not meet their expectations — as a result of poor quality or a mismatch in taste — for a full or partial refund. Essentially offering their customers an insurance against the perceived risk of the product.

And [research](#) shows these retailers make a profit with this type of guarantee, given specific conditions. [Other research also shows](#) the money-back guarantee increases customers’ feeling of satisfaction with their purchase experience, making them likely to return to the store.

This type of guarantee is particularly important for retailers who sell products online or through mail-order catalogues. This is because customers can’t enjoy the benefits of the traditional “touch-and-feel” shopping experience, to reassure them they are making the right decision.

Customers rorting the scheme

Customer returns cost retailers more than [US\\$260 billion](#) (equivalent to 8% of total retail sales) annually in the United States alone. The return rates vary significantly by category, and by channel type. It can reach as high as 35% for high fashion apparel sold in [traditional stores](#), and the rates are higher again for [internet and catalogue sales](#).

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However, in most cases, the returned products are not defective. Customers [abuse](#) the money-back guarantee, so much so that buying a product with the intention of returning it has become a trend known as wardrobing or barrowing. In the US, fraud associated with returns costs retailers around [US\\$2 billion](#) during the holiday season alone (US\$9 billion annually).

Retailers try to get around this by offering partial instead of full money-back guarantees for products. The refund is usually less a “restocking fee” charged for returns.

For example, compare the 30 day money-back guarantees from two Australian furniture retailers, Zanui and Rogerseller. [Zanui](#) offers a full refund, whereas [Rogerseller](#) charges its customers a 15% restocking fee (it pays back only 85% of the selling price rather than the full amount).

In most cases, restocking fees can range between 10% and 20% of the original purchase price, [some even as high as 50%](#).

A [survey](#) by professional services company Accenture reported that in the computer electronics industry, most customers returned their products because they simply “did not meet expectations.” More specifically, for 68% of returns, there was “no trouble found” by the customers; 27% of the products were returned due to “buyer’s remorse”.

And only 5% of the products returned were truly defective. However, regardless of the reason, returned products cannot be sold as “new,” even though the product could be new in the sense that it was never used.

Major consumer electronics retailers such as [Best Buy](#) and [Walmart](#) restock these returned items and sell them as “open-box items” at discounted prices. Open-box simply means the product is marked as being opened or used previously. A retailer’s ability to sell returned products as open-box creates an opportunity to attract more price conscious consumers.

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The downside of such product differentiation is that open-box products can have a negative impact on the demand for the new products in a store. The retailer might also have to incur additional costs for handling returns and repackaging them as open-box.

Making or losing money on the money-back guarantee

Balancing the benefits and costs of the money-back guarantee is a delicate task for retailers. [In studying the guarantee](#) we worked out how retailers could use it to increase sales and profits.

We looked at product pricing, refunding and inventory stocking decisions in money-back guaranteed sales. We took into account uncertainty in demand, the possibility of a customer's dissatisfaction with the product after purchase, as well as the lower value customers place on an open-box product, relative to brand new products.

Using this model, we figured out the best prices retailers could use reselling returned products and the restocking fees to encourage or discourage returns, for the highest possible net profit.

Even though reselling returned products meant less stock for the retailer it also reduced inventory-related costs adding to profits. In essence, retailers can claim back at least some of the costs associated with return fraud, with reselling.

In areas of retail with higher risk of returns, the temptation is to tighten returns policies, to limit them. This is especially true for highly innovative products, new technologies, or fashion-driven products (especially high-end ones).

Interestingly, our study shows that reselling returns complements the money-back guarantee. So these type of high-risk products are likely to give retailers the most benefit, when they are resold after being returned.

Retailers also feel the benefit of reselling when there are more price conscious customers who are more inclined to buy a product that is being resold, because it's at a discount.

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So the economics of the money-back guarantee can work for retailers by improving brand value and through reselling via open-box products.

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