Offering Money-Back Guarantees in the Presence of Strategic Consumers

Zhaoqiong Qin, Department of Management, School of Business, Langston University, Langston, OK, USA
Charles Mambula, Department of Management, School of Business, Langston University, Langston, OK, USA
I-Lin Huang, Department of Management, School of Business, Langston University, Langston, OK, USA

ABSTRACT
This paper studies the benefits of money-back guarantees (MBGs) on the seller under the presence of strategic consumers. The seller initially can offer the MBGs or no-MBGs in the selling season but may sell the leftover inventory at a salvage price without the MBGs at the end of the season. The strategic consumers choose the purchasing timing based on their expected surplus. The authors compare the models of the MBGs offer to no-MBGs in the selling season. By characterizing the rational expectation equilibrium, they find that the seller can charge a higher price in the case of the MBGs offer compared to no-MBGs. Accordingly, the seller’s stocking level is higher and thus the seller’s profit has the corresponding result. This result explains why MBGs is ubiquitous in the retailing world. The effects of the parameters in the model on the profit benefit are shown in the numerical analysis.

KEYWORDS
Money-Back Guarantees, Profit Benefit, Rational Expectation, Strategic Consumers

1. INTRODUCTION
Money back guarantee (MBG) as a practice started in 1868 by J.R. Watkins (Cotsill, 2010). Watkins offered full refunds on his next visit to unsatisfied customers, who did not go beyond the ‘trial mark’ and were still under the guarantee policy.

Compliance to MBG as a standard practice has a number of paybacks to firms. A MBG could be the sign that a company is confident about its products, in terms of value and quality. Some of these benefits for instance include the goodwill that the firm could benefit from its clientele in appreciation for being ethical, by bearing the costs of correction from a defective product or service that did not meet expected requirements. This practice alone gives good image to the obliging firm as one who values integrity and maintains high standards of honesty and regarded as a promise keeper. Testimonials of clientele is a powerful instrument in convincing especially first time buyers who are on the verge of making decisions in a competitive market as to which company products they should go with. Customers who benefit from MBG feel respected than ‘ripped off’ and this give confidence in the selling to come back as a repeat customer, which creates loyalty between buyer and seller. In the long run therefore, a firm would be enriching its organizational culture, by sustaining its practices through different methods that impresses customers, and MBG is one of these. According to Kutatko (2014), there are four distinct roles managers may take in rationalizing morally questionable acts.
“against the firm or “on behalf of the firm.” One of them is role assertion, which would be relevant to the practice of MBG, and refers to socially questionable acts, such as not withdrawing a product in the face of product safety allegations or not paying back money guaranteed for defective products or poor services, by denying the fault and blaming the customers.

Today many different and popular businesses that use MBG include but are not limited to, Sears, Omni Group, GM, Chrysler, and Rapper S.S. One place where MBG is not usually found is Apple’s App-Store. That is because Apple takes 30% of each sale and keeps it even if the retailer refunds 100% to a customer (Cotsill, 2010).

Increasing return rates have become one of the most challenging issues in the modern retailing world. 20-40% of sales are returned from customers to the retailers and manufacturers in the US market (Guide et al., 2006; Dowling, 1999; Vande Vate and Bedir, 2005; and Mostard et al., 2005). Vande Vate and Bedir (2005) and Mostard et al. (2005) investigate the difference of return rates between direct and brick-and-mortar sales and find that the return rate is doubled in direct sales compared to that in brick-and-mortar sales. Mostard et al. (2005) shows that the bulk of returns usually happen in the second and third weeks.

An important problem on the ubiquitous sales return is whether and how the high return rate impacts the offering of money-back guarantees (MBGs) policy, which has been used as a major tool in modern retailing industry to promote sales and satisfy customers by making refund to the buyers who are not satisfied with the product or service. In their survey, Moorthy and Srinivasan (1995) shows that the MBGs can be expected to be offered by firms with high quality products which have a low probability of return after sale. Heiman et al. (2002) demonstrates that MBGs can help better satisfy customer needs if customers have uncertain fit with the products.

Moreover, McWilliams (2012) shows that MBGs can help retailers with low quality products to gain profits in a competitive environment. However, the practical data on the Internet Retailer website1, which gathers information about retails from the top 500 ranked business-to-consumer retailers in the U.S. and Canada based on the online sales including retail chains, catalogers, web-only merchants, brand manufacturers and digital content sellers, shows that the MBGs offers have been provided by all the sample retailers on all their products regardless of their consumer return rates. Obviously the ubiquity of MBGs in the practical business world of retailers cannot be well explained by these model studies.

Furthermore, some retailers do not make the MBGs offer during the entire process of market selling. For the products on sale with discounts, for example, MBGs are usually not provided. The typical example is the hotel and air flight booking on the website2, where sales are made with a lower price in the last minute but no money-back guarantees are offered. This policy of variable MBGs can have a high impact on the purchase plan of most customers, especially for those strategic customers who are usually educated and sophisticated, and willing to wait till the sales season to purchase the products with the possibly lowest price based on their expected larger surplus from the product (Cachon and Swinney, 2009); but MBGs are often not offered for these products in the sales season.

From the customer’s viewpoint, the possible opportunity of a deep discount price at the end of the selling season can provide a great benefit while MBGs at the start of the selling season with a full price also represents a practical benefit and convenience of the purchases. From the retailers’ perspective, however, the MBGs offer increases the customer’s willingness of purchasing the products at the full price and thus helps the retailer obtain a higher profit although the MBGs policy may increase the opportunity of product returns and thus reduce the sales and profit. Therefore, an important problem is whether to offer MBGs or not. The problem can be especially complicated when costs of product return on both sides of customers and retailers, product quality, sales price, original and residual values of the returned products are involved.

To address these issues, we construct an analytical model based on the principle of maximizing the retailer’s profit. Our focus is to answering the following specific questions: is it optimal for the retailer to offer MBGs with the involvement of strategic customers? If yes, how does the benefit of...
Related Content

Fostering Creative Transformations in Organizations with Chaos
www.igi-global.com/chapter/fostering-creative-transformations-organizations-chaos/70888?camid=4v1a

Managing Chaos in Nonlinear Economic Systems: Globalization and Destination Tourism
www.igi-global.com/chapter/managing-chaos-nonlinear-economic-systems/70895?camid=4v1a

A Survey of Knowledge Work Productivity Metrics
www.igi-global.com/article/a-survey-of-knowledge-work-productivity-metrics/93087?camid=4v1a
Prioritization of Design Requirements for Quality Engineering Education
*International Journal of Applied Management Sciences and Engineering* (pp. 17-40).
www.igi-global.com/article/prioritization-of-design-requirements-for-quality-engineering-education/106838?camid=4v1a