STANFORD
GRADUATE SCHOOL OF BUSINESS

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SEARS: ACCOUNTING FOR UNCOLLECTIBLE ACCOUNTS

Sarah Simons picked up the 1999 Annual Report for Sears, Roebuck and Co., which had just been delivered to her office. As an analyst for a major brokerage, she was responsible for providing investment advice regarding companies in the retail industry, including Sears. She looked over the income statement, noting that net income grew by 39 percent over the previous year, despite a slight decrease in revenues (see **Exhibit 1**). Before long, however, she turned her attention to the Company's credit card receivables and allowance for uncollectible accounts (see **Exhibit 2**). In recent years, Sears had suffered heavy write-offs from uncollectible credit card accounts, as well as an expensive scandal caused by illegal collections procedures. These problems had depressed Sears' stock price substantially from its peak in mid-1998.

Had Sears overcome their credit card problems?

BACKGROUND

Sears, Roebuck and Co. was founded in 1886 as a retail mail-order business and grew rapidly by providing a wide range of products to people in rural areas who did not have access to large, well-stocked stores. The Company began to diversify into financial services in 1931, when it established Allstate Insurance Company. This diversification continued in the 1980s, as it acquired Dean Witter Reynolds and Coldwell Banker, and launched the Discover card.

By 1990, however, Sears was struggling and the investment community was critical of its business strategy, which was derisively characterized as "socks and stocks." Shareholder discontent drove the Company to a massive restructuring to refocus on its retailing roots. According to former CEO Edward Brennan, 1992 was a "disastrous year" in which the Company lost $3.9 billion, of which $3.1 billion was a charge related to the restructuring. By 1995, Sears had divested its financial services businesses and largely restructured its merchandising operations.

The transformation of Sears was largely credited to Arthur Martinez, the former chairman of Saks Fifth Avenue, who joined the Company in 1992 as head of the merchandising group. His actions were swift and decisive. He immediately closed the unprofitable Sears Catalog, shut 113

Research Associate David Hoyt prepared this case under the supervision of Professor Karen K. Nelson as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

unprofitable stores, cut 50,000 jobs, and launched a five year, $4 billion capital investment program to renovate and update the stores. In 1993, he initiated an intensive marketing campaign, "Come See the Softer Side of Sears," which was a hugely successful move to call attention to changes in the apparel division and attract women to the stores.

Sears made a remarkable turnaround. From its massive 1992 loss, it recovered to post net income of $1.8 billion in 1995. Martinez was named Sears' CEO in 1995 and was also recognized as Financial World's CEO of the year. The stock price responded accordingly, increasing more than seven-fold from 1991 to mid-1997.[1]

By the late 1990s, however, problems had surfaced and the financial press had become critical. They questioned whether some components of the Martinez turnaround had backfired, most notably his strategy related to the Sears' proprietary credit card, the Sears Card.

THE SEARS CARD AND CREDIT CARD RECEIVABLES

Prior to 1993, the only charge card that Sears accepted was the Sears Card. In order to attract new customers and prop up sagging store sales, Sears began accepting other major charge cards in 1993. While this helped improve sales, Sears lost the opportunity to collect interest on purchases made with other cards. To avoid a drop in profits from its own credit operations, Sears aggressively marketed the Sears Card, mailing out pre-approved card offers, hawking the card at tables positioned at store entrances and paying incentives to sales clerks for opening new accounts. Between 1993 and 1996, Sears issued 24 million new credit card accounts. In his Letter to Shareholders in the 1996 Annual Report, Martinez commented on the importance of the credit card program, stating that the "Sears Card is one of the most important ways we form an alliance with our 50 million customer households. The availability of credit is critical to the ability of moderate-income families to finance the purchases they require. Despite rising delinquencies in the industry, we have a very strong and profitable credit portfolio."

However, the new Sears Card users were not necessarily the best credit risks. Sears' marketing of their credit card tended to attract customers that had trouble paying their bills. Those that could get cheaper credit elsewhere used bank cards with low "teaser" rates and incentives. These factors, combined with an increase in delinquencies and average balances, were cause for concern (see **Exhibit 3**). By late 1997, the average Sears Card balance was more than three times that carried by J.C. Penny Co. cardholders and delinquencies exceeded the industry average by two percentage points.

Sears' drive to issue more cards, and the lax credit policies that were needed to increase cardholders at such a rapid rate, eventually caught up with them. Uncollectible receivables and charge-offs started rising in 1995. The Company responded by increasing the interest rate to a hefty 21 percent while at the same time lowering the minimum required monthly payment. This let cardholders continue to ring up purchases on their Sears Cards and also increased interest revenue on outstanding credit balances. To offset the impact of delinquencies, Sears raised late fees and other charges. However the quality of their credit card receivables was still questionable, as by 1997 Sears was a creditor in about one-third of U.S. personal bankruptcies.

[1] This case was prepared using public documents, including Sears Annual Reports and a variety of news accounts, including: Debra Sparks, "Arthur Martinez: Financial World's CEO of the Year," Financial World, March 25, 1996; John McCormick, "The Sorry Side of Sears," Newsweek, February 22, 1999; Joseph Cahill, "The Softer Side: Sears's Credit Business May Have Helped Hide Larger Retailing Woes," Wall Street Journal, July 6, 1999. Neither Sears nor any current or former employee participated in preparing this case.

The problems went further, however. In January 1997, it was discovered that Sears had illegally coerced payments from cardholders who had sought bankruptcy protection. This resulted in a criminal conviction as well as restitution payments to 187,000 customers. In the end, the scandal cost Sears $475 million in fines, refunds, interest, and legal fees, which the Company charged against income in 1997.

ACCOUNTING FOR UNCOLLECTIBLE ACCOUNTS

Generally Accepted Accounting Principles (GAAP) require that accounts receivable be recognized in the balance sheet at net realizable value—that is, at the amount the company can reasonably expect to collect from its credit customers. Moreover, Statement of Financial Accounting Standards No. 5 (SFAS 5) requires that an estimated loss from a contingency, such as uncollectible receivables, be accrued by a charge to income if two conditions are met: (1) it is probable that a loss has been incurred; and (2) the amount of the loss can be reasonably estimated.

According to their Annual Reports, Sears reported credit card receivables net of an allowance for uncollectible accounts. The allowance was based on “impaired accounts, historical charge-off patterns, and management judgments.” Until late 1998, “uncollectible accounts were generally charged off automatically when the customer’s past due balance was eight times the scheduled minimum monthly payment, except that accounts could be charged off sooner in the event of customer bankruptcy.”

In 1998, Sears began phasing in a new system in which accounts were charged off “automatically when the customer fails to make a required payment in each of the eight billing cycles following a missed payment.” In the fourth quarter of 1998, 12 percent of accounts were converted to this system, with the balance being converted in the first and second quarters of 1999. This new system was intended to help Sears better manage its collection efforts by identifying delinquent accounts earlier and enabling better control of uncollectible expenses. It also had the affect of charging off balances earlier than under the previous system.

ARE THE PROBLEMS IN THE PAST?

As she read the Letter to Shareholders in the 1999 Annual Report, Sarah noticed Martinez’s comments regarding credit: “In our credit business, we worked tirelessly to strengthen our portfolio quality, reduce our losses, and improve our collection processes.” Sarah knew that the credit business was important to the overall performance of Sears (see **Exhibit 4**) and that the Company’s stock price had been affected by credit-related issues (see **Exhibit 5**). Had Sears truly put its problems behind it? Was the allowance for uncollectible accounts adequate? What should she say to the investment community?

EXHIBITS

1. Consolidated Financial Statements
2. Analysis of Allowance for Uncollectible Accounts
3. Key Credit Portfolio Information
4. Summary Segment Data
5. Stock Performance

Exhibit 1
Consolidated Financial Statements

Income Statement (in millions)

	1995	1996	1997	1998	1999
Revenues					
Merchandise sales and services	$31,133	$33,752	$36,649	$36,957	$36,728
Credit revenues	3,702	4,313	4,925	4,618	4,343
Total revenues	34,835	38,064	41,574	41,575	41,071
Expenses					
Cost of sales, buying and occupancy	23,160	24,889	26,985	27,444	27,212
Selling and administrative	7,428	8,059	8,394	8,384	8,418
Provision for uncollectible accounts	589	971	1,532	1,287	871
Other	1,953	2,062	2,669	2,605	2,157
Total costs and expenses	33,130	35,981	39,580	39,720	38,658
Operating income	1,705	2,083	1,994	1,855	2,413
Other income, net	23	22	106	(41)	(56)
Income tax provision	703	834	912	766	904
Net Income	$1,801	$1,271	$1,188	$1,048	$1,453

Balance Sheet (in millions)

	1995	1996	1997	1998	1999
Assets					
Cash and cash equivalents	$ 606	$ 660	$ 358	$ 495	$ 729
Credit card receivables	20,925	20,104	20,956	18,946	18,793
Allowance for uncollectible accounts	(819)	(801)	(1,113)	(974)	(760)
Net credit card receivables	20,106	19,303	19,843	17,972	18,033
Other current assets	5,729	8,484	10,042	10,804	9,905
Property and equipment, net	5,077	5,878	6,414	6,380	6,450
Other assets	1,612	1,842	2,043	2,024	1,837
Total Assets	$33,130	$36,167	$38,700	$37,675	$36,954
Liabilities					
Current liabilities	$14,607	$14,950	$15,790	$14,222	$13,701
Long-term liabilities	14,138	16,272	17,048	17,387	16,414
Total liabilities	28,745	31,222	32,838	31,609	30,115
Shareholders' equity	4,385	4,945	5,862	6,066	6,839
Total Liabilities and Equity	$33,130	$36,167	$38,700	$37,675	$36,954

Source: Sears, Roebuck and Co.'s Annual Reports.

Exhibit 2
Analysis of Allowance for Uncollectible Accounts

	1995	1996	1997	1998	1999
Allowance, beginning of year	$ 808	$ 819	$ 801	$1,113	$974
Provision for uncollectible accounts	589	971	1,532	1,287	871
Net credit losses	578	989	1,220	1,426	1,085
Allowance, end of year	$ 819	$ 801	$1,113	$ 974	$ 760

Source: Sears, Roebuck & Co.'s Annual Reports.

Exhibit 3
Key Credit Portfolio Information

	1995	1996	1997	1998	1999
Sears Card sales as a % of sales	56.6%	56.6%	55.1%	51.6%	47.9%
Comparable store sales growth (%)	4.7%	5.8%	2.3%	1.1%	1.8%
Merrill Lynch Broadline Retailers Index of comparable store sales growth (%)	2.0%	3.8%	4.4%	4.4%	5.2%
Average account balance ($)	$ 914	$ 977	$1,058	$1,076	$1,121
Delinquency rates (%)	4.16%	5.40%	7.00%	6.82%	7.58%
Net credit charge-offs to average credit card receivables	2.77%	5.02%	6.23%	7.54%	6.03%

Sources: Sears, Roebuck and Co.'s Annual Reports; Merrill Lynch Broadline Retailers Index for 1999 from Merrill Lynch Industry Report "Retailing-Broadlines," January 6, 2000.

Exhibit 4
Summary Segment Data

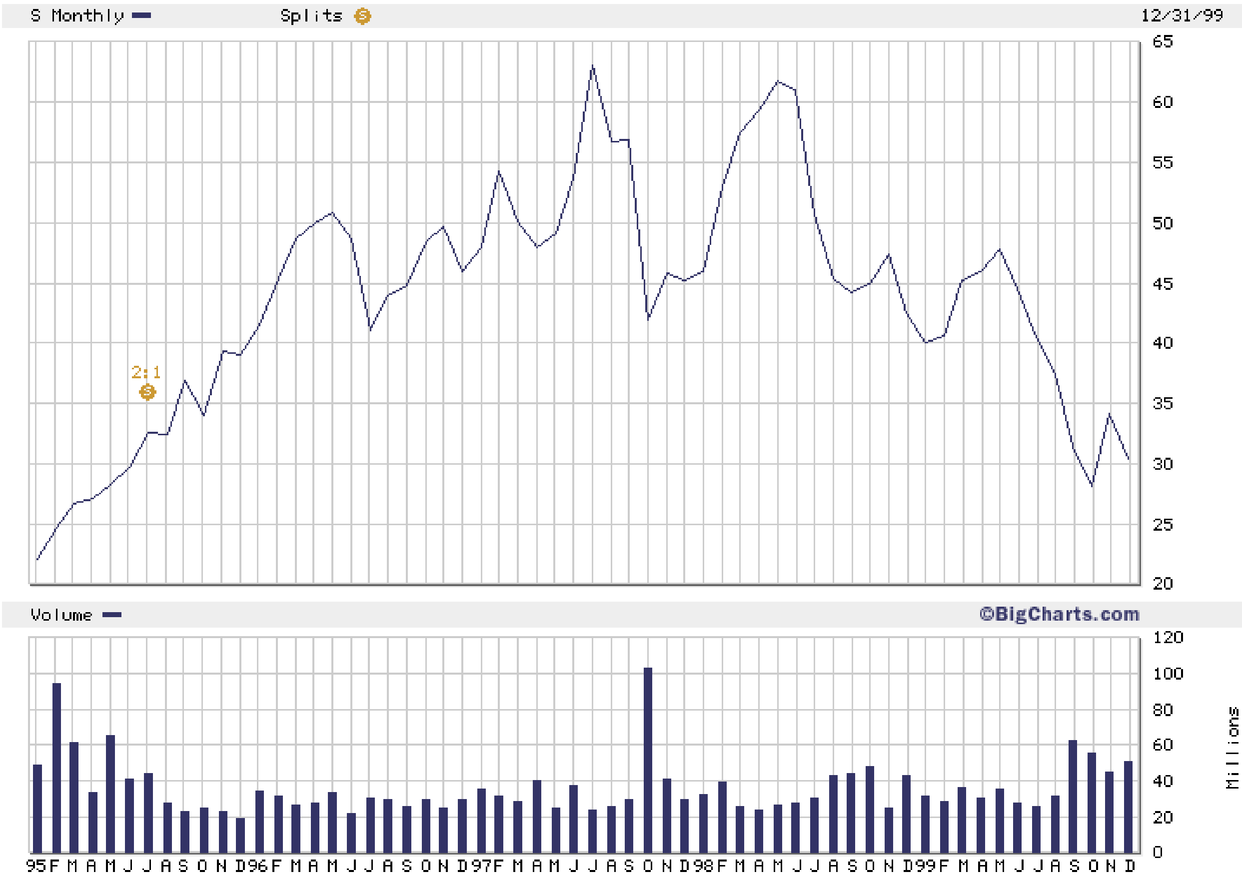
	1995	1996	1997	1998	1999
Operating Income					
Retail	N.A.	$ 841	$ 951	$ 382	$ 841
Services	N.A.	305	361	375	329
Credit	N.A.	1,164	752	1,144	1,347
International	N.A.	(11)	142	165	218
Corporate	N.A.	(216)	(212)	(211)	(322)
Consolidated	$ 1,705	$ 2,083	$ 1,994	$ 1,855	$ 2,413

The summary segment data shown above are from the 1998 and 1999 Sears Annual Reports, and are provided in accordance with SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information." SFAS 131 was effective for fiscal years beginning after December 15, 1997, with prior year information in those financial statements reported in conformance with the new standard. The first time Sears was required to report this data was in its 1998 Annual Report. Accordingly, segment information under the new standard is not available for 1995.

The 1997 Annual Report states "the Company operates primarily in the retailing industry," and gives the following segment information:

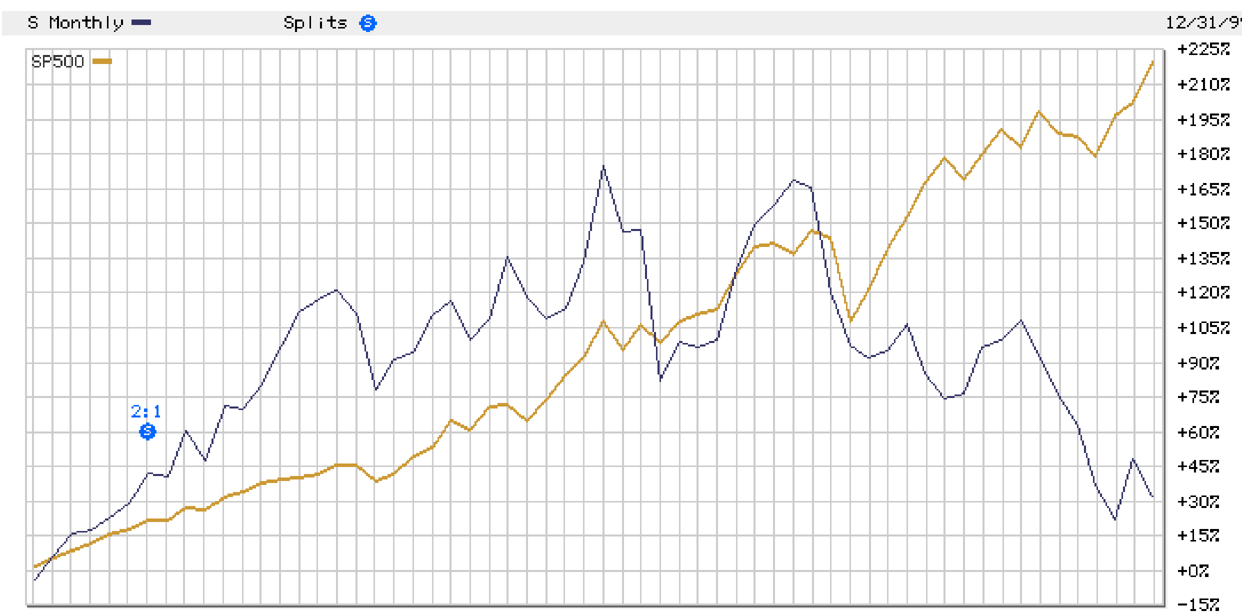
	1995	1996	1997
Operating Income			
Domestic	$ 1,729	$ 2,094	$1,852
International	(24)	(11)	142
Consolidated	$ 1,705	$ 2,083	$1,994

Exhibit 5
Stock Performance



Sears stock price and volume, January 1995 through December 1999.

Sears stock price relative to the S&P 500, January 1995 through December 1999.



Source: www.bigcharts.com (with permission)