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The impact of returns policies on profitability: A fashion e-commerce case☆

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ABSTRACT

Research on returns policies is scarce and inconclusive. This study is a first attempt to empirically analyze and describe the effects of returns policies on consumer behavior and the moderating effects of the policies on profitability. The method involves analyzing the transactional data of a Swedish online fashion retailer. The results of the regression analyses show that with a lenient returns policy, repeat customers generate a significantly higher contribution per order, while returners and customers who enjoy free returns generate a significantly lower contribution per order. In addition, returners and repeat customers generate a significantly higher total contribution, while customers who enjoy free returns generate a significantly lower total contribution. Hence, returns policies that are free of charge do not necessarily benefit retailers in terms of long-term profitability. From a managerial perspective, the results provide guidance on how to address the recent changes in European consumer legislation.

1. Introduction

A trend towards more liberalized or lenient returns policies is evident in the fashion e-commerce business. We may consider that retailers use the returns policy as a tool to reduce consumer risk and increase consumer demand (Janakiraman, Syrdal, & Freling, 2015). Retailers use returns policy in different ways: pre-purchase, to signal a certain level of retailer or product quality (Bonifield, Cole, & Schultz, 2010; Mukhopadhyay & Setaputra, 2007), and post-purchase, to alter product evaluations (Kim & Wansink, 2012). Returns policies can have varying degrees of leniency; Janakiraman et al. (2015) classify five returns policy leniency dimensions: time, money, effort, scope, and exchange.

Many markets do not have a law that requires retailers to accept returns (Chen & Grewal, 2013). In the European Union (EU), the law entitled consumers (Directive 97/7/EC, 1997) to return what they purchase online. Certain countries, such as Finland and Germany, interpreted the previous Distance Selling Directive (Directive 97/7/EC, 1997) in a way that allows customers to return products without having to pay for the return postage (monetary leniency). However, this directive has recently changed: by Jun. 13, 2014, all member states have implemented a new directive (Directive 2011/83/EU, 2011), which no longer requires organizations in the EU to allow their customers to return products free of charge (European Parliament, 2011). With this recent change, e-commerce organizations in Sweden and other EU nations that previously accepted free returns when selling online in Finland and Germany can now decide whether to continue to do so or to shift the cost of returns to consumers or segments of consumers, as Bonifield et al. (2010) suggest.

Opinions differ regarding returns policies and their level of restriction (Bahn & Boyd, 2014). In addition, the research is inconclusive on the effects of these policies (Janakiraman et al., 2015). Research indicates that returns policies used for short-term gain can have long-term negative consequences for retailers (Bower & Maxham, 2012). Retailers may use lenient return polices based on the belief that these policies increase purchases more than returns, despite the cost of processing returns (Janakiraman et al., 2015). This study sheds light on these issues and evaluates both the short- (order) and long-term (repurchase) effects of returns policy leniency on one dimension at a time, as Janakiraman et al. (2015) suggest, albeit the study is not a controlled field study.

The empirical study presented in this paper examines the impact of returns policies on consumer purchase and return behaviors (habits) in e-commerce, and the moderating effects of returns policies on profitability. The study examines the effects in a European context and addresses the recent changes in the European directive (Directive 2011/83/EU, 2011) on consumer rights that was implemented in a national legislation in the EU in June 2014. Since the legislation is relatively new, the results presented in this paper can assist managers in deciding whether to continue to offer lenient policies or to segment customers and offer differentiated policies, as researchers (Bonifield et al., 2010) suggest.

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This research continues a trend in the recent literature that use and analyze transactional data from the e-commerce industry (Bower & Maxham, 2012; Griffis, Rao, Goldsby, & Niranjan, 2012; Hjort, Lantz, Ericsson, & Gattorna, 2013; Lantz & Hjort, 2013). The aim of the study is to complement the existing literature by adding the complexity of returns policies to the analysis of the profitability of consumer purchase and return habits. This study also examines whether the conclusions of Lantz and Hjort (2013) are valid outside of their randomized and controlled experiment: that retailers should probably not offer free returns policies to all or some of the customers given that such policies are not mandatory from a legislative and/or competitive point of view. From a managerial perspective, this research intends to help guide organizations on how to set their returns policies with regard to the recent legislative changes.

The organization of the remainder of this paper is as follows. Section 2 presents the literature review, and Section 3 describes the methodology. Section 4 presents the results of the statistical analysis, and Section 5 discusses the results. Section 6 presents the conclusions and implications of the study.

2. Literature and theoretical background

2.1. Returns policy, buyer behavior, and profitability

We may consider the consumer's relationship with a retailer in an online setting as a series of transactions where the consumer evaluates the risks in terms of all the perceived transactions, and this series of transactions all boils down to a decision to purchase or not (Griffis et al., 2012). This concept implies that transaction cost economy theory can explain consumer-retailer transactions (Williamson, 1979). Chircu and Mahajan (2006) define a retail transaction as "an exchange between a consumer and a retailer in which the two parties obtain something from each other at a cost to each" (p. 899). Reducing risks or lowering transaction costs, such as by providing post-sale services and returns, can increase customer value (Chircu & Mahajan, 2006). Griffis et al. (2012) show that the customer's confidence in a retailer grows through a series of successful transactions, which includes returns processing.

The goal of lenient return conditions is often to create a marketing incentive (Rogers & Tibben-Lembke, 1999, Chapter 1) to attract and create loyal and repeat customers, and thus, to increase sales. However, a fundamental correlation between increasing sales and maximizing profitability does not exist, and profit is always the firm's first consideration (Yan, 2009). Lantz and Hjort (2013) show in their experiment that free returns are actually associated with a decrease in the average value of orders, an increased probability of returns, as well as an increased order frequency. Nevertheless, even though a liberal returns policy increases returns (Wood, 2001), a returns policy is still always valuable for e-commerce according to Yan (2009). Research on returns policies is still in development (Bower & Maxham, 2012; Janakiraman et al., 2015). An increasing stream of this research addresses returns policies in a B2C setting, and more specifically, in e-commerce with regard to consumer returns. Researchers often discuss the effects of these policies in terms of either profitability (Lantz & Hjort, 2013; Mukhopadhyay & Setaputra, 2007) or loyalty and behavioral aspects (Bonifield et al., 2010; Griffis et al., 2012; Hjort & Lantz, 2012; Pei, Paswan, & Yan, 2014; Wood, 2001). This research trend leaves a gap in the literature regarding how returns policies affect purchase and return behaviors and whether and/or how these policies affect profitability. The behavioral aspects often discuss pre- and post-returns spending in relation to different returns policies (Bower & Maxham, 2012). Knowledge regarding spending, behavior, loyalty, and purchase intentions is interesting and insightful, but one can argue that without a direct and empirical connection with profitability, these aspects are of more interest to academics than to practitioners.

Returns policies are clearly aspects of the online consumer experience, and liberal policies increase sales (i.e., demand) (Bower & Maxham, 2012; Mukhopadhyay & Setaputra, 2007; Petersen & Kumar, 2010). Griffis et al. (2012) suggest that the increased value of consumer loyalty can offset the incurred cost of a lenient returns policy. Another empirical study (Hjort et al., 2013), where repeat customers and non-returners, on average, generate a higher contribution per order, provides partial support for this finding. However, the total contribution of repeat customers per year is higher if they are also returners. Hjort et al. (2013), though, do not control for the degree of returns policy leniency.

Meanwhile, returns policies also decrease profitability. In a randomized and controlled experiment with real e-customers as participants, Hjort and Lantz (2012) confirm increased sales but conclude that, generally, it is not optimal in term of profitability to offer the same delivery and return conditions to all types of customers. Lantz and Hjort (2013) go on to argue that the main managerial implication of their study is to not offer free delivery and return policies, given that they are not required from a legislative and/or competitive point of view. They argue that an economic perspective would not recommend such policies due to the absence of a significant upside to compensate for the downside (i.e., a decreased coverage of costs).

Janakiraman et al. (2015) challenge what they describe as an "underlying assumption in most prior returns policy research — that all forms of returns policies affect product purchase and returns in a similar manner" (p. 8). They also suggest that returns policies per se benefit retailers, at least in increased product purchase. However, literature appears to report an inconclusive understanding of the effects of returns policies in prior research as Janakiraman et al. (2015) previously mention, or at least that prior research describes the effects only for one aspect at a time, that is, for either behavior/intention or profitability. This tendency might also explain why (as the introduction states) retailers use lenient returns policies based on the belief that such policies increase purchases more than returns, despite the cost of processing returns (Janakiraman et al., 2015). Consequently, this study analyzes the moderating effects of returns policies on consumer behavior and whether and/or how these affect profitability per customer by measuring the contribution per order and the total contribution over time, aggregating actual repurchase behavior, not intention (see Fig. 1). The study aims to determine whether and/or how the moderating effects vary between customers with and without experience with the retailer, as the literature states (Hernández, Jiménez, & Martín, 2010). The existing research indicates that customer behavior does not remain stable over time because past purchases influence subsequent behavior (Hernández et al., 2010).

The study's three hypotheses based on the theoretical and empirical literature reviewed above are as follows:

H1. Repeat customers are, on average, more profitable than non-repeat customers are.

H2. Non-returners, on average, more profitable than returners are.

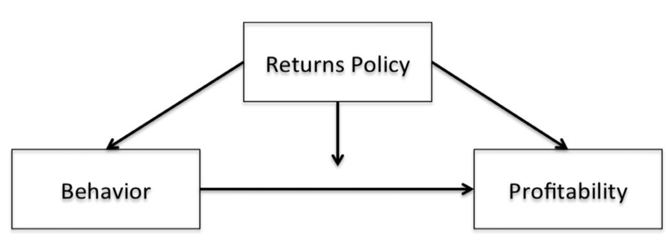

Fig. 1. Returns policy effects on consumer behavior and its moderating effects on profitability.