THE CAPITOL FORUM

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Signet Jewelers: Acceleration of Revenue Recognition Puts Pressure on Signet to Continue to Sell ESPs at Accelerated Pace; A Closer Look at Likelihood of Add-on Product Enforcement by CFPB

Update on Revenue Recognition

Acceleration of revenue recognition. Signet Jewelers undertook an operational change in its Sterling Jewelers division to accelerate revenue recognition in connection with the sale of extended service plans (ESPs). As a result of the operational change, the Sterling Division now defers and recognizes revenue over 17 years for ESPs, with approximately 57% of the revenue recognized within the first two years for plans sold on or after May 2, 2015, and with 42% of the revenue recognized within the first two years for plans sold prior to May 2, 2015.

Sales pressure around ESPs in focus. Acceleration of revenue recognition, according to sources, generally leads to a greater corporate focus on sales of products tied to the revenue recognition strategy because of the enhanced ability to boost near-term earnings. With the sale more important to Signet's near-term growth numbers, stakeholders should continue to monitor whether or not Signet is increasing pressure on its sales force; further, if such pressure is increased, it would make CFPB actions on add-on product disclosure requirements and other enforcement actions more likely.

For this article, we spoke with Gerard M. Zack, Managing Director in the Global Forensics practice at BDO Consulting, as well as various other sources on background.

A Closer Look at Signet's Acceleration of Revenue Recognition

Sterling ESPs. In the second quarter of fiscal year 2016, the Sterling Jewelers division undertook an operational change to align the Sterling and Zale ESPs. Prior to the change, the Sterling Jewelers division deferred and recognized revenue on its ESPs over a period of 14 years, with approximately 45% of the revenue recognized in the first two years. After the operational change, the Sterling Jewelers division deferred and recognized revenue over 17 years for all ESPs, with approximately 57% of the revenue recognized within the first two years for ESPs sold on or after May 2, 2015 and 42% of the revenue recognized in the first two years for ESPs sold before May 2, 2015.

Zale ESPs. There does not appear to be any change to revenue recognition associated with the Zale ESP. Revenue from the sale of the Zale ESP is deferred and recognized over 10 years, with approximately 69% of the revenue recognized within the first two years.

Explanation for operational change. It is important for stakeholders to understand that most rings in any jewelry store are size 7 for women and size 10 for men. If a consumer's finger is not one of those two sizes, the consumer will have to pay to resize the ring. In conversations with sales representatives in Kay, Jared, and Zales' stores, the typical sales pitch was that the consumer should just pay for the ESP (which covers ring sizing) as it is only a little more expensive than the cost of sizing the ring the first time and allows a consumer to have the ring sized for life.

Signet indicated that the operational change is associated with ring sizing and was made to further align the Zale and Sterling ESP policies. The explanation provided is that the Sterling segment did not include the cost of ring sizing for customers who had purchased an ESP as part of the ESP plan claims. Post the alignment, the cost for ring sizing for customers who purchased an ESP are included in the claims cost. Now that both the Sterling and Zale components offer ring sizing as part of the ESP, and because the vast majority of consumers (anyone outside of a women's 7 or men's 10) will have to pay to have their ring resized in connection with the purchase, the Sterling component can recognize more revenue in connection with ring sizing up front.

A Closer Look at Significance of ESP Sales on Signet's Growth

The Capitol Forum looked back at Signet's sales of ESPs relative to overall sales in previous quarters. Jewelry sales are very seasonal, but year over year in a given quarter, the amount of ESP sales as a percentage of overall sales has been increasing over the past three years:

	Q1	Q2	Q3	Q4
2014	5.6%	5.2%	5.3%	5.2%
2015	6.1%	6.0%	6.2%	6.0%
2016	6.8%	6.3%	6.5%	-
Source: Company Filings				

Although the sale of ESPs accounts for roughly 6-7% of Signet's total sales, it has a much larger impact on comp sales in each quarter. In the second quarter of fiscal year 2016, which is when Signet undertook its operational change, Signet stated that "the second quarter comp sales were favorably impacted by 60 basis points associated with the operational change." The total increase in comp sales for that quarter was 4.2%, so the operational change accounted for approximately 15% growth in comp sales. In the third quarter of fiscal year 2016, Signet's comp sales received a 40 basis point increase as a result of the operational change. The total growth in comp sales was 3.3%, so the operational change accounted for approximately a 12% increase in growth in comp sales in quarter three. The acceleration of revenue recognition, although not a huge component of Signet's overall sales, is important to Signet's comp sales growth.

Signet Jewelers continued sale of ESPs? Our sources agreed that Signet Jewelers change in estimates for revenue recognition for ESPs is likely to provide a temporary bump in earnings. According to Mr. Zack, the duration of the bump varies from company to company, but in this case it looks like the bump in revenues will be about two years, and most companies generally experience a bump in revenue in the quarter in which the change is announced. Mr. Zack also noted that unlike a change in accounting methodology, which results in a cumulative effect adjustment to retained earnings, a change in revenue recognition estimates is recognized prospectively in the revenues reported on the income statement.

Because the bump in this case is tied directly to ESPs, stakeholders should continue to monitor the pace at which Signet sells these ESPs. According to Mr. Zack, if the sale of ESPs is a growth area for Signet, then the acceleration of revenue recognition will continue to help Signet. For instance, if the pool of money from ESP sales continues to increase, Signet will continue to recognize a greater percentage of the money from the sales of ESPs early on. But if the sale of ESPs decreases, then there is a smaller pot of money from which to recognize revenues. Similarly, Mr. Zack cautions that if the sale of ESPs is flat, it has the potential to harm the company in later years because ESP growth may not keep pace with the acceleration of revenue recognition.

Potential impact of CFPB action. Because the sale of ESPs is important to Signet's comp sales growth, and the continual sale of ESPs is important to Signet's overall revenue, any CFPB or regulatory action that hinders Signet's ability to sell ESPs at an accelerated or, at a minimum, consistent pace would likely have a negative impact on Signet's growth and revenue.

Why the CFPB is likely to take interest: Signet is more financial services firm than retail operation. Stakeholders may already have started to question whether Signet more closely resembles a financing company than a retail operation, because approximately 63% of Signet's sales are done on in-house financing. As Signet's business relies more and more on the financial services side of the business, the company becomes an easier target for the CFPB.

A Closer Look at Avenues for CFPB Enforcement

Stakeholders should be mindful of the fact that the CFPB could take action either directly or indirectly against Signet. Indirect action could result from CFPB guidance or regulations that enhance the types of disclosures required in add-on products such as ESPs, or through enforcement actions or settlements regarding similar products. The CFPB could also take direct enforcement action by issuing a Civil Investigative Demand to investigate the various debt collection complaints or financing related complaints about the Sterling Jewelers division on the CFPB database, which could be expanded to look into warranty issues.

Although the bulk of the complaints on the CFPB database pertain to Signet's debt collection practices, the CFPB could still take enforcement action against Signet relating to the sale of its ESPs. According to a source, the CFPB's CIDs are broadly worded and their statement of purpose will generally include a catchall provision about determining violations of any other consumer financial laws. And, according to our source, the document requests in the CIDs themselves generally include requests for things like "all consumer complaints." Accordingly, even if the initial scope of the CFPB's investigation is on Sterling's debt collection practices, the document requests could unearth violations or consumer complaints that were not initially on the CFPB's radar.

We looked back at the CFPB complaint database and gathered information about the number of complaints against companies against which the CFPB recently took enforcement actions. We continue to stress that the number of complaints against a company is not necessarily a driving factor behind whether the CFPB will take action against a company. The agency takes into account other considerations such as the company's record in dealing with consumer complaints and how the action fits into the agency's set of factors for setting enforcement priorities (including number of victims, whether there is an impact on a vulnerable population, and the ripple effect on the rest of the market, among others). But for those stakeholders concerned with whether the number of complaints against Sterling Jewelers is significant, we tallied the number of complaints against Sterling compared to other companies against which the CFPB recently took action, as shown below:

Entity	# of Complaints	1st Complaint Date	Enforcement Action Date
Sterling Jewelers	259	06/21/2012	n/a
Westlake Services LLC	231	01/08/2013	10/01/2015
EZCORP	94	08/06/2013	12/16/2015
EOS	788	07/10/2013	12/07/2015
Source: CFPB Complaint Database			

Outstanding Questions for Signet Management

As we continue to dig into Signet's fairly confusing financial disclosures, the following outstanding questions remain:

- **Loans and loan performance.** Are there any additional details that Signet can provide on loans and loan performance (length of loans, FICO scores, delinquencies, defaults, etc.)?

- **Recency accounting.** Does Signet plan to provide more transparency into delinquencies from a recency basis versus a contractual basis?