EXPENSE RECOGNITION RED FLAGS: RESERVE ACCOUNTS AND WRITE-OFFS

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Reserve Accounts

- Companies have to make assumptions each period for certain expenses associated with revenue activities
  - Rules require that expected future losses due to customer defaults and due to warranty claims must be recognized at time sales are made
  - Provision for doubtful accounts, warranty expense
- These expenses require "reserve" accounts on the balance sheet to bridge the gap between expense recognition and cash flows
  - Allowance for doubtful accounts, warranty liability
- Companies can adjust the assumptions at the end of the period to manipulate earnings
  - Ratio of Allowance for DA to Gross Accounts Receivable
    - Estimate of percentage of total receivables that will not be collected in the future
  - Ratio of Warranty Expense to Revenues
    - Estimate of percentage of current sales that will result in future warranty claims

Delaying Write-Downs

- Companies are required to account for non-financial assets at “lower-of-cost-or-market”
  - Inventory, PP&E, Intangible Assets
  - If current fair value of asset > book value, do nothing
    - “Fair value” is market value or an estimate of market value if there is no market
  - If current fair value of asset < book value, write-down book value to current fair value
    - Decision rule is based on fair value using undiscounted cash flows; write-down is based on discounted cash flows
- Companies can delay write-downs to manipulate earnings
  - Days Inventory or Days Finished Goods
  - Ratio of Revenue to Non-Financial Asset
    - e.g., PP&E, Goodwill, or Intangible Assets

Dogamer Enterprises Inc.

- **Dogamer Enterprises develops and manufactures video games for dogs**
  - Dogs cannot play traditional video games due to their lack of opposable thumbs
  - Dogamer developed a gaming unit with eye scan technology that lets dogs play by moving their eyes to different parts of the screen
  - Company went IPO in 2003 and grew rapidly
- **In 2012, American Veterinary Medical Association issued research on dangers of screen time for dogs**
  - Recommended no more than two hours of screen time per week
- **Sales of Dogamer products started to suffer as a result**
  - Company posted Net Losses of $145 million in 2013 and $89 million in 2014
  - Company needed emergency bridge loan of $30 million in early 2015
  - Auditor gave Company a “going concern” opinion in 2014

Dogamer Enterprises Inc.

- **Dogamer implemented turn-around plan in late 2014**
  - Change in top management
  - Cost-cutting actions (employee lay-offs, delayed capital expenditures)
  - Strategic alliance with Shibatendo of Japan to boost sales in Asia
- **Strategy was a great success**
  - Sales up 4%
  - Net Income of $13 million
  - Auditor removed going concern opinion
- **Future looks bright**
  - Based on turn-around, Company was able to sign deals to be exclusive provider of dog gaming products in Big W chain in Australia and The Warehouse chain in New Zealand
  - Signed contact with government of Switzerland to develop St. Bernard training simulation games

Warranty Footnote

Product warranties

The Company provides for estimated product warranty expenses when it sells the related products. Because warranty estimates are forecasts that are based on the best available information — mostly historical claims experience — claims costs may differ from amounts provided.

An analysis of changes in the liability for product warranties follows.

($000)	2015	2014
Balance at January 1	12,134	12,901
Provision	3,351	5,263
Utilizations	(6,207)	(6,030)
Balance at December 31	9,278	12,134

Inventory Footnote

Inventories

The Company’s inventories as of December 31, 2015 and 2014 were as follows:

	2015	2014
Raw materials	7,111	9,691
Work in process	13,211	17,455
Finished goods	49,355	39,109
Total	69,676	66,255

Capitalized Product Costs Footnote

Capitalized Product Costs

The Company's capitalized product costs include third-party licensed content costs, consisting primarily of design, artwork, animation, layout, editing, voice, audio and software included in its fence alignment products and third-party consulting and design costs related to the Company's website. The Company's website has an application designed specifically for use with certain of its products.

December 31	2015	2014
Content costs	44,502	32,773
Website development costs	13,998	11,156
	58,500	43,929
Less: accumulated amortization	(25,030)	(29,528)
Total	33,470	14,401

Capitalized Product Costs Footnote (continued)

The amortization expense related to content is charged to cost of sales in the statement of operations and totaled $2,431, $5,840 and $3,786 for the three years ended December 31, 2015, 2014 and 2013, respectively. Amortization expense related to website development is charged to selling, general and administrative expenses and totaled $1,333, $885 and $1,045 for the three years ended December 31, 2015, 2014 and 2013, respectively.

The Company performs a quarterly assessment of the appropriate amortization period for capitalized costs based on expected product lives. In accordance with the initial success of products introduced in 2015, the Company determined that it was appropriate to extend the amortization period for its content costs, resulting in a decrease in cost of sales of $3,821 in 2015.

PP&E Footnote

Property and Equipment

As of December 31, 2015 and 2014, property and equipment consisted of the following:

December 31	2015	2014
Tooling, cards, dies and plates	17,331	18,883
Computers and software	38,515	39,115
Equipment, furniture and fixtures	5,399	9,449
Leasehold improvements	6,179	5,335
	67,424	72,782
Less: accumulated depreciation	(44,033)	(53,166)
Total	23,391	19,616

PP&E Footnote (continued)

Property and equipment is depreciated over its useful life. Depreciation expense for tooling cards, dies and plates and manufacturing equipment is charged to cost of sales in the statement of operations as the expense relates directly to the product manufacturing process. The expense charged to cost of sales was $2,486, $4,307 and $4,286 for the three years ended December 31, 2015, 2014 and 2013, respectively.

Depreciation expense related to the remainder of property and equipment is charged to selling, general and administrative expense in the statements of operations. The expense charged to selling, general and administrative expense was $3,851, $7,158 and $7,167 for the three years ended December 31, 2015, 2014 and 2013, respectively. During 2015, the Company completed an assessment of its capital investment plans and determined that the useful life of its computers should be extended by two years, resulting in a decrease in selling, general and administrative expense of $3,625.

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