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Case

Capitalized customer acquisition costs and earnings quality: A case study of PhotoWorks, Inc

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Abstract

This case examines issues related to accounting method choice, earnings management, and earnings quality. Specifically, the case examines a company (PhotoWorks, Inc.) that chose the less conservative approach of capitalizing and then amortizing a certain type of advertising expenditure rather than expensing the costs as incurred. The primary purpose of this case is to illustrate the role of judgment in accounting method choice and how it provides potential opportunities for earnings management. The case also allows students to explore the multi-dimensional nature of financial reporting decisions and to develop a greater appreciation for how their accounting coursework relates to important "real-world" issues. After completing this case, students should be able to do the following: (1) describe factors that are involved in accounting method choice and support the appropriateness of an accounting method choice based on a search of the accounting standards; (2) understand and evaluate the effects of accounting method choice on the financial statements; (3) describe the conflicting motivations managers face when deciding on financial accounting methods versus tax accounting methods; (4) explain what is meant by earnings management, factors that motivate managers to manage

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earnings, methods they can use to manage earnings, and how earnings management affects earnings quality; and (5) describe the role of auditors in analyzing a company's accounting method choices and in assessing the quality of a company's earnings.

Keywords: Earnings management; Earnings quality; Accounting method choice

1. Introduction

PhotoWorks, Inc., formerly Seattle FilmWorks, Inc., was incorporated in 1976. The principal business of PhotoWorks is the selling of film and photofinishing services through a direct-to-consumer mail order program. When Gary Christophersen joined PhotoWorks in 1982 as Vice President-Operations and became one of its Directors, the company was small and barely surviving. However, under Christophersen's leadership, the company began to prosper and he became President and CEO in 1988.

Part of Christophersen's business strategy was to focus on service rather than price. For example, the company was the first to offer both prints and slides from the same roll of film. Another important component to PhotoWorks' strategy was its extensive use of direct marketing programs to obtain new customers. Christophersen's strategy proved to be very successful for many years. For example, through fiscal year 1997, the company increased its revenues each year with the exception of 1988. Revenues grew from $33 million in 1990 to $101 million in 1997. In addition, from 1990 through 1997, PhotoWorks' average annual earnings growth was 25% and return on equity averaged over 30%. In 1996, PhotoWorks was included on *Forbes*' list of the 200 Best Small Companies in America (Woolley, 1997).

PhotoWorks began to experience significant challenges in 1998, primarily due to the emergence of digital imaging technologies and Internet photo services, as well as increased competition in the traditional film-based systems. As a result, revenues in 1998 declined to $97 million, and by 2000 revenues had fallen to $82 million.

A major accounting issue facing PhotoWorks was how to account for the cost of the primary direct marketing technique that it uses. This technique involves an "Introductory Offer" in which free (or very low-cost) film and/or film processing is offered directly to targeted prospective customers. Of course, the goal of the introductory offer is to acquire long-term customers who, once they have experienced the convenience of film processing through the mail, will use PhotoWorks repeatedly. A question that arises from this marketing technique is how to properly account for the costs associated with the promotion, which the company refers to as customer acquisition costs. Two basic alternatives exist. The first alternative is to fully expense all customer acquisition costs in the period in which they are incurred. The second alternative, and the one adopted by PhotoWorks until 1999, is to capitalize the customer acquisition costs and then amortize them over the number of years that the company expects to benefit from these expenditures.