EXPENSE RECOGNITION RED FLAGS: CAPITALIZING VS. EXPENSING

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Expense Recognition

- Expenses are decreases in net income (not necessarily cash) that arise in the process of generating revenues
- Expenses are recognized when either:
  - Related revenues are recognized or
  - Incurred, if difficult to match with revenues
- Many expense-related manipulations create a big gap between expenses and cash flows
  - Look at Balance Sheet
    - Big capitalized cost accounts
    - Reserve accounts
  - Look at Statement of Cash Flows
    - Gap between Net Income and Cash from Operations
- 35% of SEC enforcement actions are related to expenses

Expense Recognition Manipulation: Capitalization vs. Expensing

- **Capitalization vs. Expensing Immediately**
  - "Capitalization" means the company creates an asset when cash is paid, and then "amortizes" (expenses) it over time
  - Alternative is to recognize an expense when cash is paid
- **Example: Spend $120 in 2016 on Software Development costs**
  - Have a three-year benefit for generating revenue

- **Capitalization**
  - 2016
    - Increase Asset 120
    - Decrease Cash 120
  - 2016, 2017, and 2018
    - Increase Expense 40
    - Decrease Asset 40

- **Expensing immediately**
  - 2016
    - Increase Expense 120
    - Decrease Cash 120
  - 2017 and 2018
    - No entry

Expense Recognition Manipulation: Amortization Periods

- **Amortization periods**
  - Should reflect period over which costs will help generate revenues
  - Lengthening periods reduces expenses (but more years of expense)
  - Shortening periods increases expenses (but fewer years of expense)

- **Three-year life**
  - 2016
    - Increase Expense 40
    - Decrease Asset 40
  - 2017
    - Increase Expense 40
    - Decrease Asset 40
  - 2018
    - Increase Expense 40
    - Decrease Asset 40

- **Four-year life**
  - 2016
    - Increase Expense 30
    - Decrease Asset 30
  - 2017
    - Increase Expense 30
    - Decrease Asset 30
  - 2018
    - Increase Expense 30
    - Decrease Asset 30
  - 2019
    - Increase Expense 30
    - Decrease Asset 30

- **Two-year life**
  - 2016
    - Increase Expense 60
    - Decrease Asset 60
  - 2017
    - Increase Expense 60
    - Decrease Asset 60

Expense Recognition Red Flags

- Ratio of Deferred Cost assets to Total Assets
- Ratio of Amortization Expense to Revenue
- Average Amortization Period
  – Months Amortization = (Avg Asset / Amortization Expense) * 12
- Gap between Net Income and Cash Flow from Operations
- Net Income if expense immediately
  – Net Income if expense immediately = Net Income + Amortization Expense – Cash Costs – Tax Adjustment
  – Tax Adjustment = (Amortization Expense – Cash Costs) * tax rate

Dog

Nutrition

Associates

Source: http://cliparts.co

Dog Nutrition Associates Case

- Dog Nutrition Associates is a custom dog food provider
  - Customers use saliva swabs to collect dog's DNA and send results to company
  - Food is custom crafted to dog's DNA profile and sent to customers weekly
- Company aggressively markets its product by sending free DNA kits in the mail to people (regardless of whether they requested them or not)
  - Hope was people would decide to use free kit and then become "subscribers"
- Company had Initial Public Offering in 2011 and had to file 10-K with SEC
  - Accounting guidance was not clear about whether DNA kit marketing costs had to be expensed immediately
  - Advertising and other Marketing Expenditures have to be expensed immediately
- Company decided to capitalize these "Deferred Subscriber Acquisition" costs and to amortize over expected period they would generate revenue
  - Average subscriber life was estimated to be 12 months

Dog Nutrition Associates Case

- **Analysts and investors were disappointed by mixed results in 2012**
  - **Revenue up 350%, but Net Income flat and Cash from Operations negative**
- **At start of FY2013, Company changed its amortization policy based on "changes in subscriber experience data"**
  - **Customers were maintaining food subscriptions for longer than expected**
  - **Now, amortize Deferred Subscriber Acquisition costs over 24 months**
- **Analysts and investors started to criticize capitalization policy in 2014**
  - **Company decided to switch to expensing immediately in middle of the year**
  - **Wrote-off all of its Deferred Subscriber Acquisition costs in 2014**

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