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PolyMedica Corporation (A)

On June 30, 2003, PolyMedica Corporation disclosed in its Form 10-K for the year ended March 31, 2003, that the company had been in discussions with the staff of the Securities and Exchange Commission (SEC) regarding its capitalization rather than expensing of direct-response diabetic and respiratory product advertising expenditures. The company was "eager to resolve this issue as quickly as possible."[1]

The Company

PolyMedica Corporation (ticker symbol PLMD) was a leading provider of direct-to-consumer medical products, conducting business through its Liberty Diabetes, Liberty Respiratory and Pharmaceuticals segments. The Liberty Diabetes segment provided direct-to-consumer diabetes testing supplies and related products primarily to Medicare-eligible customers suffering from diabetes and related chronic diseases. The Liberty Respiratory segment provided direct-to-consumer prescription respiratory medications and supplies primarily to Medicare-eligible customers suffering from chronic obstructive pulmonary disease (COPD). The Pharmaceuticals segment provided prescription oral medications not covered by Medicare directly to consumers and sold prescription urology and suppository products, over-the-counter female urinary discomfort products, and home medical diagnostic kits.

As of March 31, 2003, PolyMedica had approximately 545,000 active diabetes customers, as compared to approximately 440,000 as of March 31, 2002.[2] The company met the needs of customers suffering from diabetes by: providing mail order delivery of supplies directly to its customers' homes; billing Medicare and/or private insurance companies directly for those supplies that were reimbursable; providing 24-hour telephone support to customers; and using sophisticated software and advanced order fulfillment systems to provide products.

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[1] PolyMedica Corporation Press Release, June 30, 2003.

[2] PolyMedica defined a person as an active customer if that person had placed an order and the company had shipped supplies to that person in the past 12 months.

Professors David F. Hawkins and Jacob Cohen, Affiliate Professor of Accounting & Control at INSEAD, prepared this case. This case was developed from published sources. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

As of March 31, 2003, PolyMedica had approximately 63,000 active customers for its prescription respiratory medications and supplies, compared to approximately 46,000 as of March 31, 2002. The customers were serviced in a similar manner to the diabetic product customers.

Business Strategy

PolyMedica's principal strategy was to leverage its operating platform and compliance management to expand its business.

PolyMedica pursued continued growth in its direct-to-consumer businesses by expanding its customer base. Since 1996; the company had invested in an ongoing program of direct-response television advertising to reach a larger portion of the Medicare-eligible patient market. This campaign resulted in a significant increase in sales as the company expanded its active Medicare-eligible diabetes customers from approximately 17,000 to approximately 545,000 customers in 2003.

As a result of the expansion of its customer base, and emerging ability to leverage the value of its customer base by marketing a range of products to its customers, PolyMedica was considering a number of new marketing initiatives. These initiatives included the use of broad-based advertising that might not qualify as direct-response advertising. The company was also considering expanding its customer base by purchasing businesses that provided products to consumers that were complementary to PolyMedica's existing products.

Accounting Controversy

In early 2003, the capitalization method used by PolyMedica to account for its approximately $50 million annual diabetic and respiratory products advertising campaign was questioned by several investors.

At the heart of the debate was a question: Were direct-response advertising expenditures for diabetic and respiratory products an expense—a cost to be deducted from revenue as incurred? Or were they an asset, something that generates a future benefit for a company? (See **Exhibit 1** for PolyMedica's policies regarding advertising expenditures.)

In 1993, the American Institute of Certified Public Accountants (AICPA) in Statement of Position (SOP) 93-7 ruled that most advertising should be treated as an expense, and charged against revenue.[3] An exception was direct-response advertising, where it is possible to reasonably match the expenses with sales generated by each advertisement. In this case, the expenditure must be put on the balance sheet as an asset, and written off over time. (See **Exhibit 2** for a summary of SOP 93-7).

To qualify for the direct-response exclusion, companies had to show proof that ads generated specific sales. Ads that only yielded leads, for which the company was required to expend additional marketing effort to create a sale, didn't qualify for the special treatment. The exclusion was intended to be a narrow opening enabling companies to employ the asset-creation strategy only for specific ads that met a long list of conditions. "The criteria for getting into the box were intended to be tight" said Norman Strauss, the former national director of accounting for Ernst & Young. "The ad campaigns

[3] Jeffrey Krasner, "Woburn, Mass.-Based Blood Glucose Test Company Gets New Spokesman," *The Boston Globe*, January 22, 2003.

had to be narrowly targeted. You needed to set up systems for tracking responses."[4] Thereafter, to write off the capitalized advertising costs over a period longer than a year, the firm had to demonstrate that each sale generated a continuing stream of revenue.

PolyMedica ran hundreds of commercials directed at potential diabetic and respiratory product customers each year and tracked the results independently by giving each commercial its own toll-free number. "We have over one thousand 800 numbers;" said Stephen C. Farrell, PolyMedica's chief financial officer.[5] "One of our challenges is getting good 800 numbers."[6] Thereafter, PolyMedica's business was based on taking the hassle out of buying the test strips, billing Medicare or insurers directly for payment and filling out the paperwork. For each customer, the firm kept track of the prescription, doctor, and insurance carrier.

Typically, new customers responding to PolyMedica's ads purchased a three-month supply of glucose test strips, worth about $120. When the 90-day supply was close to running out, customer service representatives made calls to the customer's doctor, to ensure the prescription was still active and consistent with the patient's current test regimen; to the insurance firm, to arrange payment directly to PolyMedica; and to the customer, to confirm the additional sale in the event they haven't returned a reorder card included with the first shipment. Some, such as the SEC and short sellers, questioned whether this work constituted significant additional marketing activity that would disqualify the initial ads from the special accounting treatment. At PolyMedica, though, such calls are considered administrative work, according to Farrell.[7] That enables the company to claim that the initial sale generates the ongoing stream of income, and hence to write off the advertising expense over a longer period.

When questioned about the accounting treatment of advertising costs, PolyMedica officials said they have no choice but to capitalize direct advertising costs. "Our business is more akin to an insurance or annuity business than a traditional medical supplier. The formula of our business means we have to do it this way," said Samuel L. Shanaman, PolyMedica's CEO.[8] Moreover, Shanaman commented, "investors who feel uncomfortable with the treatment can calculate an alternate income statement that removes the advertising from the balance sheet and treats it as an ordinary expense."[9] However, given our business model we believe that our current accounting is proper. In fact, PolyMedica's external auditors, PricewaterhouseCoopers LLP, approved of the company's treatment of direct-response advertising expenditures.

As of June 9, 2003, 4.1 million shares of the company's stock had been sold by short sellers, who among other concerns about the company, such as a loss of brokerage research coverage and inquiries by the Department of Justice into the company's sales practices, believed that the company should be required to change its accounting policy for direct-response advertising to one of expensing as incurred.

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[4] Jeffrey Krasner, "Woburn, Mass.-Based Blood Glucose Test Company Gets New Spokesman," *The Boston Globe*, January 22, 2003.

[5] Ibid.

[6] Ibid.

[7] Ibid.

[8] Ibid.

[9] Ibid.

Questions

1. Explain the difference between an asset and an expense.
2. Explain the role of advertising in the company's customer acquisition strategy.
3. What are the arguments in favor of capitalizing the direct-response advertising expenditures? What are the arguments in favor of expensing the direct-response advertising expenditures as incurred? As a CEO of PolyMedica, would you favor capitalizing or expensing the direct-response advertising costs?
4. What would be the impact on the company's financial statement if PolyMedica had expensed the costs as incurred in 2003 and 2002? Calculate key balances that highlight any major differences.
5. As a CEO of PolyMedica, how might you respond to this direct-response advertising accounting issue raised by the SEC and short sellers?

Exhibit 1 PolyMedica Accounting Policies Regarding Advertising Expenditures

Advertising

Nondirect response advertising, promotional and marketing costs are charged to earnings in the period in which they are incurred.

Direct-Response Advertising

In accordance with Statement of Position 93-7 ("SOP 93-7"), direct-response advertising and associated costs for our diabetes supplies and related products, included in the Liberty Diabetes segment, for all periods presented are capitalized and amortized to selling, general and administrative expenses on an accelerated basis during the first two years of a four-year period. The amortization rate is such that 55% of such costs are expensed after two years from the date they are incurred, and the remaining 45% is expensed on a straight-line basis over the next two years. Management assesses the realizability of the amounts of direct-response advertising costs reported as assets at each balance sheet date by comparing the carrying amounts of such assets to the probable remaining future net cash flows expected to result directly, from such advertising. We expense in the period advertising that does not meet the capitalization requirements of SOP 93-7.

Direct-response advertising and related costs for our respiratory supplies, included in the Liberty Respiratory segment, for all periods presented are capitalized and amortized to selling, general and administrative expenses on a straight-line basis over a two-year period.

In accordance with SOP 93-7, we recorded the following activity related to our direct-response advertising asset for the periods presented (in thousands):

	Fiscal Year Ended		
	March 31, 2003	March 31, 2002	March 31, 2001
Capitalized direct-response advertising	$48,409	$42,478	$31,466
Direct-response advertising amortization	36,460	30,306	19,604
Increase in direct-response advertising asset, net	$11,949	$12,172	$11,862
Beginning direct-response advertising asset, net	52,112	39,940	28,078
Ending direct-response advertising asset, net	$64,061	$52,112	$39,940

Source: PolyMedica Corporation, 10-K Filing with the Securities and Exchange Commission, March 2003.

Exhibit 2 Summary of Statement of Position 93-7

The guidance in the SOP is based on the premise that most advertising may result in probable future economic benefits that meet the definition of an asset in FASB Concept Statement No. 6, Elements of Financial Statements. However, the American Institute of Certified Public Accountants' Accounting Standards Executive Committee (AcSEC) concluded that those assets (with the exception of assets resulting from certain direct-response advertising) would not meet the recognition criteria of reliability in FASB Concept Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises. Under Concept Statement No. 5, to be reliable, the information must be representationally faithful, verifiable, and neutral. AcSEC concluded that for most advertising, the probable future economic benefits are not measurable with the degree of reliability required to report an asset in the financial statements. The exception is direct-response advertising that may result in probable future economic benefits that are measurable with the degree of reliability required to report an asset in the financial statements. The SOP requires the following.

Generally, the costs of all advertising should be expensed either in the periods in which those costs are incurred or the first time the advertising takes place.

The exception is direct-response advertising a) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and b) that results in probable future economic benefits (future benefits).

The future benefits are probable future revenues the entity would not have without the advertising in excess of the costs to be incurred in realizing those revenues.

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 that resulted in future benefits.

Showing that a customer responded to direct-response advertising requires documentation linking the advertising to the sale, including a record that can identify the customer and the advertising that elicited the direct response. Such a record may include a file indicating the customer name and related direct-response advertisement; a coded order form, coupon, or response card included with an advertisement indicating the customer name; or a log of customers who have made phone calls to a number appearing in an advertisement.

Industry statistics would not be considered objective evidence that direct response advertising will result in future benefits.

The costs of advertising directed to all prospective customers, not only the portion of the costs attributable to individuals who become customers, should be used to report such assets initially. The costs eligible for capitalization include only incremental direct costs of the direct-response advertising.

The amounts of direct-response advertising reported, as assets should be amortized over the estimated period of the benefits, based on the proportion of current period revenue from the advertisement to probable future revenue, subject to a net realizable value test. The realizability of amounts at which the future benefits of direct-response advertising are reported as assets should be evaluated at each reporting date.

Source: Reprinted with permission. Andrew D. Finger, "Reporting on Advertising Costs," *The CPA Journal Online*, May 1994.

Exhibit 3 PolyMedica Corporation Consolidated Balance Sheet

For Period Ended March 31, 2003 (in thousands)	3/31/03	3/31/02
Current assets:		
Cash and cash equivalents	$ 27,162	$ 27,884
Investments	1,442	–
Accounts receivable (net of allowances of $22,556 and $15,539)[a]	61,168	44,059
Inventories	18,850	21,663
Deferred income taxes	13,960	10,622
Prepaid expenses and other current assets	3,438	1,727
Total current assets	$126,020	$105,955
Property, plant, and equipment, net	$ 53,304	$ 34,603
Goodwill	5,946	29,748
Intangible assets, net	108	698
Direct-response advertising, net	64,061	52,112
Other assets	1,530	1,276
Total assets	$250,969	$224,392
Current liabilities:		
Accounts payable	$ 12,576	$ 10,270
Accrued expenses	17,003	17,788
Current portion, capital lease obligations and note payable	2,310	742
Total current liabilities	$ 31,889	$ 28,800
Long-term note payable, capital lease, and other obligations	1,877	1,485
Deferred income taxes	20,528	20,524
Total liabilities	$ 54,294	$ 50,809
Shareholders' equity:		
Preferred stock, $.01 par value; 2,000,000 shares authorized		
Common stock, $.01 par value; 50,000,000 shares authorized; 13,314,982 and 13,300,477 shares issued as of March 31, 2003 and 2002, respectively	133	133
Treasury stock, at cost (1,029,393 and 1,143,158 shares as of March 31, 2003 and 2002, respectively)	(21,067)	(22,185)
Deferred compensation	(54)	–
Additional paid-in capital	119,375	119,891
Retained earnings	98,288	75,744
Total shareholders' equity	$196,675	$173,583
Total liabilities and shareholders' equity	$250,969	$224,392

Source: PolyMedica Corporation, 10-K Filing with the Securities and Exchange Commission, March 2003.

[a]The majorities of PolyMedica's products provided are reimbursed by Medicare, a federally funded program that provides health insurance coverage for qualified persons age 65 or older and for some disabled persons, and are therefore subject to extensive regulation. Medicare reimbursement payments are sometimes lower than the reimbursement payments of other third-party payers, such as traditional indemnity insurance companies. Current Medicare reimbursement guidelines stipulate, among other things, that quarterly orders of diabetes supplies to existing customers be verified with the customers before shipment and that all doctor's orders for supplies be re-validated every 12 months prior to billing.

PolyMedica accepts assignment of Medicare claims, as well as claims with respect to other third-party payers, on behalf of our customers. It processes claims, accepts payments and assumes the risks of delay or nonpayment. The company also employs the administrative personnel necessary to transmit claims for product reimbursement directly to Medicare and private health insurance carriers. Medicare reimburses at 80% of the government-determined reimbursement prices for reimbursable supplies, and PolyMedica bills the remaining balance to either third-party payers or directly to customers.

The valuation of accounts receivable is based upon the credit-worthiness of customers and third-party payers and the company's historical collection experience. Allowances are recorded as a selling, general, and administrative expense for estimated amounts expected to be uncollectible from third-party payers and customers. Estimates are based on historical collection and write-off experience, current trends, credit policy, and on PolyMedica's analysis of accounts receivable by aging category. Changes in judgment regarding these factors could affect the timing and amount of costs recognized.

Exhibit 3 (continued) PolyMedica Corporation Consolidated Statements of Income

For Period Ended March 31, 2003 (in thousands)	3/31/2003	3/31/2002	3/31/2001
Net revenues	$356,185	$279,661	$220,046
Cost of sales	126,844	97,519	76,973
Gross margin	229,341	182,142	143,073
Selling, general, and administrative expenses	163,768	133,609	97,554
Income from operations	$65,573	$48,533	$45,519
Other income and expenses:			
Investment income	$ 247	$ 1,105	$ 2,867
Interest and other expense	(272)	(180)	(348)
Minority interest	–	(564)	(733)
	$ (25)	$ 361	$ 1,786
Income before income taxes	$65,548	$48,894	$47,305
Income tax provision	25,301	18,483	17,645
Income before cumulative effect of change in accounting principle	$40,247	$30,411	$29,660
Cumulative effect of change in accounting principle, net of taxes of $9,187 and $4,121[a]	($14,615)	–	$(6,926)
Net income	$25,632	$30,411	$22,734
Income per weighted average share cumulative effect of change in accounting principle:			
Basic	3.29	2.43	2.26
Diluted	3.21	2.38	2.18
Cumulative effect of change in accounting principle:			
Basic	(1.20)	–	(0.53)
Diluted	(1.17)	–	(0.51)
Net income per weighted average share:			
Basic	2.09	2.43	1.73
Diluted	2.04	2.38	1.67
Weighted average shares, basic	12,241	12,506	13,176
Weighted average shares, diluted	12,546	12,780	13,596

Source: PolyMedica Corporation, 10-K Filing with the Securities and Exchange Commission, March 2003.

[a]During the third quarter of fiscal 2003, PolyMedica implemented Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), retroactive to April 1, 2002. Effective April 1, 2002, the company recorded a goodwill impairment charge of $14.62 million, net of related taxes, or $1.17 per diluted weighted average share, as a cumulative effect of change in accounting principle for the adoption of SFAS No. 142. Net income for the fiscal year ended March 31, 2003 included this charge.

During the fourth quarter of fiscal year 2001, PolyMedica implemented Staff Accounting Bulletin 101 ("SAB 101"), "Revenue Recognition in Financial Statements," retroactive to April 1, 2000. Effective April 1, 2000, the company recorded a cumulative effect of change in accounting principle of $6.93 million, net of related taxes, or $0.51 per diluted weighted average share, for the adoption of SAB 101.

Exhibit 3 (continued) PolyMedica Corporation Consolidated Statements of Cash Flows

For Period Ended March 31, 2003 (in thousands)	3/31/2003	3/31/2002	3/31/2001
Cash flows from operative activities:			
Net income	$25,632	$30,411	$22,734
Adjustments to reconcile net income to net cash flows:			
Impairment of goodwill, net	14,615	–	–
Depreciation and amortization	6,250	5,733	5,214
Amortization of direct-response advertising	36,460	30,306	19,604
Direct-response advertising expenditures	(48,409)	(42,478)	(31,467)
Minority interest	–	564	662
Deferred income taxes	5,853	1,909	(1,533)
Tax benefit from stock options exercised	1,562	620	4,087
Provision for bad debts	25,901	21,000	15,530
Provision for sales allowances/returns	16,775	12,525	11,899
Stock-based compensation	267	–	–
Other	126	32	674
Changes in assets and liabilities:			
Accounts receivable	(59,785)	(45,615)	(19,635)
Inventories	2,813	1,128	(15,209)
Prepaid expenses and other assets	(1,553)	(997)	604
Accounts payable	2,306	(2,848)	(969)
Accrued expenses and other liabilities	636	10,609	2,429
Total adjustments	$ 3,817	$ (7,512)	$ (8,110)
Net cash flows from operating activities	$29,449	$22,899	$14,624
Cash flows from investing activities:			
Purchase of investments	$(1,442)	$(5,499)	($20,300)
Proceeds from the sale of investments	–	5,499	20,300
Proceeds from sale of certain assets	–	–	1,300
Investment in other assets	–	–	(200)
Purchase of property, plant, and equipment	(22,076)	(15,251)	(8,912)
Proceeds from sale of equipment	1	22	72
Net cash flows from investing activities	$(23,517)	($15,229)	$(7,740)
Cash flows from financing activities:			
Proceeds from issuance of common stock	$ 2,282	$ 532	2,320
Repurchase of common stock	(3,563)	(18,002)	(6,641)
Contributions to deferred compensation plans	(1,384)	(1,125)	(1,768)
Payment of dividends declared on common stock	(3,088)	–	–
Payment of obligations under capital leases and note payable	(901)	(762)	(1,911)
Net cash flows from financing activities	$ (6,654)	($19,357)	$ (8,000)
Net decrease in cash and cash equivalents	$ (722)	($11,687)	$ (1,116)
Cash and cash equivalents at beginning of year	27,884	39,571	40,687
Cash and cash equivalents at end of year	$27,162	$27,884	$39,571

Source: PolyMedica Corporation, 10-K Filing with the Securities and Exchange Commission, March 2003.