How AcSEC's New SOP Tightens Accounting and Reporting on Advertising Costs

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Currently, there is diversity in practice related to the accounting for advertising costs. Many companies expense the costs for advertising as incurred, but others capitalize these costs and amortize them in current and subsequent periods. While certain FASB statements provide guidance on the reporting of such costs for a few specific activities (such as leasing, loan origination, motion picture film promotion) and industries (such as cable television, insurance, real estate), there has been no broad guidance that specifies the accounting for advertising costs in general. The new AICPA Statement of Position 93-7, "Reporting on Advertising Costs," provides that guidance. This article details its demands.

In December 1993, the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) issued Statement of Position (SOP) 93-7, "Reporting on Advertising Costs". This SOP provides guidance on the financial reporting of advertising costs in annual financial statements. It requires that all costs of advertising be expensed in the period the costs are incurred or the first time the advertising takes place—except for certain direct-response advertising costs, which can be reported as an asset and amortized over the future benefit period. For costs to qualify as direct-response advertising, a company must be able to demonstrate a direct link between a specific sale to a customer and a specific advertising expenditure. This SOP, which has been cleared by the Financial Accounting Standards Board (FASB), is effective on a prospective basis for fiscal years beginning after June 15, 1994.

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IMPACT IS UNCERTAIN

The impact this new SOP will have on the financial reporting community has yet to be seen. Some companies will report a decrease in earnings as the SOP will not allow the continued deferral of certain types of advertising costs, while other companies will report an increase in earnings as amounts of direct-response advertising previously expensed will be capitalized and amortized over future periods. Further, the earnings of many other companies will be unaffected by the new accounting rules because the new rules will be consistent with their current accounting practices. The SOP, however, does require all companies that incur advertising costs to make additional financial statement disclosures.

In 1988, AcSEC added a project to its agenda to address the accounting for various costs incurred to create intangible assets, which some companies defer while others expense, in an effort to eliminate some of the diversity that exists in current practice. AcSEC intends to ultimately address the reporting of various costs in addition to advertising, such as preopening, start-up, training, and customer acquisition. However, due to the difficulty in developing one methodology that could be applied broadly, AcSEC decided to issue an SOP on advertising costs that would serve as a first step in developing guidance that could be followed for the reporting of these other intangibles as well. The exposure draft on advertising was issued by the AICPA in June 1992. Although several changes were made based on the comment letters received, the SOP is substantially the same as the original proposal.

As stated in the SOP, "advertising is the promotion of an industry, an entity, a brand, a product name, or specific products or services as to create or stimulate a positive entity image or to create or stimulate a desire to buy the entity's products or services." Typically, advertising uses some form of media—such as mail, television, radio, telephone, newspaper, magazine, or billboard—to communicate its message to potential customers.

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Advertising costs include production costs, such as the costs of idea development, writing, artwork, printing, audio and video crews, and actors; and communicating costs, such as magazine space, television air time, billboard space, and distribution. The costs of producing advertising are incurred throughout the production process. The costs of communicating advertising (as when the advertisement is shown on television) are not incurred until the item or service has been received.

AS INCURRED OR FIRST SHOWING

The first and foremost issue that AcSEC had to confront was whether any advertising costs could be capitalized as an asset. To assist in this evaluation, AcSEC looked to the definition of an asset included in FASB Concepts Statement No. 6, "Elements of Financial Statements." Concepts Statement No. 6 defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." AcSEC concluded that for the most part (with the exception of direct-response advertising) the probability of realizing any future benefits was too uncertain and that the benefits could not be measured with the degree of reliability necessary to report an asset in the financial statements.

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Having reached this conclusion, AcSEC then had to decide when advertising costs should be expensed. One view that received significant support required that all advertising costs be expensed as incurred, the same approach as required for research and development expenditures. However, others on AcSEC felt that if the advertisement had not yet been shown, expensing the costs as incurred was unduly conservative. The result was a compromise requiring advertising costs to be expensed as incurred or at the time of first showing unless the costs qualified as direct-response advertising costs. Only direct-response advertising costs that could be shown to have a measurable future benefit are eligible for amortization over future periods.

Examples of the first-showing alternative include the first time a commercial is aired on television or the first running of an advertisement in a magazine.

To illustrate: Assume a calendar year-end company produced a television commercial to be aired during the Super Bowl. Production costs incurred prior to year-end aggregate $500,000. However, any revenue generated obviously would not be realized until after the commercial was shown during the Super Bowl in January. Under the SOP, the company could elect to expense the $500,000 prior to year-end or in January. By permitting the deferral of production costs until the time of first showing, the SOP alleviated the concern that immediate expensing would not always result in a proper matching of revenue and expense.

Further, assume that the advertisement aired in January was the initial showing of a two-year campaign. All of the producing costs related to the campaign should still be expensed either as incurred or at the time of first showing, regardless of the length of the campaign. This accounting will represent a significant change for those companies that have been using a longer period. Regardless of the method selected, the costs of communicating the advertisement(e.g., television airtime) would be expensed as incurred, each time the advertisement is subsequently shown.

The SOP does not apply to interim financial statements. Pursuant to "Interim Financial Reporting," Accounting Principles Board (APB) Opinion No. 28, "when a specific cost or expense item charged to expense for annual reporting purposes benefits more than one interim period, the cost or expense item may be allocated to those periods." APB 28 further states that "advertising costs may be deferred within a fiscal year if the benefits of an expenditure made clearly extend beyond the interim period in which the expenditure is made." Accordingly, since AcSEC does not have the authority to amend an APB, the SOP does not require a change in accounting for advertising costs for interim periods.

DIRECT-RESPONSE ADVERTISING

The primary purpose of direct-response advertising is to elicit sales from customers who can be shown to have responded to a specific advertisement. To conclude that such expenditures qualify to be accounted for as direct-response advertising costs, a company must be able to demonstrate that the customer responded to a specific advertisement and that the costs capitalized have future economic benefit. Pursuant to the SOP, qualifying costs are to be capitalized and amortized over the future benefit period. Companies will be required to maintain supporting documentation that identifies the customer and the specific advertisement that elicited the response in order to justify the deferral of the costs. Examples of documentation that could link a customer response by name to a specific advertisement include a coded order form, coupon, response card, or phone log.

To demonstrate that direct-response advertising costs have future benefit, a company must provide persuasive evidence that the effects of the advertising costs incurred will be similar to the effects of past direct-response advertising costs that resulted in a future benefit. That benefit must be future revenue in excess of future costs to realize those revenues, sufficient to recover the advertising costs deferred. When evaluating whether the responses will be similar, the company also must have verifiable information that supports the historical response rate, the demographics of the audience, the method of advertising, the product being sold, and the economic conditions.

Response rates based on industry statistics are not acceptable.

The evidence a company develops to support the future economic benefit of its direct-response advertising costs must be based on its own operating history. Response rates based on industry statistics are not acceptable. Companies marketing a new product can look at the response rates realized on their other new products, if it can be demonstrated that statistics of the two products are likely to be highly correlated. If a high correlation is not expected, the advertising costs should not be capitalized beyond the first showing. Overall company response rates based on the historical relationship of successful products to total products would not yield an acceptable basis for capitalizing direct-response advertising costs beyond the first showing. Further, direct-response advertising costs not initially capitalized due to the absence of historical evidence should not be restated and capitalized if that evidence subsequently becomes available.

Companies undertake direct-response advertising activities expecting that some recipients will benefit the company by becoming customers while other recipients will not. Regardless of what the response rate may be, it is the company's expectation that the benefits realized on the positive responses will justify the total advertising expenditure. Accordingly, the total cost of the advertising directed to all potential customers, not just that portion resulting in direct benefit to the company, should be used to measure the amount of advertising costs reported as an asset.

For example, if 10,000 pieces of direct-response advertising are mailed and there is an expectation that 5 percent of those recipients will buy, the costs for the entire mailing and not just for the 500 recipients expected to respond are eligible for capitalization.

The advertising costs capitalized and reported as an asset should only include (1) incremental direct costs of direct-response advertising incurred in transactions with independent third parties involved in the production and communication of the advertisement and (2) payroll and payroll-related costs for the direct-response advertising activities of employees who are directly associated with and devote time to advertising reported as an asset. Payroll and payroll-related costs should include only that portion of an employees' compensation and related fringe benefits directly related to the time spent on the direct-response advertising activities. Administrative costs, rent, depreciation (other than the depreciation on assets used directly in the advertising activities), and other occupancy costs should not be considered as costs of direct-response advertising. This approach to capitalizing costs is similar to the approach specified in FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Indirect Costs of Leases."

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Direct-response advertising costs should be amortized on an advertisement-by-advertisement basis over the period during which future benefits are expected to be realized. Amortization should be computed based on the ratio of current period revenues attributable to a specific direct-response advertisement to the total of current and estimated future period revenues attributable to the same advertisement. The amounts used in this calculation should not be discounted to net present value. The estimates of future revenue used in the amortization calculation may increase or decrease periodically. Accordingly, the ratio used to determine amortization should be recalculated at each reporting date.

Direct-response advertising costs related to a product or service that can be renewed or generate repeat sales without a subsequent significant advertising effort should include an estimate of such revenue in the amortization calculation, if the company has an established operating history of such renewals or repeat sales.

For example, a company with a subscription business that is able to reliably predict the number of subscribers that will renew their contracts should include the revenue attributable to the renewal period in the amortization calculation. Before including the renewal period or repeat sale revenue in the amortization calculation, the company should evaluate the reliability of the information used to predict such revenues and whether those revenues are in fact attributable to the direct-response advertising being accounted for and not a subsequent advertising campaign.

The amount of direct-response advertising costs reported as an asset needs to be evaluated as to realizability at each balance sheet date. This evaluation is to be done on an advertisement-by-advertisement basis. If the carrying costs of an individual advertisement exceed the future net revenues (gross revenues less the probable future costs of all goods and services necessary to earn those revenues) expected to be realized as a result of such advertising, the excess should be reported as current period advertising expense. Carrying amounts previously reduced should not be adjusted upward if the estimates of future net revenue are subsequently increased.

OTHER ISSUES

Some costs, such as product endorsements and sponsorships, may be incurred pursuant to executory contracts. Costs incurred in accordance with such contracts should be accounted for as performance under the contract is received. However, the nature of the costs incurred under an executory contract should be reviewed and to the extent such costs represent advertising, they too should be accounted for in accordance with the SOP.

To illustrate: Assume a company contracts with a professional athlete to endorse its brand of athletic shoes. The contract requires the athlete to appear in several television commercials in addition to making personal appearances to promote the company's products during the two-year period subsequent to the signing of the contract. The costs associated with producing the commercials and the contract costs allocated to the commercial segment of the contract should be accounted for as advertising costs in accordance with the company's policy, either expensed as incurred or at the time of first showing. The contract costs allocated to the personal appearances and other services rendered under the contract should be expensed over the term of the contract as the services are rendered.

Cooperative advertising involves an obligation assumed by a company to reimburse a customer for costs incurred to advertise the company's products.

Another exception to expensing advertising costs as incurred or the first time the advertisement is shown relates to "cooperative advertising" costs. Cooperative advertising involves an obligation assumed by a company to reimburse a customer for costs incurred to advertise the company's products. Typically, the level of costs reimbursed is correlated to the level of revenue realized. Cooperative advertising obligations should be accrued and the costs expensed at the same time the related revenue is recognized, which could be before the advertising costs are actually incurred.

To illustrate: Assume a pharmaceutical company that manufactures suntan lotion sells its product through a network of distributors. The distributors purchase the product in December 19X1, but do not resell it to their customers until 19X2. Based on a percentage of the amount of suntan lotion the distributor purchases, the pharmaceutical company agrees to pay the distributor for advertising costs that will be incurred in 19X2. The pharmaceutical company should accrue a liability for the advertising costs at the same time it records the sale of the suntan lotion to the distributor, not at the time the advertising costs are incurred.

Advertising costs might also involve tangible assets, such as a billboard or blimp. The cost of tangible assets should be capitalized and depreciated or amortized using a systematic and rational method over the estimated useful life of the asset. Such an expense may be considered a cost of advertising, if the assets are used for that purpose.

Sales materials, such as brochures and catalogues, may be accounted for as prepaid supplies until they are no longer owned or expected to be used. At that time, the remaining costs should be considered advertising costs and accounted for in accordance with the SOP.

DISCLOSURE REQUIREMENTS

The SOP has several new disclosure requirements, which are applicable even for companies that need not make an accounting change. The notes to the financial statements should disclose

- The accounting policy selected from the two allowed alternatives, that is, either to expense advertising costs as incurred or to expense such costs the first time the advertising takes place
- (If a company is reporting any direct-response advertising costs as an asset) a description of the asset, the accounting policy being followed, and the period over which such costs are being amortized
- The total amount of advertising costs reported as an asset in each balance sheet presented
- The total amount of advertising expense for each period an income statement is presented
- Separate disclosure of any write-downs of advertising costs to net realizable value

To illustrate, the following is an example of the financial statement disclosure required by the SOP:

> Note X—Advertising
>
> The Company expenses the production costs of advertising as incurred, except for direct-response advertising, which is capitalized and amortized over its expected period of future benefits.
>
> Direct-response advertising consists primarily of the costs to produce direct-mail-order catalogs that include order forms for the Company's products. The capitalized production costs are amortized over the three-month period following the distribution of the catalog.
>
> At December 31, 19X2 and 19X1, advertising totaling $2,500,000 and $2,000,000 respectively was reported as assets. Advertising expense for the years ended December 31, 19X2 and 19X1 was $5,000,000 and $4,500,000 respectively, including $700,000 in 19X2 for amounts written down to net realizable value.

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EFFECTIVE DATE AND TRANSITION

The SOP is effective for financial statements for years beginning after June 15, 1994, and earlier application is encouraged for financial statements that have not yet been issued. Costs incurred, regardless of whether or not they are reported as assets, before the initial application of this SOP should not be adjusted to the amounts that would have been reported as assets had the SOP been in effect when those costs were incurred. However, any amounts that were reported as assets prior to the adoption of the SOP that continue to be reported as assets after the SOP is effective are subject to its amortization and net-realizable-value provisions and disclosure. In the year the SOP is first applied, the nature of any accounting changes adopted to conform to the provisions of the SOP and their effect on income before extraordinary items, net income, and related per-share amounts should be disclosed in the financial statements.

IMPACT ON OTHER ACCOUNTING GUIDANCE

To conform AICPA pronouncements on advertising costs, the SOP amends the following:

- SOP 88-1, "Accounting for Developmental and Preoperating Costs, Purchases, and Exchanges of Take-off and Landing Slots, and Airframe Modifications"
- SOP 89-5, "Financial Accounting and Reporting by Providers of Prepaid Health Care Services"
- SOP 90-8, "Financial Accounting and Reporting by Continuing Care Retirement Communities"

However, the SOP does not amend any FASB literature specifically providing guidance on advertising costs (for example, FASB Statement No. 13, "Accounting for Leases," and FASB Statement No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects"), as AcSEC does not have the authority to do so. Also, the reporting for the cost of advertising conducted for others under the terms of a contract would be accounted for as contract costs and, accordingly, would not be covered by the guidance in this SOP.

IMPLEMENTATION PLANNING

Prior to the effective date, companies will need to consider the nature of the advertising costs they incur and evaluate those costs in light of the accounting requirements specified in the SOP. Companies that already expense their non-direct-response advertising costs as incurred or at the time of first showing will be minimally affected, needing only to make the additional required disclosures. Companies that defer such costs and amortize them in subsequent annual periods will need to challenge the accounting for those costs and either expense them in accordance with the SOP or ascertain that they meet the direct-response criteria. Time also may be necessary to develop the appropriate documentation to support the capitalization of direct-response advertising costs. Companies that address the requirements of the SOP early may be able to minimize any disruption that accounting changes typically cause and will allow for sufficient time to assess the likely impact of SOP 93-7 on the financial statements. ◆