Financial Warnings

Cost Capitalization and Amortization

"Short-Term Help, Long-Term Hindrance"

Aggressive Cost Capitalization

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Extended Amortization Periods

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Financial Warnings Checklist

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Aggressive Cost Capitalization

An Accountant Tried in Vain
To Expose HealthSouth Fraud (Exceprts)

Ex-Employee Took His Case to Auditors, Then Internet -- But Convinced No One

By CARRICK MOLLENKAMP
Staff Reporter of THE WALL STREET JOURNAL

At 10:06 a.m. on Feb. 13, someone made a sensational claim on the Yahoo bulletin board devoted to discussion of HealthSouth Corp.

"What I know about the accounting at HRC will be the blow that will bring HRC to its knees," wrote the individual, alluding to the company's stock symbol and using the alias Junior followed by eight numbers. A few minutes later, he added, "what is going on at HRC ... if discovered by the right people will bring change to the accounting department at HRC if not the entire company."

"Junior" was Michael Vines, a former bookkeeper in HealthSouth's accounting department. Since leaving the company, Mr. Vines tried to spread the word about alleged questionable practices in the department -- but at every turn his disclosures came to nothing. He sent an e-mail to HealthSouth's auditor, Ernst & Young LLP, flagging one small area of alleged fraud, but Ernst concluded that the accounting was legitimate. Later, he tried to make his case online, where readers of the Yahoo forum dismissed his claims as typical Internet blather.

But his warnings were on target -- and today they offer a lesson in how hard it can be to sound the alarm against corporate wrongdoing.

A native of Birmingham, Mr. Vines learned accounting by taking classes over several years at three Alabama colleges but hasn't completed a degree. "I just like working with numbers and making sure everything balances at the end of the day," he says.

He began work in HealthSouth's asset-management division, one of three employees overseeing expenses and the purchase of equipment at the company's 1,800 facilities.

According to his testimony at the April federal court hearing, he came to believe that people in the department were falsifying assets on the balance sheet. The accountants, he testified, would move expenses from the company's income statement -- where the expenses would have to be deducted from profits immediately -- to its balance sheet, where they wouldn't have to be deducted all at one time. Thus, the company's expenses looked lower than they were, which helped artificially boost net income.

The individual expenses were relatively small -- between $500 and $4,999 apiece, according to Mr. Vines's testimony -- because the auditor, Ernst & Young, examined expenses over $5,000. Overall, according to the SEC complaint, about $1 billion in fixed assets were falsely entered. In his testimony, Mr. Vines identified about $1 million in entries he believed were fraudulent.

Mr. Vines said on the stand, Ernst was conducting a routine review of how HealthSouth depreciated its assets. As part of the review, Ernst asked about an asset on the company's balance sheet.

The problem: There was no invoice showing that the asset, for a facility in Kansas, had been purchased. (The court papers don't specify what the asset actually was.) So, Mr. Vines testified, Ms. Edwards ordered Mr. Vines to pull an invoice for a different purchase, for a facility in Braintree, Mass., that roughly matched the asset's price. She then scanned the invoice into her computer and altered the shipping cost and other information to make it fit the asset that Ernst was asking about, according to Mr. Vines's testimony.

Mr. Vines argues that the three accounts he pointed out raise plenty of serious questions by themselves -- and an accounting expert agrees.

For example, court documents show that one of the expenses that was shifted to the balance sheet was the sponsorship of the Erie Otters junior-league hockey team in Pennsylvania -- which was listed as Internet cost. Charles Mulford, director of the DuPree Financial Reporting and Analysis Lab at the Georgia Institute of Technology, acknowledges there's a gray area in accounting for assets. But he argues that assets such as the hockey sponsorship and others, such as newspaper advertisements, clearly should be expensed immediately and don't belong on the balance sheet, where things such as land, buildings and equipment reside.

On Feb. 21, Mr. Vines was back on Yahoo: "I know for a fact that HRC has assets on the books that are made up to trick the auditors." A naysayer replied: "If you really had information, you would have shorted the stock and given your info to the appropriate people. You wouldn't be babbling about it here. You'd be too busy picking out your new trailer." Mr. Vines says he owns few shares of HealthSouth and never shorted the stock, a strategy in which traders sell borrowed shares in hopes of buying them back later at a lower price.

Mr. Vines was finally able to crow on March 20 -- the day after a former HealthSouth chief financial officer pleaded guilty to fraud in the criminal investigation and the SEC filed its civil complaint in U.S. District Court in Birmingham.

"Everyone sees what I have been talking about," he wrote on the Yahoo board.

Expense or Capitalize?

The following accounting practices for store preopening costs were taken from the accounting policy notes of selected retailers.

How are reported results impacted?

The Good Guys

Store pre-opening costs are expensed as incurred.

Sun Television & Appliances

Costs of opening new stores are capitalized and amortized on a straight-line basis over the twelve-month period following the store opening.

Lechters

Preopening costs are capitalized and amortized over a period of 24 months from the date operations commenced.

Such ranges of capitalization policies led the American Institute of CPAs to issue SOP 98-5, requiring immediate expensing of start-up and preopening costs.

Expense or Capitalize?

A Company Changes Its Policies - The Impact on Earnings is Immediate

Value Merchants

From the notes . . .

The Company changed its inventory valuation method to absorb certain direct warehouse expenses into inventory values. This new method, which was accounted for as a change in accounting principle, was made to better approximate the expenditures and charges directly incurred in bringing inventories to their existing location and condition. The cumulative effect of this change on prior periods was $721,000, or $.12 per share (net of income taxes). For the current year, the effect due to this change was to increase income before the cumulative effect of the accounting change by approximately $606,000 or $.10 per share (net of income taxes).

Note that this accounting change also increased inventory values by the pre-tax amount of the change, or approximately $2,212,000. A deferred tax liability was also increased by approximately $885,000.

Guidelines for Expense Recognition

The matching principle:

- "Let the expense follow the revenue"
- Whenever possible, expenses incurred in generating revenue are recognized in the same time period as the revenue.
    - Inventory costs are charged to cost of sales when goods are sold
    - Commissions paid a salesman are expensed when related sales revenue is recognized

O.I. Corporation

From the notes . . .

> The Company's products carry warranties of 90 days to one year. Possible expenses associated with such warranties have been provided for in the financial statements based upon management's best estimates.

A warranty policy helps to sell company products. Accordingly, warranty costs are matched with revenues and expensed in the same period as revenues are recognized.

- When impractical to match expenses directly with revenues, an allocation policy is used to approximate matching.
  - Costs incurred are capitalized (given asset treatment)
  - Periods benefited are charged an expense allocation
  - A systematic and rational system for amortizing costs incurred to expense through time
    - Depreciation of property, plant and equipment
    - Amortization of intangible assets

Top Air Manufacturing

From the notes . . .

Amortization:
Amortization on patents is computed by straight-line method, primarily over a six-year period.

- Immediate expense or loss recognition is appropriate when no future benefit will be derived from the expenditure.

- Immediate recognition is appropriate whether the charge has been paid or is scheduled for future payment.

    - General and administrative expense

    - Loss from foreign exchange transaction

Dynatech Corporation

From the notes . . .

> The cost of improvements is charged to the property accounts, while maintenance and repairs are charged to income as incurred.
>
> Costs related to research and development are expensed as incurred.

In some instances, difficulty in determining whether or not expenditures will benefit future periods (questions about realizability) leads GAAP to favor the expensing option.

- Research and development is a case in point.

- Advertising expenditures is another

Advertising Expenditures

Are There Instances Where Capitalization Is Proper under GAAP?

CPI Corp.

From the Notes . . .

The Company expenses costs involved in advertising the first time the advertising takes place, except for direct response advertising, which is capitalized and amortized over its expected period of future benefits.

Direct-response advertising consists of direct mail advertisements that include coupons for the Company's products and of certain broadcast costs. The costs of the advertising are amortized over the expected period of future benefits following the delivery of the direct mail in which it appears.

Direct Response Advertising -

The firm has sufficient historical evidence to permit a reasonable assessment of realizability of advertising costs incurred.

Why Wasn't AOL Allowed to Capitalize Direct Response Advertising?

From the Wall Street Journal . . .

About-Face on Accounting Raises hard Questions About Past, Future Net
New York - America Online, Inc. disclosed plans to take a pretax charge of $385 million to reverse a much-criticized accounting approach that had let the company post quarterly profits by forgoing the immediate write-off of massive marketing expenses.

The accounting charge is more than five times as large as the total pretax earnings that AOL had reported for the past five fiscal years combined. It underscores just how massive the company's marketing efforts have been - and how illusory its profits may have been. The change raises the question of whether AOL will be able to report much profit at all in future quarters.

The SEC Describes Why Capitalization Was Inappropriate for AOL (Enforcement Action #1257)

"This case involves AOL's capitalization of certain advertising costs that should have been expensed as they were incurred. Although AOL was generating positive net revenues (gross revenues from subscribers minus direct costs of earning such revenues), AOL was operating in a new, evolving, and unstable business sector, and thus could not provide the "persuasive" historical evidence needed to reliably estimate the future net revenues it would obtain from its advertising expenditures. As a consequence, AOL could not satisfy the requirements of Accounting Standards Executive Committee *Statement of Position* 93-7 ("SOP 93-7"), which contains a limited exception to the general rule, under Generally Accepted Accounting Principles ("GAAP"), that all advertising costs be expensed as incurred."

That exception is for certain direct-response advertising costs, which are costs of advertising whose primary purpose is to elicit sales to customers who can be shown to have responded specifically to the advertising

"AOL rapidly expanded its customer base as an Internet service provider through extensive advertising efforts. These efforts involved, among other things, distributing millions of computer disks containing AOL startup software to potential AOL subscribers, as well as bundling AOL software with computer equipment. Largely as a result of its extensive advertising expenditures, this period was characterized by negative cash flows from operations."

"AOL capitalized most of the costs of acquiring new subscribers as "deferred membership acquisition costs" ("DMAC")--including the costs associated with sending disks to potential customers and the fees paid to computer equipment manufacturers who bundled AOL software onto their equipment--and reported those costs as an asset on its balance sheet, instead of expensing those costs as incurred."

SEC Enforcement Action Against AOL (cont'd)

"Demonstrating that direct-response advertising will result in future benefits requires *persuasive evidence* that its effects will be *similar* to the effects of responses to past direct-response advertising activities of the entity that resulted in future benefits. *Such evidence should include verifiable historical patterns of results for the entity.* Attributes to consider in determining whether the responses will be similar include (a) the demographics of the audience, (b) the method of advertising, (c) the product, and (d) economic conditions."

"AOL Did Not Have an Adequate Basis to Capitalize and Amortize the Costs of Subscriber Acquisition

AOL did not meet the requirements of SOP 93-7 for capitalizing and amortizing DMAC. AOL was in a volatile, developing market that was subject to unpredictable, potentially material adverse developments and thus, could not reliably forecast future subscriber retention, revenues, or cost of services."

Exercise on Cost Capitalization

Required: Consider each of the following expenditures and determine whether a capitalization or expense approach is appropriate. Why?

Company	Costs Incurred
1. About.Com, Inc.	Deferred offering costs in connection with initial public offering (IPO).
2. Darling International, Inc.	Environmental expenditures incurred to mitigate or prevent environmental contamination that has yet to occur and that may result from future operations
3. Forcenergy, Inc.	Productive and non-productive petroleum exploration, acquisition, and development costs
4. Gehl Co.	Costs incurred in conjunction with new debt
5. Hometown Auto Retailers	Leasehold improvements
6. InfoUSA, Inc.	Direct marketing costs associated with the printing and mailing of brochures and catalogs
7. J Jill Group, Inc.	Creative and production costs associated with the company's e-commerce website
8. Lions Gate Entertainment	Costs of producing film and television productions
9. Miix Group, Inc	Policy acquisition costs representing commissions and other selling expenses
10. RF Micro Devices, Inc.	Costs of bringing the Company's first wafer fabrication facility to an operational state
11. U.S. Aggregates, Inc.	Expenditures for development, renewals and betterments of quarries and gravel pits
12. CHDT Corp.	Packaging artwork and design costs related to the company’s advanced lighting products
13. Texas NM Power	Payroll-related costs such as taxes, pension and other fringe benefits and administrative costs related to construction of a new power plant

What is Aggressive Cost Capitalization?

Accounting guidelines call for costs to be capitalized when they will benefit future periods.

- Effect is to increase assets and pretax earnings

Even though cost capitalization has a direct and potentially material effect on earnings, capitalization guidelines are not rigid.

- Deciding whether or not future periods will benefit is an art, not a science.

- Management judgment plays a key role.

Often, whether future periods will benefit or not likely will not be known until later.

Yet, in the mean time, capitalization has resulted in increased earnings.

Class Exercise
CUC International

From the Wall Street Journal:

Cendant Stock Plummets 46.5% on News That Accounting Woes Hurt Earnings

The once-highflying stock of Cendant Corp. plunged 46.5%, knocking $14 billion off the company's market value, after the marketing and franchising concern said accounting problems would require it to reduce last year's earnings and would hurt this year's results.

Late Wednesday, the company said that it was investigating several former managers of CUC International Inc. after discovering accounting irregularities at its membership division, a core unit that sells travel, dining, entertainment and shopping club memberships. The investigation is expected to take just a few weeks.

The disclosure is particularly embarrassing considering Cendant was formed only in December from the $14 billion stock swap combining HFS Inc. with CUC International Inc. yesterday, the total market value of the company was equal to about the original value of one of the original companies.

Investors who have spoken with the company say the heart of the problem appears to be how the CUC business booked its revenue from some club-memberships sales and how it handled the expenses associated with marketing to those members. But, the investors say, CUC appear to have been booking too much revenue up front, and deferring the expenses to future periods, thereby easing the sting to earnings.

What's particularly interesting about the above disclosure is the fact that the company had recorded special charges to correct for similar aggressive accounting practices as many as ten years earlier.

The following exercise is based on financial-statement disclosures provided at that earlier time.

Class Exercise
Cendant / CUC International (cont'd)

CUC International is a membership shopping club. The company serves as an affiliation of retail stores who agree to provide member shoppers with price discounts. The company incurs marketing and administrative costs to acquire new members and earns fees from those members.

Excerpts from the company's financial statements are provided below.

Required:

1. How does the company account for member acquisition costs and membership fees?

2. Does the balance sheet offer any indication of cost capitalization tactics that would seem to be aggressive? If so, by what amount has the company's capitalization policy boosted pretax earnings for Year 2?

Cendant/CUC International
Capitalized Costs (cont'd)

From the Balance Sheet (000s) . . .

	Year 2	Year 1
Total Current Assets	$ 62,622	$ 42,307
Noncurrent Assets:		
Deferred membership charges, net	22,078	13,112
Prepaid solicitation costs	17,089	4,915
Prepaid commissions	6,267	8,127
Contract renewals rights, net	27,944	30,443
Excess of cost over net assets acquired, net	33,301	19,066
Properties, net	16,048	10,074
Other	1,519	4,416
Total Assets	$186,868	$132,460

From the income statement (000s). . .

	Year 2	Year 1
Total Revenues	$198,457	$141,759
Expenses:		
Operating	64,092	43,248
Marketing	68,937	56,496
General and administrative	31,729	23,342
Interest	2,259	2,663
Total expenses	167,017	125,749
Pre-tax income	31,440	16,010
Provision for income taxes	14,017	7,350
Income before extraordinary credit	17,423	8,660
Extraordinary credit		1,041
Net income	$ 17,423	$ 9,701

Cendant/CUC International
Capitalized Costs (cont'd)

From the notes . . .

Deferred Membership Charges, Net: Deferred membership charges is comprised of (000s):

	Year 2	Year 1
Deferred membership income	$(52,834)	$(43,205)
Unamortized membership acquisition costs	74,912	56,317
Deferred Membership charges, Net	$ 22,078	$ 13,112

The related membership fees and membership acquisition costs have been between $30 and $39 per individual member. In addition the annual renewal costs have remained between ten and twenty percent of annual membership fees for the same period.

Renewal costs consist principally of charges from sponsoring institutions and are amortized over the renewal period. Individual memberships are principally for a one-year period. These membership fees are recorded, as deferred membership income, upon acceptance of membership, net of estimated cancellations, and pro-rated over the membership period. The related initial membership acquisition costs are recorded as incurred and charged to operations as membership fees are recognized, allowing for renewals, over a three-year period. Such costs are amortized commencing with the beginning of the membership period at the annual rate of 40%, 30% and 30%, respectively. Membership renewal rates are dependent upon the nature of the benefits and services provided by the Company in its various membership programs. Membership renewal rates have been sufficient to generate future revenue in excess of deferred membership acquisition costs over the remaining amortization period.

Amortization of membership acquisition costs, including deferred renewal costs, amounted to $44.6 million and $35.5 million for year 2 and year 1.

Prepaid Solicitation Costs: Prepaid solicitation costs consist of initial membership acquisition costs pertaining to membership solicitation programs that were in process at year end. Accordingly, no membership fees had been received or recognized at year end.

Prepaid Commissions: Prepaid commissions consist of the amount to be paid in connection with the termination of contracts with the Company's field sales force and the termination of special compensation agreements with an officer and former officer. The amount relating to the termination of the field sales force is being amortized, using the straight-line method, over eight years and the amount relating to the termination of the special compensation agreement is being amortized ratably over ten years.

Contract Renewal Rights: contract renewal rights represent the value assigned to contracts acquired in acquisitions and are being amortized over 9 to 16 years using the straight-line method.

Excess of Cost over Net Asses Acquired: The excess of cost over net assets acquired is being amortized over 15 to 25 years using the straight-line method.

Cendant/CUC International (cont'd)
Other Practices That Caused Problems

- Significant portions of membership revenue for memberships that extended over a one-year period were recognized up-front.
- Fictitious (nonexistent) revenue was recognized
- Revenue was boosted by delayed recognition of cancellations and credit card rejections
- Merger reserves were improperly charged with recurring operating expenses

How Do I Recognize Aggressive Cost Capitalization?

A useful technique is to compare the capitalization policies of the company in question with those of competitors or other companies in the industry.

- Is the company in question capitalizing costs that other companies expense?

- Or does it expense more, taking a more conservative approach?

It is possible, however, that even companies chosen for comparison are being overly aggressive.

Accordingly, one should consider the following question:

What do the capitalized costs represent?

- An identifiable asset with utility separate and apart from the company?

    - An ascertainable market value.

- A bookkeeping entry, whose value, if any, is tied to the fortunes of the company?

If the capitalized costs represent an identifiable asset, then capitalization would seem to be appropriate.

Caution: capitalized costs should not exceed net realizable value, or what the asset could be sold for, less the costs of disposal.

If the capitalized costs represent nothing more than a bookkeeping entry with no intrinsic value, then capitalization should be considered aggressive.

Capitalized Sales Commissions
What is the Impact of Capitalization on 2017 Pretax Income?

Legal Services, Inc.

Selected Financial Statement Data: Legal Services, Inc., Years Ending December 31, 2016 and 2017 (thousands of dollars)

Financial Statement Item	2016	2017
Income Statement Accounts:		
Revenue	$ 160,453	$ 196,240
Income before income taxes	41,332	59,927
Balance Sheet Accounts:		
Membership commission advances - current portion	21,224	32,760
Membership commission advances - noncurrent portion	60,661	87,828
Total membership commission advances	81,885	120,588
Stockholders' equity	101,304	114,464

What's the Significance of Deferred Acquisition Costs for Insurers?

What Would be The Impact if These Costs Were Expensed?

The Effects on Pre-Tax Income of Capitalization of Deferred Acquisition Costs, Net of Amortization (Amounts in $ Millions).

Company Name	Reported Pre-tax Income	Inc (Dec) in DAC, net	Adjusted Pre-tax Income	% change
ACE LTD	1,567	93	1,474	-5.93%
AFLAC INC	1,914	461	1,453	-24.09%
ALLSTATE CORP	(3,025)	(44)	(2,981)	1.45%
AMERICAN INTERNATIONAL GROUP	(108,761)	2,306	(111,067)	-2.12%
ARCH CAPITAL GROUP LTD	305	5	299	-1.69%
ASSURANT INC	563	(245)	808	43.44%
AXIS CAPITAL HOLDINGS LTD	407	(4)	411	0.91%
BERKLEY (WR) CORP	326	(60)	387	18.52%
CHUBB CORP	2,407	17	2,390	-0.71%
CIGNA CORP	378	(27)	405	7.14%
CINCINNATI FINANCIAL CORP	540	17	523	-3.15%
CNA FINANCIAL CORP	(562)	(36)	(526)	6.41%
EVEREST RE GROUP LTD	(84)	(45)	(39)	53.31%
GENWORTH FINANCIAL INC	(942)	409	(1,351)	-43.42%
HARTFORD FINANCIAL SERVICES	(4,591)	(596)	(3,995)	12.98%
LINCOLN NATIONAL CORP	(25)	11	(36)	-44.00%
LOEWS CORP	587	(36)	623	6.13%
MARKEL CORP	(161)	(19)	(142)	11.51%
METLIFE INC	5,090	143	4,947	-2.81%
PARTNERRE LTD	62	(25)	87	39.93%
PRINCIPAL FINANCIAL GRP INC	453.6	307	147	-67.59%
PROGRESSIVE CORP-OHIO	(222.3)	12	(235)	-5.53%
PRUDENTIAL FINANCIAL INC	(1118)	879	(1,997)	-78.62%
RENAISSANCERE HOLDINGS LTD	85	(22)	107	26.33%
TORCHMARK CORP	661	157	504	-23.71%
TRANSATLANTIC HOLDINGS INC	3	(8)	12	262.83%
TRAVELERS COS INC	3,716	(35)	3,751	0.94%
XL CAPITAL LTD	(873)	(43)	(830)	4.97%
			Average	6.91%

Note: Pre-tax income for RenaissanceRE Holdings LTD is before minority interests.

The Effects on Total Assets and Shareholders' Equity of Capitalized Deferred Acquisition Costs, net of Accumulated Amortization (Amounts in $ Millions).

Company Name	DAC, net	Total Assets	Shareholder's Equity (SE)	DAC as % of Total Assets	DAC as % of SE (net of tax)
ACE LTD	1,214	72,057	14,446	1.68%	5.46%
AFLAC INC	8,237	79,331	6,639	10.38%	80.65%
ALLSTATE CORP	8,542	134,798	12,641	6.34%	43.92%
AMERICAN INTERNATIONAL GROUP	45,782	860,418	52,710	5.32%	56.46%
ARCH CAPITAL GROUP LTD	295	14,617	3,433	2.02%	5.59%
ASSURANT INC	2,651	24,515	3,710	10.81%	46.45%
AXIS CAPITAL HOLDINGS LTD	273	14,283	4,461	1.91%	3.98%
BERKLEY (WR) CORP	395	16,121	3,046	2.45%	8.42%
CHUBB CORP	1,532	48,429	13,432	3.16%	7.41%
CIGNA CORP	789	41,406	3,592	1.91%	14.28%
CINCINNATI FINANCIAL CORP	509	13,369	4,182	3.81%	7.91%
CNA FINANCIAL CORP	1,125	51,688	6,877	2.18%	10.63%
EVEREST RE GROUP LTD	355	16,847	4,960	2.11%	4.65%
GENWORTH FINANCIAL INC	7,786	107,389	8,926	7.25%	56.70%
HARTFORD FINANCIAL SERVICES	13,248	287,583	9,268	4.61%	92.91%
LINCOLN NATIONAL CORP	11,936	163,136	7,977	7.32%	97.26%
LOEWS CORP	1,125	69,857	13,126	1.61%	5.57%
MARKEL CORP	184	9,478	2,181	1.94%	5.48%
METLIFE INC	16,653	501,678	23,734	3.32%	45.61%
PARTNERRE LTD	617	16,279	4,199	3.79%	9.55%
PRINCIPAL FINANCIAL GRP INC	4,153.0	128,182.40	2,472.80	3.24%	109.17%
PROGRESSIVE CORP-OHIO	414	18250.5	4,215.30	2.27%	6.38%
PRUDENTIAL FINANCIAL INC	15,126	445,011	13,422	3.40%	73.25%
RENAISSANCERE HOLDINGS LTD	82	7,984	3,033	1.03%	1.76%
TORCHMARK CORP	3,340	13,529	2,223	24.69%	97.66%
TRANSATLANTIC HOLDINGS INC	240	13,377	3,198	1.79%	4.87%
TRAVELERS COS INC	1,774	109,751	25,319	1.62%	4.55%
XL CAPITAL LTD	714	45,682	6,115	1.56%	7.58%
				Average	**Average**
				4.41%	32.65%

The Effects of Capitalization of Deferred Acquisition Costs on Financial Leverage (Amounts in $ Millions).

Company Name	DAC, net	Shareholder's Equity (SE)	Revised SE	Total Liabilities	Total Liab./SE	Total Liab./Revised SE
ACE LTD	1,214	14,446	13,657	57,611	3.99	4.22
AFLAC INC	8,237	6,639	1,285	72,692	10.95	56.57
ALLSTATE CORP	8,542	12,641	7,089	122,157	9.66	17.23
AMERICAN INTERNATIONAL GROUP	45,782	52,710	22,952	807,708	15.32	35.19
ARCH CAPITAL GROUP LTD	295	3,433	3,241	11,184	3.26	3.45
ASSURANT INC	2,651	3,710	1,987	20,805	5.61	10.47
AXIS CAPITAL HOLDINGS LTD	273	4,461	4,284	9,822	2.20	2.29
BERKLEY (WR) CORP	395	3,046	2,790	13,075	4.29	4.69
CHUBB CORP	1,532	13,432	12,436	34,997	2.61	2.81
CIGNA CORP	789	3,592	3,079	37,814	10.53	12.28
CINCINNATI FINANCIAL CORP	509	4,182	3,851	9,187	2.20	2.39
CNA FINANCIAL CORP	1,125	6,877	6,146	44,811	6.52	7.29
EVEREST RE GROUP LTD	355	4,960	4,730	11,886	2.40	2.51
GENWORTH FINANCIAL INC	7,786	8,926	3,865	98,463	11.03	25.47
HARTFORD FINANCIAL SERVICES	13,248	9,268	657	278,315	30.03	423.74
LINCOLN NATIONAL CORP	11,936	7,977	219	155,159	19.45	709.78
LOEWS CORP	1,125	13,126	12,395	56,731	4.32	4.58
MARKEL CORP	184	2,181	2,061	7,297	3.35	3.54
METLIFE INC	16,653	23,734	12,910	477,944	20.14	37.02
PARTNERRE LTD	617	4,199	3,798	12,080	2.88	3.18
PRINCIPAL FINANCIAL GRP INC	4,153.0	2,472.80	(227)	125,710	50.84	-
PROGRESSIVE CORP-OHIO	414	4,215.30	3,946	14,035	3.33	3.56
PRUDENTIAL FINANCIAL INC	15,126	13,422	3,590	431,589	32.16	120.22
RENAISSANCERE HOLDINGS LTD	82	3,033	2,980	4,951	1.63	1.66
TORCHMARK CORP	3,340	2,223	52	11,306	5.09	217.49
TRANSATLANTIC HOLDINGS INC	240	3,198	3,042	10,179	3.18	3.35
TRAVELERS COS INC	1,774	25,319	24,166	84,432	3.33	3.49
XL CAPITAL LTD	714	6,115	5,651	39,567	6.47	7.00
					Average	**Average**
					9.88	63.91

It must be remembered, that typically, even aggressive cost capitalization may be within the guidelines of generally accepted accounting principles.

It is a matter of degree.

Most managements choose to charge costs to expense when it is unclear if future periods will benefit.

- The conservative stance

The optimism of some managements, however, lead them to assign a higher likelihood to the benefits to be derived from costs incurred.

- The aggressive stance

If positive future period results prove them correct, then in hindsight, capitalization was the appropriate decision.

If difficulties develop, however, this latter group may have to face the need to write-off capitalized costs.

A Host of Capitalized Costs
Can You Identify Possible Problem Areas?
Medical Disposal Technologies

	2017	2016
Total current assets	$1,755,941	$ 85,635
Property, plant and equipment, net	1,149,379	23,705
Investment in restricted securities	682,500	2,616,250
Excess of cost over net assets acquired, net	2,631,298	--
Incineration rights, at cost, net	1,968,586	--
Customer listing, net	442,500	--
Non-compete agreement, net	222,223	--
Deferred offering costs	442,174	--
Other	76,971	956
Total assets	$9,371,572	$2,726,546
Total liabilities	7,797,714	2,311,564
Total shareholders' equity	1,573,858	414,982
Total liabilities and shareholders' equity	$9,371,572	$2,726,546

A slight miscalculation in the realizability of the many intangibles reported by the company would wipe out its meager amount of stockholders' equity.

Computer Software Development Costs
A Special Form of Research and Development

Key issue: are software costs sufficiently similar to research and development as to necessitate being expensed at the time of expenditure?

- Some argue that economic viability of computer costs can be determined more accurately and earlier than spending on research and development.

- This point of view is reflected in the accounting guidelines for software development costs.

- "The key distinction between our spending (on software development) and R & D is recoverability. We know we are developing something we can sell." From a financial executive in a computer software company.

Costs incurred in creating a computer software product should be charged to research and development expense as incurred until technological feasibility has been established for the product.

- Technological feasibility - management's best estimate that the software product being developed will work, and be economically viable.

Cost incurred in creating a computer software product after technological feasibility has been reached are capitalized.

- A noncurrent asset that is amortized to expense over the estimated useful life of the software product.

Capitalizing Software Development Costs

The definition of technological feasibility is vague and leaves much to management judgment.

As would be expected, companies capitalize software development costs to varying degrees.

The higher the proportion of software costs capitalized, the more likely that future write-downs of previously capitalized costs will be needed.

Capitalizing Software Development Costs

System Software

From the notes . . .

Software costs

The Company capitalizes software development costs in accordance with Statement of Financial Accounting Standards (SFAS) No. 86. Amortization of capitalized costs is computed on a straight-line basis using an estimated useful life of five years or in proportion to current and anticipated revenues, whichever provides the greater amortization. Capitalized software costs are summarized as follows (in millions):

	Year 2	Year 1
Purchased software.......................................	$ 10.6	$ 9.5
Internally developed software............................	178.1	134.4
	188.7	143.9
Less--Accumulated amortization...........................	(89.3)	(61.1)
Net capitalized software costs.........................	$ 99.4	$ 82.8

Amortization of capitalized software costs charged to cost of license fees aggregated $28.2 million and $14.9 million during Years 2 and 1, respectively.

Research and development
Research and development expenses, principally the design and development of software products (exclusive of costs capitalized under SFAS No. 86), are expensed as incurred. Research and development expenses totaled $51.7 and $54.4 in years 2 and 1, respectively.

The percent of software costs incurred that were capitalized was 45.8% computed as follows:

Software costs capitalized of $43.7 (i.e., $178.1 - $134.4) divided by software costs incurred of $95.4
(i.e., $43.7 + $51.7).

Compare this 45.8% to American Software's percent capitalized in the next example.

Class Exercise
American Software

American Software writes computer software for business applications. Excerpts from the company's financial statements are provided below.

Required:

1. Calculate the percentage of software costs incurred that are capitalized by the company. Compare the percentage with the percentages capitalized by Microsoft and System Software. What are the implications of your findings?

2. American Software reported pretax operating earnings of $1.681 million in year 2. What would the company's earnings have been if it had followed Microsoft's lead and expensed all of its software costs?

3. What are the implications for future earnings of American Software's capitalization policy? Are there any other indications that the company may have in the past been aggressive in its capitalization policy?

American Software (cont'd)

From the notes . . .

(e) Capitalized Computer Software Development Costs

The Company capitalizes computer software development costs by project, commencing when technological feasibility for the respective product is established and concluding when the product is ready for general release to customers. The Company capitalized computer software development costs totaling approximately $9.9 million and $12.8 million in years 2 and 1, respectively.

Capitalized computer software development costs are being amortized using the straight-line method over an estimated useful life of three years. Amortization expense was approximately $4.7 million and $7.1 million in years 2 and 1, respectively.

The total of research and development costs and additions to capitalized computer software development costs were approximately $12.2 million and $16.1 million in years 2 and 1, respectively. The Company incurred research and development costs totaling approximately $2.3 million and $3.4 million, which were expensed in years 2 and 1, respectively.

The Company makes an ongoing assessment of the recoverability of its capitalized software projects by comparing the amount capitalized for each product to the estimated net realizable value (NRV) of the product. If the NRV is less than the amount capitalized, a write-down to NRV is recorded. In the most recent prior year, the Company expensed approximately $3.6 million as these amounts were deemed unrealizable based on future revenue projections.

(f) Purchased Computer Software Costs

Purchased computer software costs represent the cost of acquiring computer software. Amortization of purchased computer software costs is calculated using the straight-line method over a period of three to five years. Amortization expense was approximately $734,000 and $2.4 million in years 2 and 1, respectively. The Company expensed $2.6 million in the most recent prior year as this amount was deemed unrealizable based on future revenue projections.

From the balance sheet . . .

(in thousands of dollars)	Year 2	Year 1
Capitalized computer software development costs, less accumulated amortization of $31,838 in Year 2 and $27,167 in Year 1	$ 28,171	$ 22,944
Purchased computer software costs, less accumulated amortization of $4,833 in Year 2 and $4,101 in Year 1........	846	1,231
Total computer software costs.............................	29,017	24,175

The range in software cost capitalization policy is interesting. Different companies interpret the guideline of technological feasibility very differently.

System Software has elected to capitalize about 46% of its costs.

In contrast, American Software capitalizes a much higher portion of its software development costs.

The impact on earnings can be significant.

Moreover, future earnings are subject to software amortization charges and write-downs in the event the capitalized software costs prove to be unrealizable.

Disconnected: Inside WorldCom 's Unearthing Of a Vast Accounting Scandal
Internal Auditor Discovered An Unorthodox Treatment
Of Long-Distance Expenses (Exceprts)

The Wall Street Journal
by Jared Sandberg, Deborah Solomon and Rebecca Blumenstein
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NEW YORK -- It all started a few weeks ago with a check of the books by Cynthia Cooper, an internal auditor for **WorldCom** Inc. The telecom giant's newly installed chief executive had asked for a financial review, and her job was to spot-check records of capital expenditures.

According to people familiar with the matter, Ms. Cooper soon found something that caught her eye. In quarter after quarter, **WorldCom** 's chief financial officer, Scott Sullivan, had been using an unorthodox technique to account for one of the long-distance company's biggest expenses: charges paid to local telephone networks to complete calls.

Instead of marking them as operating expenses, he moved a significant portion into the category of capital expenditures. The maneuver was worth hundreds of millions of dollars to **WorldCom**'s bottom line, effectively turning a loss into a profit.

Ms. Cooper contacted Max Bobbitt, the head of **WorldCom** 's auditing committee, setting in motion a chain of events that resulted in Mr. Sullivan's firing late Tuesday. The company said that it had turned up $3.8 billion of expenses that were improperly booked and will now be restated.

Extended Amortization Periods

Guidelines for Choosing an Amortization Period

Systematic and rational amortization of capitalized costs to expense requires selection of an amortization period (i.e., useful life).

The longer the amortization period, the lower the recorded expense amount, increasing pretax earnings.

Determining asset amortization periods is a management decision, providing much discretion over reported results.

Differences of opinion among managements regarding the amortization periods for property, plant and equipment items is evident in the accounting policy notes provided below.

All companies are from a single industry, medical supplies and devices.

Bausch & Lomb

From the notes . . .

Depreciation of property, plant and equipment, including the amortization of capital lease obligations and capitalized interest, is calculated for financial reporting purposes using the straight-line method based on the estimated useful lives of the assets as follows: buildings, 30 to 40 years; machinery and equipment, 2 to 10 years; and leasehold improvements, the lease periods.

Cordis Corp.

From the notes . . .

The lives used in calculating provisions for depreciation and amortization of the principal assets using the straight-line method are as follows:

Building and improvements	10 - 30 years
Leasehold improvements	10 - 20 years
Machinery and equipment	3 - 10 years

Surgical Corp.

From the notes . . .

Depreciation and amortization is provided using the straight-line method over the following estimated useful lives:

Buildings	40 years
Molds and dies	5 - 7 years
Machinery and equipment	3 - 10 years
Leasehold improvements	10 - 20 years

The Impact of Amortization Periods on Pretax Results
Surgical Corp.

At 2017 and 2016, Property, plant, and equipment (at cost) was comprised of the following items:

(In thousands)	2017	2016
Land	$ 21,200	$ 26,700
Buildings	154,100	164,100
Molds and dies	91,100	88,600
Machinery and equipment	292,000	289,300
Leasehold improvements	158,600	154,600
	717,000	723,300
Less allowance for depreciation and amortization	(295,800)	(275,600)
	$ 421,200	$ 447,700

Applying an amortization period of 40 years to the average cost of buildings account, and an average amortization period of 6 years and 6.5 years to the average cost of molds and dies and machinery and equipment accounts, respectively, and an average amortization period of 15 years to leasehold improvements yields a depreciation charge of $ 74,108 for 2017.

Reducing the amortization period for the buildings to 30 years and for the molds and dies and machinery and equipment to 4 years and 4.5 years, respectively, and for leasehold improvements to 10 years, would yield a depreciation charge of $108,015 for 2017.

This revised depreciation charge, recomputed using asset amortization periods that are not inconsistent with what competitors are using, yields a depreciation charge that is $33,907 higher. Pretax earnings would be reduced accordingly.

The $33,907 depreciation difference is 28% of the company's reported pretax earnings of $ 121,000 for 2017. Moreover, the impact is cumulative, boosting asset book values and stockholders' equity by a greater amount each year.

Differences in the Selection of Amortization Periods
Capitalized Software Development Costs

Bolt Beranek and Newman

From the notes . . .

> Costs incurred internally, after establishing technological feasibility and before general release of a computer software product, are amortized over 3 years. Costs incurred for purchased software technology are amortized over 7 years.

Autodesk

From the notes . . .

> Costs incurred in the initial design phase of software development are expensed as incurred. Once the point of technological feasibility is reached, direct production costs (programming and testing) are capitalized and amortized ratably as revenues are recognized, but not less than on a straight-line basis over two to five year periods.

BMC Software

From the notes . . .

> The cost of capitalized software is amortized over the products' estimated useful lives or five years, whichever is less.

Brazen Steps Taken to Boost Earnings Through Extended Amortization Periods

Livent, Inc.
Capitalized Preproduction Costs

The accounting scheme was conducted in three parts.

(1) Preproduction costs, which include costs for advertising, sets and costumes, incurred before a show opens, were transferred to fixed asset accounts, such as the cost of theater construction. While preproduction costs are expensed through amortization once a production begins over a period not to exceed five years, fixed assets are depreciated over their useful life, which could be up to forty years for buildings. As an example, $15 million was transferred from preproduction costs to fixed assets.

(2) At the end of each quarter, certain expenses and related liabilities were removed from the general ledger, literally erasing them from the Company's books. In the following quarter, the expenses and related liabilities would be re-entered as the original entries. This movement of expenses from current periods to future periods was referred to as the "Expense Roll". As an example, total expenses rolled from the first to second quarter of the year totaled $10 million.

(3) Costs were transferred from one show currently running to another show that had not yet opened or that had a longer amortization period. This permitted capitalization of expenses and allowed non-amortization for capitalized costs. During the year, $12 million relating to several different shows and locations were transferred in this way. The amount of amortization moved from the current period to future periods was referred to as the "Amortization Roll".

What's an Extended Amortization Period?

Earlier it was noted that the impact of increased amortization periods (i.e., useful lives) has a cumulative effect on asset book values and stockholders' equity.

Asset book values are boosted each year by the reduced depreciation and amortization expense that a longer amortization period provides.

Stockholders' equity is raised by the after-tax effect of the increased asset book value.

All assets, including property, plant and equipment, intangibles and capitalized software development costs are not to be carried on the balance sheet at amounts greater than net realizable value.

- When book value exceeds net realizable value, an asset is value impaired, a writedown and accompanying charge to income are needed.

- Different names for the loss:

    - Asset writedown
    - Impairment loss
    - Restructuring charge

Historically, inflation helped to alleviate the need for asset writedowns.

- As prices rose generally, net realizable values were pulled up and tended to exceed historical cost-based book values.

- More recently, with disinflation generally and deflation in many high-technology industries, net realizable values are falling, sometimes rapidly.

- Add to this stable to declining price environment, extremely rapid technological advances which tend to quickly render fixed asset and intangible asset investments obsolete and future losses from asset impairment are more likely.

An extended amortization period is one which leads to insufficient amortization and depreciation charges. It raises the likelihood of asset writedowns later.

In effect, earnings are overstated in prior years.

A "catch-up" is needed in the form of an asset writedown to make-up for insufficient charges in prior years.

Writedown of Overvalued Assets
Did Underdepreciation in Prior Years Play a Role?
Snax, Inc.
(in thousands)

	2015	2016	2017
Revenues (amounts in 000's):			
Restaurant sales................	$ 216,411	$ 225,625	$ 233,212
Franchise sales and other revenues......................	10,055	11,309	17,678
	226,466	236,934	250,890
Costs and expenses:			
Cost of food and paper products.	77,250	85,631	90,385
Restaurant operating expenses:			
Labor.........................	57,860	60,266	63,593
Occupancy.....................	26,709	28,529	28,514
Other........................	27,592	26,569	27,430
	112,161	115,364	119,537
Depreciation and amortization...	14,879	16,195	16,861
General and administrative......	12,818	14,979	16,418
Non-recurring charge (Note 6)...	8,500	4,435	-
	225,608	236,604	243,201
Operating income.................	858	330	7,689

6. Non-recurring Charges

During the third quarter of fiscal 2016, the Company recorded a non-recurring charge of $4.4 million principally to reflect a write-down under Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for the Long-Lived Assets to be Disposed of". SFAS 121 establishes accounting standards for recognizing and measuring the impairment of long-lived assets and requires reducing the carrying amount of any impaired asset to fair value. The charge was taken as a result of continued less than expected performance results at certain restaurants. The $4.4 million non-cash charge included a $1.4 million goodwill write-down, a $0.6 million fixed asset write-down and a $1.4 million write-down of an office building held for resale. The charge represented a reduction of the carrying amounts of the assets to their estimated fair values as determined by using discounted estimated future cash flows. In addition, the $4.4 million charge included a $1.0 million charge to write-down the book value of six restaurants whose leases expired in 2017 and which were not renewed. For the fifty-two weeks ended December 28, 2016 and December 27, 2017 the restaurants included in the reserve had sales of $3,096,000 and $1,559,000, respectively and a pre-tax loss of $578,000 and $313,000, respectively.

Signs that a company may be a candidate for an asset writedown through the use of an extended amortization period is found in the average amortization periods used to expense fixed and intangible assets.

The appropriateness of the average amortization periods employed given the company's operating circumstances should be considered.

In considering the appropriateness of the amortization periods employed, a comparison with the amortization periods employed by competitors would be helpful.

Unfortunately, as seen earlier, the amortization periods are typically disclosed in an inconcise way (e.g., machinery and equipment are depreciated over useful lives of between 2 and 10 years) making comparisons difficult.

A useful alternative technique is to compute an average amortization period.

Calculating the Average Amortization Period for Property, Plant and Equipment

American Semiconductor

From the notes . . .

Property, plant and equipment (in millions)

(in millions)	2017	2016
Land	$ 19.1	$ 19.1
Buildings and improvements	460.7	523.9
Machinery and equipment	1,321.3	1,604.7
Construction in progress	470.8	369.0
	2,271.9	2,516.7
Less accumulated depreciation	1,008.5	1,208.6
Property, plant and equipment, net	$ 1,263.4	$ 1,308.1

Because they are not depreciated, land and construction in progress should be subtracted from asset costs at the end of 2016 and 2017. The resulting average asset cost for 2017 is $1,955.3, (($1,782.0 + $2,128.6) / 2).

The company reported depreciation expense of $231.0 on property, plant and equipment during 2017.

$231.0 is 11.81% of the average asset cost of $1.955.3.

Taking the reciprocal of 11.81% indicates an average useful life of just over 8 years, which is in line with the semiconductor industry average.

While the technique is somewhat "rough and dirty" it is a useful preliminary indicator for under-expensing arising from the use of an extended amortization period.

The technique assumes use of the straight-line method of amortization, which for book purposes, is employed in most companies.

It should be kept in mind that companies with large investments in buildings will tend to have higher amortization periods than companies with proportionally higher investments in machinery and equipment. Companies with buildings under operating lease will tend to have a proportionately higher investment in machinery and equipment.

Class Exercise
Micron Technology

Micron Technology is a computer memory chip manufacturer. Excerpts from the company's financial statements are provided below.

Required:

1. Calculate the average amortization period for the company's product and process technology assets? Does that period seem reasonable?

2. What are the implications for future earnings of carrying the asset, product and process technology?

	Year 2	Year 1
ASSETS (amounts in millions)		
Cash and equivalents	$ 619.5	$ 276.1
Liquid investments	368.2	10.7
Receivables	458.9	347.4
Inventories	454.2	251.4
Prepaid expenses	9.4	13.4
Deferred income taxes	62.2	65.0
Total current assets	1,972.4	964.0
Product and process technology, net	51.1	43.2
Property, plant and equipment, net	2,761.2	2,708.1
Other assets	66.6	36.2
Total assets	$4,851.3	$3,751.5

PRODUCT AND PROCESS TECHNOLOGY: Costs related to the conceptual formulation and design of products and processes are expensed as research and development. Costs incurred to establish patents and acquire product and process technology are capitalized. Capitalized costs are amortized on the straight-line method over the shorter of the estimated useful life of the technology, the patent term or the agreement, ranging up to 10 years. Amortization of capitalized product and process technology costs was $11.4 million in Year 2 and $13.6 million in Year 1.

Product and process technology, at cost	$108.1	$ 93.1
Less accumulated amortization	(57.0)	(49.9)
	$ 51.1	$ 43.2

Class Exercise
American Software

Earlier we calculated the percentage of software costs incurred that were capitalized by American Software. Once capitalized, these costs must be amortized. Excerpts from the company's financial statements are provided below.

Required:

1. Calculate the length of time over which American Software is amortizing capitalized and purchased software costs. Does this length appear to be reasonable?

2. What are the implications for future earnings? What would amortization expense have been if the amortization period had been half as long?

3. What can cause your calculated amortization period to be inaccurate?

From the balance sheet . . .

(in thousands of dollars)	Year 2	Year 1
Capitalized computer software development costs, less accumulated amortization of $31,838 in Year 2 and $27,167 in Year 1.............................	$ 28,171	$ 22,944
Purchased computer software costs, less accumulated amortization of $4,833 in Year 2 and $4,101 in Year 1	846	1,231
Total computer software costs.............................	29,017	24,175

From the notes . . .

(e) Capitalized Computer Software Development Costs
The Company capitalized computer software development costs totaling approximately $9.9 million and $12.8 million in Year 2 and Year 1, respectively. Capitalized computer software development costs are being amortized using the straight-line method over an estimated useful life of three years. Amortization expense was approximately $4.7 million and $7.1 million in Year 2 and Year 1, respectively.

(f) Purchased Computer Software Costs
Purchased computer software costs represent the cost of acquiring computer software. Amortization of purchased computer software costs is calculated using the straight-line method over a period of three to five years. Amortization expense was approximately $734,000 and $2.4 million Year 2 and Year 1, respectively. The Company expensed $2.6 million in the earliest prior year as this amount was deemed unrealizable based on future revenue projections.

Rules for Goodwill

Goodwill is not amortized but must be reviewed for impairment on an annual basis.

As a result, latent losses may be carried on the balance sheet when goodwill is carried at an amount that exceeds its fair value.

Evidence of an impairment loss may be obtained by comparing the fair value of an acquired entity to its book value.

American Standard Companies, Inc.

Goodwill. The carrying value is reviewed if the facts and circumstances, such as significant declines in sales, earnings or cash flows or material adverse changes in the business climate, suggest that it may be impaired. If this review indicates that goodwill will not be recoverable, as determined based on the estimated undiscounted cash flows of the entity acquired, impairment is measured by comparing the carrying value of goodwill to fair value. Fair value is determined based on quoted market values, discounted cash flows or appraisals.

Goodwill Impairment

Another Write-Off May Loom for AOL
Despite Stock's Recent Recovery, Investors Aren't Likely to Agree
With Values Assigned to Assets (Excerpts)
The Wall Street Journal

By Jonathan Weil
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ANOTHER LARGE WRITE-OFF of intangible assets could be on the way at AOL Time Warner Inc. -- and investors would have a much harder time dismissing it as a nonevent.

Even with the recent rebound in AOL's stock off its summer lows, the values of the intangible assets listed on AOL's books once again look out of whack with what investors suggest they are worth. And barring a rapid improvement in its operations' outlook, the company before long might have no choice but to chop tens of billions of dollars off its asset values once again.

AOL already holds the record for the largest write-off ever. During the first quarter the company took a $54.2 billion pretax charge to write down the value of much of the goodwill assets it booked from its acquisition of Time Warner. Goodwill is an accounting entry reflecting the amount by which the purchase price for a deal exceeds the fair value of the acquired company's net assets. In its public filings, AOL largely dismissed the event as a noncash charge reflecting, in part, "the decline in the company's stock price" since the merger was announced.

However, another 11-figure charge to earnings wouldn't be so easy to play down. Under a new $10 billion set of bank credit agreements signed in July, AOL pledged that it wouldn't allow its book value to fall below $50 billion -- a little more than half its present book value, or the difference between a company's assets and liabilities.

A look at AOL's remaining intangible assets suggests the present gap between AOL's book value and the loan-covenant figure could narrow significantly -- and soon. AOL's gargantuan charge earlier this year didn't reduce any of the goodwill assigned to the company's America Online Internet service provider unit.

AOL's chief financial officer, Wayne Pace, says "it's absolutely premature and inappropriate to take an impairment charge at this time," and that the company will formally review its goodwill and other intangible-asset valuations during the fourth quarter.

But some accounting specialists say those rich goodwill valuations defy common sense, especially given the well-documented troubles of AOL's America Online unit. "Just on the surface, it's difficult to see where they would find value in the business sufficient to justify that much goodwill," says Douglas Carmichael, an accounting professor at Baruch College in New York.

Corporate-earnings reports have been littered with massive goodwill-impairment charges to earnings in recent months. That is thanks to a series of rule changes this year by the Financial Accounting Standards Board that allows companies to avoid recognizing quarterly amortization

expenses but require them to write off any goodwill assets whose values they no longer can justify.

Investors often treat such charges as one-off events, amounting to admissions that past acquisitions failed to meet expectations. But these write-offs signal vital information about the future, including that a company's executives are reducing their cash-flow projections for the divisions whose assets they are writing down. As in AOL's case, lenders periodically require that borrowers promise to keep their net assets above certain minimums. Violations of those covenants can prompt bankers to insist on stricter terms, such as higher interest rates or shorter terms.

AOL's America Online division has been suffering from slowing subscriber growth, plummeting advertising sales and criminal and civil investigations by federal authorities into its accounting practices. Considering the unlikely prospect that the dot-com bubble will return, if there is any division whose assets have declined in value since the merger that formed AOL Time Warner last year, it is America Online, says Charles Mulford, an accounting professor at Georgia Institute of Technology in Atlanta.

Based on AOL's closing stock price yesterday of $14.07, down 56% year to date and 41% since the end of the first quarter, the company now sports a $60.4 billion market value, well under its book value of $97.7 billion. And if it weren't for its $125.2 billion of intangible assets -- $80.1 billion of which is goodwill -- AOL would have negative book value.

For the time being, AOL doesn't look as if it is in any danger of tripping up its debt covenant, given that its present book value is nearly twice the $50 billion threshold. But Mr. Mulford says it could get close, especially if market values for cable and Internet assets don't improve in the coming months. "It's not hard to see a scenario that would result in the company violating the $50 billion net-worth covenant," Mr. Mulford says.

Company spokesman Edward Adler says it would be "irresponsible" to conclude that impairment charges are needed, because outsiders can't access the company's internal data. He notes the $5.5 billion estimate for the value of AT&T's minority stake comes from securities analysts and not the company, which didn't release a figure. He says the figure shouldn't be used to gauge the value of AOL's cable holdings because AT&T won't hold a controlling stake. Mr. Adler says an independent appraisal firm retained by AOL, which he declined to identify, recently determined that its goodwill and cable-franchise assets were properly valued.

Other Denials of the Need for Goodwill Impairment Charges

1. Management believes the Company's forecasted cash flows constitute a better indicator of the current fair value of Alcoa's reporting units than the current pricing of its common shares (*Alcoa, Inc.).*
2. Emtec's market capitalization was less than the total shareholders' equity, which is one factor the Company considered when determining whether goodwill should be tested for impairment between annual tests. The Company doesn't believe that the reduced market capitalization represents a goodwill impairment indicator (*EMTEC, Inc.*).
3. Management believes that the recent decline in the Company's market capitalization is not due to any fundamental change or adverse events in the Company's operations. Accordingly, the Company has not recognized any impairment of its goodwill (*Keynote Systems, Inc.*).
4. The Company's stock price has been trading below its book value and tangible book value for two consecutive quarters. The Company attributes this low stock price to both the overall market conditions and company specific factors, including low trading volume of the Company's stock. Based on our evaluation, there was no impairment of goodwill (*Misonix, Inc.).*
5. The market price of Parkvale stock was $12.42 per share, which is below the book value of $24.23 at such date. Management does not consider goodwill to be impaired. If the financial markets remain under stress and if Parkvale stock continues to trade at a range of 50% to 55% of book value, a goodwill impairment charge is possible in a future quarter. (*Parkvale Financial Corp.).*
6. The Company's market capitalization declined below book value. While management considered the market capitalization decline, management believes that the decline would not impact overall goodwill impairment analysis as management believes the decline is to be primarily attributed to the negative market conditions as a result of the credit crisis, beginning a recession and current projections within the building industry" (*Quanex Building Products Corp.).*
7. The the market value of the Company's Class A common stock traded below its book value. The Company determined that no triggering event had occurred, as the long-term fundamentals of the Company's business have not changed (*Schnitzer Steel Industries, Inc.*).
8. During the latter part of the fourth quarter our market capitalization was below book value. While we considered the market capitalization decline in our evaluation of fair value of goodwill, we determined it did not impact the overall goodwill impairment analysis as we believe the decline to be primarily attributed to the negative market conditions as a result of the credit crisis, indications of a possible recession and current issues within the poultry industry. We will continue to monitor our market capitalization as a potential impairment indicator considering overall market conditions and poultry industry events (*Tyson Foods, Inc.).*

Financial Warnings Checklist
Aggressive Cost Capitalization

Is the company's general policy with respect to cost capitalization aggressive or conservative?

- Is the company capitalizing costs that competitors or other companies in the industry expense?
- Does the company expense more, taking a more conservative stance?
- What do capitalized costs represent?
    - An identifiable asset with an ascertainable market value?
    - Not an identifiable asset, market value, if any is tied to the fortunes of the company?
- Do capitalized costs exceed net realizable value?
- For companies capitalizing software development costs, does the company capitalize a higher proportion of software development costs incurred than competitors or other firms in the industry?

- For companies capitalizing interest costs, should capitalization of interest costs be discontinued?

    - Is the asset complete and available for its intended use?

    - Do costs incurred on the asset under construction give an indication of approaching net realizable value?

        - Have there been construction delays?

        - Have there been cost overruns?

- A policy of capitalizing the following costs should be considered very aggressive, potentially at odds with generally accepted accounting principles:

    - Advertising, marketing and promotion costs
    - Foreign exchange losses on long-term borrowings
    - Costs incurred on internally conducted research and development activities

- Special warning - has the company shown evidence inthe past of being aggressive in its capitalization policies?

    - Is there an example of a prior year writedown of capitalized costs that, in hindsight, should not have been capitalized?

Extended Amortization Periods

Has the company selected extended amortization and depreciation periods for capitalized costs and fixed assets?

- As data permits, how does the calculated average amortization period for each asset class compare with competitors or other firms in the industry?
    - Property, plant and equipment - reciprocal of depreciation expense divided by average asset costs excluding land and construction in process from the calculation
    - Intangibles and technology-based assets, including capitalized software development costs - reciprocal of amortization expense divided by average asset costs
- Special warning - be particularly alert for extended amortization periods in the following situations:
    - Company's industry is experiencing price deflation
    - Company is in an industry that is experiencing rapid technological change
    - Company has shown evidence in the past of employing extended amortization periods.
        - Is there an example of a prior year writedown of assets that became value impaired?