SBI Cards – Reported profits vs Economic profits

Accounting of Customer Acquisition Costs

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14th Apr 2020

Reported financials have to follow accounting guidelines when they are presented to investors. However, while analyzing, it is important for an investor to make necessary adjustments to the reported numbers in order to make them relevant and understand the underlying economics of the business.

Below is case study of SBI Cards wherein we discuss how the accounting policies and changes therein impact the reported profits vis-a-vis economic profits of the business.

Customer Acquisition Costs -

Credit card companies incur customer acquisition cost which comprise of:
a. Costs for acquiring customers through various channels and
b. Marketing cost - costs for advertisements and discounts or cashbacks offered.

For SBI Cards, these cost mainly form part of "Advertisement and Sales promotions". This has shown an increasing trend as % of total income over years.

	2013	2014	2015	2016	2017	2018	2019
Advertisement and Sales Promotion	13.5%	14.0%	19.3%	18.8%	21.5%	26.9%	27.1%

How has SBI Cards been accounting for these costs?

Till 2014	Amortized over a period of 12 months.
Change in 2015	Recognizing upfront – as and when incurred
Change in 2019	Adopted Ind AS norms – Amortizing over the behavioral life of the customer

How has Ind AS impacted the profitability?

Accounting for Customer Acquisition Cost under Ind AS (Rs mn)	2017	2018	2019
Opening Balance	1,197	1,680	3,714
Capitalized during the year	1,724	5,771	4,995
Amortised during the year	-1,240	-3,737	-2,904
Closing balance	1,680	3,714	5,806
Closing balance as % of Non-interest income	10.6%	14.3%	15.7%
~ Amortization period = (Opening balance + Capitalized) / Amortized during the year	**2.4**	**2.0**	**3.0**

Impact on Profitability	2017	2018	2019		Avg
Capitalized minus Amortized during the year (unrecognized cost)	483	2,034	2,092		
(PBT under Ind AS is higher by above amount)					
As % of Ind AS PBT	8.5%	22.1%	15.7%		15.4%
Adjusted PBT - had it followed earlier method of recognizing upfront	5,233	7,159	11,224		
Adjusted PAT (Profits that may be more relevant for investors)	3,413	4,681	7,272		
Reported PAT	3,729	6,011	8,627		
RoE using Ind AS adjusted Net worth (i.e. after making above adjustment)	26.6%	23.6%	24.2%		24.8%
Reported RoE	25.7%	25.5%	24.1%		25.1%

- The change has led to PBT under Ind AS being higher by ~ 15.4% on average during 2017-19 period.

- Impact on RoE is not significant, since along with lower PAT even the denominator i.e. net worth is lower (due to lower profits) under old method.

- The company has followed normal accounting norms. The change has led to matching concept i.e. costs are matched with expected benefits into the future.
However, from an investor's perspective, the benefits may not be certain and the costs may remain part and parcel of the regular business for a long period of time.
During high growth phase, actual cash costs incurred would generally be higher than amortized costs.
One may want to consider profits after adjusting for entire customer acquisition costs that the company has incurred.

- While company has stated that Membership Fee Income and Sales & Promotion Expense are recognized over 12 months, as per Ind AS the customer acquisition cost is to be recognized over the behavioral life of the customer. Management discretion and estimates are involved while assessing the "behavioral life".
(For SBI Cards, our calculation in table #2 suggests amortization period of 2-3 years. One may even want to seek clarity from the management on this policy).

- One may want to use such adjusted profits to compare numbers with peers considering estimates used by the management of different companies could differ.

To conclude:

Given the nature of cost, this may be a recurring expense while the expected benefits may not be certain for the company. The company itself had been recognizing costs upfront before adopting Ind AS, probably an indication that this may be more practical way of looking at the profits of this business.

Thus, while the reported profits are in line with the prevalent accounting standards, an investor may want to use adjusted numbers to get closer to economic reality, before taking an investment decision.

This example illustrates that Accounting standards themselves may not be the "most conservative" way to present economic earnings and that analysts and investors may want to make adjustments to suit their perspective and style.

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