

## Return Fraud and Abuse: How to Protect Profits

BY DAVID SPEIGHTS AND MARK HILINSKI

Fraudulent and abusive returners—camouflaged in the T-shirt and jeans uniform of the average shopper—are launching a multi-front attack on the retail industry. These secret operatives are draining \$16 billion annually (KingRogers International) from retailers' coffers and costing the average household of four \$225 per year. As executives and employees, we've been alerted to the enemy's presence, but we've lacked an effective counterattack—until now.

Approximately 9 percent of all returns in the United States are fraudulent, indicating an assault of staggering proportions. Discovering that their current return policies do nothing to stop most fraud and abuse has led many retailers to seek new protection tactics. While our adversary's arsenal contains many fraud and abuse schemes, new consumer-based return authorization systems allow retailers to intercept perpetrators before they have the opportunity to initiate a fraudulent or abusive return.

### Return Fraud and Abuse Schemes

Although fraudulent and abusive return procedures are myriad, some schemes are more commonly used than others. Understanding these schemes, despite their ever-evolving nature, is the first step toward choosing the best defense.

#### *Renting/Wardrobing*

Renting/wardrobing begins with a legitimate merchandise purchase. The item is then used once or twice and returned as if it were new. The classic example is the purchase of an expensive cocktail dress for a wedding, reunion, or other special event. The consumer simply tucks the tags into the garment in an inconspicuous manner, dazzles partygoers with her finery, and then returns the dress for a full refund the following day, in essence having “rented” it for free.

This technique has spread to other valuable merchandise. When consumers buy durable goods, such as a camcorder to tape a graduation, a big screen television to watch the Super Bowl, or a trendy watch to accessorize a job interview suit, and then return the items after using them, they are violating a retailer's traditional return policies. Unfortunately, the widespread notion that this is an acceptable behavior has only exacerbated its effects.

#### *Receipt Fraud*

Sales receipts can be used to defraud a retailer, and criminals have devised numerous avenues for obtaining them. Some thieves forge receipts, using computers and color printers. Sophisticated practitioners actually may obtain the retailer's paper stock from store contacts or paper suppliers in order to enhance the appearance of the counterfeit receipt. Others simply find receipts in store trash

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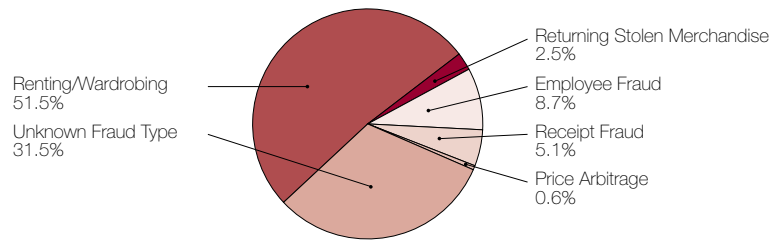
*The Return Exchange* provides fraud and abuse detection products used by retailers to track illegal merchandise returns. Its *Verify-1*<sup>®</sup> product stores a consumer's ID and payment information when returning an item and then determines trends that alert management to fraudulent returns.



The *Retailing Issues Letter* is a quarterly essay co-published by IBM and the Center for Retailing Studies at Texas A&M University.

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FIG. 1- Estimated Distribution of Some Retail Fraud Types



SOURCE: THE RETURN EXCHANGE (percentages are rounded)

receptacles, shopping carts, or discarded shopping bags. Internet-savvy individuals may visit questionable web sites that purchase legitimate receipts and sell them to criminals who need a receipt for a particular item.

Regardless of how the receipt is acquired, it can be used for a novel type of fraud called *shoplifting* because it works much like a shopping list. The individual enters a store with the receipt in hand and proceeds with one of two scenarios: 1) Pick up the item[s] listed on the paper and head to the returns counter, or 2) shoplift the item[s] and come back at another time to conduct the fraudulent return. Shoplifting enables the petty thief to eliminate the middleman, someone who will buy the stolen merchandise. Instead, this individual is essentially selling the product back to its owner, the retail store. This method has become the province of the less criminally inclined because it has shed its dark alley aura through some quick computer work and a daylight trip to the store.

#### Price Arbitrage

Criminals with working capital—called *go money*—can engage in several types of price manipulation. One example occurs when an individual purchases two similar items with different retail prices. By repackaging the cheaper item in the expensive item's box and returning it for a full refund, the fraudulent returner has basically stolen the better item. This is particularly effective with electronics because cheap units often resemble expensive ones. Selling the more expensive item online, even at a discount, adds dollars to the criminal's pocketbook.

Other forms of price arbitrage include switching boxes in the store to purchase

a higher-priced item for less or purchasing an item at a discount and returning it for a full price refund. Regardless of the fraudulent returner's approach, the retailer pays the difference.

A recent *eWeek* article (January 5, 2005) describes a price arbitrage scheme committed by one group at Wal-Mart stores that cost the retailer a total of \$1.5 million across 19 states. The group switched the bar codes from low-priced items to high-priced items before the purchase. Then the group removed the phony bar code and returned the item to obtain the full price as store credit, cash, or a gift card.

#### Check Fraud

Abusers who practice theft for a living are drawn to the world of bank accounts, preferably a false one or perhaps yours. They purchase merchandise with an illegitimate check or with one backed by insufficient funds and then return the merchandise before the check clears the bank. Here the retailer is simply handing over its profits to the unscrupulous among us. One retailer reported that recent investigations uncovered check fraud rings that wrote a suspected \$100,000 in bad checks to that retailer and more than \$450,000 to other retailers.

#### Returning Stolen Merchandise

Profiting from stolen merchandise, one of the many ways to defraud retailers, has many faces. Small-time criminals may steal merchandise themselves or buy it directly from the thief. They then return it to the store for a full cash refund, either with a forged, found, or purchased receipt or without a receipt at all, depending on the store's return policy. More complex forms of this scheme entail stealing entire truckloads of merchandise and distributing them to a ring of criminals

who will return the items to different retail outlets in a large geographic area. In essence, the store is buying the merchandise twice, first from the manufacturer and secondly from the thief.

A *Washington Post* article (January 6, 2005, Page A01) detailed a scheme in which shoplifters returned merchandise without a receipt, obtained store credit, and sold the store credit online for 76 cents on the dollar.

#### Employee Fraud

Employees have the necessary insider information to conduct endless retail frauds. Acting alone or in collusion, they are uniquely positioned to cause significant financial damage in a relatively short period. Some employees act as facilitators, leaving back doors open or making loading docks accessible; some provide sales receipt paper stock; some actually execute the return transaction for their co-conspirators. The insidious nature of employee fraud can be debilitating if left unchecked.

#### Many Fronts of Return Fraud and Abuse

The chart above (Fig. 1) illustrates our estimate of the frequency of various types of return fraud and abuse. The numbers are based on our experience with a number of large retail clients.

Renting/wardrobing, with nearly 52 percent of total, is the most aggressive attack on retailers' profit margins. But each fraudulent or abusive return, regardless of its form, contributes to the substantial losses retailers sustain annually. The widespread nature of return fraud and abuse reinforces the need for a focused defense strategy.

<sup>1</sup> EXPENSES TO PROCESS RETURNS INCLUDE SALES STAFF TIME, MARK-DOWNS, DAMAGED GOODS, BACK OFFICE EXPENSES, AND OTHER OPERATING EXPENSES RELATED TO PROCESSING RETURNS.

### Traditional Return Policy vs. Consumer-Based Systems

Most traditional return policies do not consider who is making a return. Simple facts, such as the presence of a receipt, the age of the receipt, and the word of the consumer that the product is unused, are sufficient for a return. Some of the more advanced traditional systems check the validity of the receipt by using receipt reconciliation. Verifying the authenticity of the receipt, however, reduces the problem of receipt forgery, which is estimated to be a smaller fraction of all return fraud and abuse. Unfortunately, traditional systems do little or nothing to stop the fraud and abuse schemes described in this article; hence, the emergence of consumer-based systems.

A consumer-based system tracks each consumer's behavior and identifies aberrant patterns to flag likely fraud and abuse. Fraudulent and abusive returners make many returns, and the system detects them before they inflict too much damage. This system typically allows a retailer to extend a more liberal return policy to the majority of consumers but use a more focused policy for problem consumers.

### Financial Casualties Caused by Consumer Returns

Clearly, returns cause the retailer to lose the profit margin earned on the original sale. The monetary drain, however, does not end there. Additional losses accrue when you factor in the time employees spend processing returns, evaluating the item's resale potential, and restocking the returns. When an item must be discounted or, even worse, discarded after a return, it further compounds the company's losses. Then, of course, there are the administrative expenses of accounting

FIG. 2 – Profit/Loss Calculations for Original Sale (without Returns)

Gross Sales	Gross Profit/(Loss) on Original Sale	Operating Expenses to Make Original Sale	Operating Profit/(Loss) on Sale
\$2,000	\$800	(\$550)	\$250

FIG. 3 – Profit/Loss Calculations for Returns

Return Rate	Net Sales (After Returns)	Gross Profit/(Loss) on Return	Expense Incurred from Returns <sup>1</sup>	Contribution to Operating Profit/(Loss) After Return Considered
100%	0%	(\$800)	(\$450)	(\$1,000)
50%	\$1,000	(\$400)	(\$225)	(\$375)
20%	\$1,600	(\$160)	(\$90)	\$0
0%	\$2,000	—	\$0	\$250

for returns and managing the entire return system. For mass merchandisers and nationwide chains, the industry-wide costs can reach hundreds of millions of dollars annually.

As a result of the aforementioned expenses, our experience indicates that an individual consumer with a long-term pattern of return rates greater than 20 to 30 percent negatively affects operating profit. The tables above (Fig. 2 & 3) illustrate our computation of these losses at four return rate levels when assuming a 40 percent gross margin and a \$100 item retail price for 20 items.

Even at a 20 percent return rate, the retailer sees zero profit. In addition, as a retailer's gross margins fall, the break-even return rate also falls. The obvious implication is that profitability is directly connected to return rate.

### Countering Return Fraud

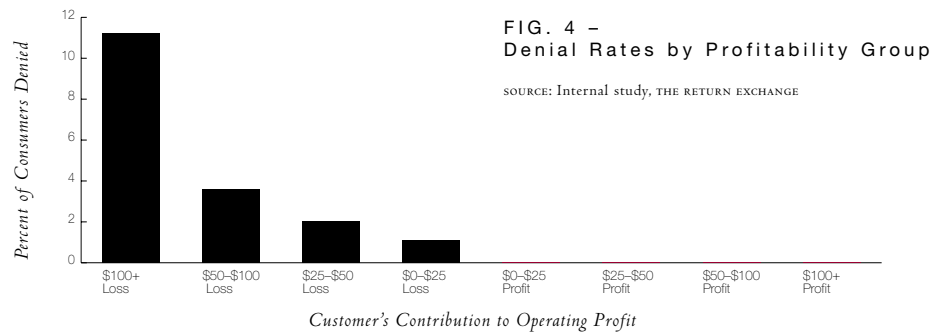
Return policies once were a point of differentiation—Nordstrom would take back any item at any time in any condition while a mom-and-pop operation said all sales were final—but with return fraud reaching nearly 9 percent of returned merchandise dollars, return policies need to be scrutinized. Curbing return fraud can be critical to cutting expenses and improving the bottom line. The question is no longer *if*, but *how*.

The responsibility of managing the return policy for a retailer may not always be clearly defined. Different teams within the organization, each having separate goals, may share part of the burden. Centralizing the return authorization

function within a consumer-based system, however, can assist in organizing the management of a return policy. Such a system can assist in quick ad-hoc analyses of the impact of any proposed changes on the consumer.

Computer technology can track consumer return behavior, using objective criteria. Working from a centralized location to deny returns to systematic fraudsters is now possible. For example, The Return Exchange system uses the swipe of a driver's license or other government-issued ID cards to collect information on each consumer. By eliminating the dependence on a store associate to manually enter information, the system records more accurate data. Using the data collected, statistical fraud detection models are developed to identify common patterns of fraud and abuse. The models are consistently applied to every consumer, which eliminates the variables of sales staff subjectivity and potential discrimination. Retailers can focus on specific fraudulent returners to stop the financial drain.

When reviewing the common return fraud and abuse schemes, most retailers discover that their current return policies do nothing to prevent them. For example, a consumer who purchases clothes every Sunday and returns them the following Sunday every week for a year is not violating most return policies. Retailers who wish to fight costly fraud must focus on the consumer's return patterns, i.e., pinpointing the abusive consumer to prevent the fraudulent return transaction.



### *Allaying Concerns about a Consumer-Focused Strategy*

Management may voice concerns about replacing a traditional return policy with a consumer-level return authorization system. They may argue that tracking individual consumers rather than using blanket return procedures may drive consumers away. However, our research shows that approximately 75 percent of all shoppers never return purchases. Of the remaining 25 percent that do return items, only 1 to 2 percent are netted for fraud or abuse because an effective return authorization system denies returns to only the worst offenders. The other 98 to 99 percent of consumers are unaffected. In contrast, most traditional return policies can adversely affect up to 15 percent of return consumers.

The final question retailers pose is: "What happens to a consumer's shopping behavior following a denial?" Using a controlled sample that analyzed shopping patterns before and after a denial on the same consumers, we found two significant facts:

- (1) The shopping patterns of 35 to 40 percent of consumers who experience a return denial are not affected afterward.
- (2) Within 60 days of a denial, on average, net sales for all denied consumers resume their pre-denial levels.

Thus, while denying a consumer may generate some short-term effects, eventually the consumer is rehabilitated into a more profitable consumer, which is the desired end result.

Another concern involves the privacy of the consumer's data; retailers think consumers might be leery of handing over personal information to facilitate a return.

Retailers can allay these fears by instituting a formal privacy policy and setting up a call center that allows consumers to obtain a copy of their activity report and to dispute inaccuracies, similar to a credit reporting agency.

### *Deterrence*

A consumer-based authorization system can also deter potential fraudulent returners. Once return abusers realize that the retailer will not tolerate abusive or fraudulent return behavior, they will search for a softer target. In fact, return rates have dropped following installation of a prevention system but before the issuance of any denials. Would-be criminals simply go elsewhere when they recognize that they cannot perpetrate fraud and abuse schemes.

### *Efficacy*

The true test of a return authorization system is the number of unprofitable consumers to whom it denies returns compared to the number of profitable consumers it allows to make returns. The chart above (Fig. 4) illustrates a study of one large retailer following system implementation.

Note that as the consumer population approaches profitability for the retailer, there are fewer and fewer incidences of return denial, so that eventually only unprofitable consumers are denied their abusive or fraudulent returns. Reducing the number of unprofitable consumers leads to an improvement in a retailer's operating profits.

### *Benefits for Retailers and Consumers*

Many retailers are moving toward a consumer-based return system as a way to dramatically improve their bottom line.

According to our internal studies, just a small improvement in the average retailer's return rate, e.g., falling from 10 to 9 percent, could mean an improvement in operating margins of between 4 and 6 percent. One retailer in particular demonstrated more than a 10 percent drop in return rates year-over-year using a consumer-based system (see Fig. 5).

Another study revealed a 15 percent reduction in shrink rates at a large retailer in the six months following implementation of our system. Arguably, few areas of retail diligence can bring such rapid financial improvement to the bottom line.

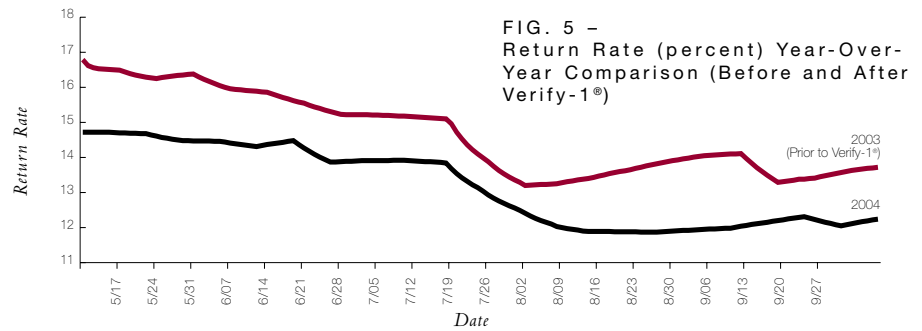
Return authorization provides additional benefits for retailers by allowing them to:

- Model consumer return behavior
- Change return policies according to the competitive environment
- Protect against fraudulent and abusive returns
- Deter employee-assisted inventory shrinkage
- Consistently apply operational procedures
- Utilize fact-based data to make informed decisions

A fact-based return authorization system helps consumers as well as retailers. Consumers benefit from the objectivity of the system. They know the store's return policy is free from personal bias or preference. Furthermore, consumers enjoy more lenient return policies at retailers that target only fraudulent and abusive returns.

### *Strategy for the Future*

Of course, management teams want to know the metrics derived from studies



of a consumer-based return authorization system. They are:

- Decline in the return rate
- Increase in operating profit
- Decrease in inventory shrinkage

These metrics continue to show material, favorable movement in the battle against return fraud. In short, a protection system makes it possible to defeat return fraudsters who are decimating retailers' profit margins.

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## Top Ten Signals of Return Fraud

Return policies are affecting your competitive position if your...

1. Return rate is above the average return rate for your direct competitors.
2. Shrink rate is larger than the average shrink rate for your direct competitors.
3. Return rate has increased in two of the last three years.
4. Return policies are based on subjective intuition and do not measure the impact on consumers.
5. Return policies are arbitrary with respect to a consumer's loyalty or profitability.
6. Return policy has not been reviewed in the last 12 months.
7. Return policy has not changed significantly in the last three years.
8. Return policies are not enforced uniformly throughout the stores.
9. Average markdown rates following a return are increasing.
10. Percentage of returned merchandise you are able to resell has declined.

## Perspectives

### *Preventing Return Fraud and Abuse*

BY STEVE MCCLAIN

The perspectives presented by Speights and Hilinski effectively portray the damage that a handful of customers can inflict on a retailer and the subsequent damage this does to good customers. A customer-focused solution has helped The Sports Authority (TSA) reduce fraudulent and abusive returns and has provided us with a tool to investigate and prosecute any criminal behavior we identify.

A customer-focused approach allows us to stop fraud and abuse while not affecting our good customers. The following examples illustrate situations in which a consumer-focused approach protected our good customers and was essential for reducing our losses.

### Examples of Fraud at TSA

#### *Credit Card Return Scam*

Speights and Hilinski describe an example of fraud and abuse that has plagued TSA. Recently, a wave of criminals who use credit cards to recover cash from a return has hit TSA. They return heavily discounted or stolen merchandise and have it credited to a card that was not used to make the purchase transaction. The criminals obtain multiple credit cards (sometimes in the hundreds) to facilitate the crime and evade detection. This is one of the fastest growing frauds perpetrated on retailers.

One difficulty with credit card fraud is prosecuting involved individuals. Because this crime relies on the banking system, it falls under federal jurisdiction, thus increasing the burden on our ability to prosecute. We estimate that this scam

costs TSA hundreds of thousands of dollars per year and has been going on for several years. By using a consumer-based authorization system (Verify-I®), we are able to identify these individuals faster and study their return patterns. Additionally, the data collected by the system assist us in any prosecution we pursue.

#### *Price Switching Scam*

Another example of return fraud occurred in TSA stores in multiple states, involving more than 100 transactions with a total return amount in the tens of thousands of dollars. The individual used multiple schemes to purchase high-end merchandise at deeply discounted prices and return it for full retail value. Tactics such as switching price tags with lower priced similar items allowed the price arbitrage.

#### *Box Stuffing*

One pair of thieves devised the following complex process to profit. First, one of the thieves entered the store and placed many different items into a single products box. After the first person left, the second person entered the store to buy the box full of merchandise, pretending to have no knowledge of the first person's actions. By committing this act over a significant span of time, both parties could proclaim ignorance of the other's actions, making prosecution more difficult. Once the merchandise was purchased, the team would return all the merchandise to obtain cash or a store credit that could be sold online.

#### *Receipt Forgery*

We have investigated many different occurrences of return fraud that involved receipt forgery. One investigation, in cooperation with local law enforcement,

resulted in the discovery of receipt forging equipment in the subject's automobile. Another recent case involved individuals approaching TSA store associates to purchase receipt tape to assist in their forgery efforts. Yet another case of receipt tampering revealed an individual's altering the receipt after a return in order to use the same receipt again to return other stolen merchandise.

#### Prosecuting Criminal Behavior

With the reorganization and new focus of local and federal law enforcement agencies, it has become more difficult to obtain resources for investigating these complex fraud schemes. The more sophisticated criminals who cause the most damage to retailers are committing crimes that fall under a federal jurisdiction, and federal resources are spread very thin.

When the recent changes are coupled with the proliferation of the internet and web sites where criminals can quickly liquidate merchandise, fighting retail return fraud becomes more difficult. In times past, criminals used professional fences or pawnshops to liquidate stolen merchandise. Today, criminals return merchandise for full credit, using fraudulent receipts which they print themselves, or they sell the merchandise or store credits (often given on gift cards) online. Electronic tracking tools are a necessity to keep up with today's more advanced criminals. Such tools deter criminals and drive them out of a retailer's store.

#### Efficient Monitoring and Detection

Each day our staff monitors and analyzes customers and employees to identify, deter, and prosecute criminals. A consumer-based authorization system

helps us by providing a way to track fraudulent and abusive behavior and take real-time actions to stop that consumer. We combine the captured data with data from other vendors and internal sources to give us a more complete picture of a suspect.

#### Benefits of a Consumer-Based Return Authorization System

These examples illustrate some of the worst offenders in TSA experience. A consumer-based return authorization system has the ability to detect this type of fraud and abuse and identify it early, before it costs retailers too much money. Not mentioned in the examples are the countless petty thieves and small-time criminals who collectively cause much more damage than the few large-scale criminals.

The small-time fraud and abuse schemes can also add up to huge losses for a retailer and a devaluation of general merchandise for the consumer. These schemes

often are perpetrated by seemingly good consumers and include such fraud and abuse as "renting" merchandise (e.g., using equipment for a few days and then returning it) and price arbitrage (e.g., buying merchandise with a coupon and returning it for full price).

Every day we are surprised by the creativity of the criminals. A detection system provides protection and deterrence that convince many criminals to commit their crimes elsewhere.

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