CAPITALISATION OF ADVERTISING EXPENDITURE IN THE MEDIA INDUSTRY: REGULATORY DIFFERENCES AND THEIR CONSEQUENCES FOR INTERNATIONAL FINANCIAL ACCOUNTING

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Paper delivered to the International Conference on Business Analysis, Accounting, Taxes and Auditing (IBAATA) at Tallinn University of Technology
ABSTRACT

Even though the IASB and the FASB have placed high emphasis on convergence efforts to reach one consistent set of international standards, the regulations with respect to advertising expenditures still incorporate differences in accounting treatment. Significant debates of how to handle intangible assets and internally generated value continue. In this context, the purpose of this study is to analyse the existing regulations on advertising expenditure and to highlight the consequences of divergent regulations. Additionally, the authors identify issues where the existing regulations either are not comprehensive or not consistent in their approach.

INTRODUCTION

As part of the annual improvements project 2008 of the International Accounting Standards Board (IASB) the regulations regarding advertising expenditure in IAS 38 Intangible Assets have been amended. With this regulatory change the board sought after clarifying at what point in time expenditures for advertising and promotional activities should be expensed (IAS 38. BC46A). The amendment, however, has not brought the regulations closer to the existing US American regulations. This seems surprising in the context of the ongoing convergence process: although advertising expenditures generally need to be expensed in both regulatory systems, the point in time when the expenditures are recognised, even after the amendment of IAS 38, can differ significantly with respective consequences for performance measurements.

The basis for the diverging regulations appears to be the different emphasis the standard setters put on the definition and recognition criteria of intangible assets. Where the IASB obliges to expense advertising costs because the intangible assets they are related to are not separable from the business as a whole (e.g. brand value or customer relationships), the Financial Accounting Standards Board (FASB) justifies the necessity to expense merely with the difficulties to measure the future economic benefits from advertising reliably.

Departing from this difference in the underlying basic assumptions about capitalisation, the purpose of this paper is to analyse the existing regulations on advertising expenditure and to highlight the consequences of divergent regulations. Additionally, the authors intend to identify issues where the existing regulations either are not comprehensible or not consistent in their approach.

As media companies traditionally spend a large fraction of their budget on advertising, this industry is particularly sensible to the regulations under inspection and will therefore build the basis for our analysis. Nevertheless, the issues raised in the discussion are of general terms and exist across industries. The financial impacts, however, increase with the level of advertising spending in the industry.
EXISTING REGULATIONS AND THE DIVERGENCE OF INTERNATIONAL STANDARDS

This section introduces the relevant regulations on accounting for advertising activities under International Financial Reporting Standards and their interpretations (referred to as “IFRS”) and US Generally Accepted Accounting Principles (US-GAAP). Moreover, it highlights the divergences in the existing international standards.

Under both regulatory systems, advertising activities are expected to lead to future economic benefits. It is acknowledged that advertising has value beyond the period of the expenditures, with the main purpose of creating brands and customer relationships to ultimately increase sales and company value. However, even if the asset definition criteria\footnote{An asset is defined as a resource controlled by the company as a result of past events and from which future economic benefits are expected to flow to the company (F.49, CON 6.25).} appear to be met by most advertising material, these assets generally do not fulfil the recognition criteria required for capitalisation.

Indeed, IAS 38 prohibits the capitalisation of costs related to internally generated brands and/or customer relationships because these costs are not seen as separable from the development of the business as a whole (IAS 38.63 and IAS 38.64 in connection with 38.69 and IAS 38.BC46B; IASB, 2007a). Under US regulations on the other hand, the rationale for exclusion merely is based on the opinion that the probable future economic benefits connected to advertising (other than direct response marketing) cannot be reliably measured (AsSEC SoP 93-7.69). Although the effect is the same, the regulatory boards thus have different notions on the possible capitalisation of advertising activities.

Consistency with existing regulations under IAS 38 direct the IASB’s decisions with respect to advertising expenditure. The future economic benefits of advertising are perceived as increase in brand value, customer relationships and subsequently sales. Because assets such as internally generated brands and customer relationships are not capitalisable under IAS 38, neither are assets from advertising activities (IAS 38.BC46B). The reliable measurability of the future economic benefits is not reviewed. The decision simply links back to the underlying assumption that future economic benefits from internally generated intangible assets like brands and customer relationships are not separately identifiable.

The FASB on the other hand sets its focus on the measurability of probable future economic benefits which, generally, are not assumed to be reliably measurable. However, direct-response marketing in that respect represents an exception, resulting in the most obvious divergence between the two regulatory approaches.

Under US-GAAP regulations, direct-response marketing is seen as generating probable future economic benefits that are reliably measurable, if certain conditions are fulfilled. Because the FASB is not equally strict in respect to the connection between advertising and internally generated brands, costs for direct-response marketing have to be capitalised as intangible assets if the advertising is intended to elicit sales to customers who specifically respond to the advertisement. However, companies have to establish the future benefits by documenting the customers’ responses and verifying the similarity to former campaigns that resulted in future
economic benefits (Finger, 1994; Kreuze and Pung, 1997). The amount capitalised under US-GAAP equals the incremental direct cost plus a portion of employees' total compensation and payroll-related fringe benefits for the time spent performing the direct-response advertising activities, i.e. “full costing” (Flesher, et al., 2002). The amortisation takes place over the estimated period in which benefits are obtained from the advertising on a cost-pool-by-cost-pool basis and the amortisation ratio has to be recalculated each reporting date (Kreuze and Pung, 1997).

According to AcSEC SoP 93.7 all other advertising costs must be expensed either when they are incurred, with respect to production cost of advertising (AcSEC 93.7.43), or, regarding the communication of advertising, when the advertising first takes place (AcSEC SoP 93-7.44). The accounting choice has to be consistent over the periods and must be disclosed in the notes (Maples, 1999).

While the US regulations explicitly distinguish between production and communication expenses, IAS 38 focuses on the buying of advertising material from a supplier and does not specifically deal with the communication of advertising to customers. Here, all advertising and promotional costs must be expensed when the enterprise has a right to access the goods or – in the case of the supply of service – the company must record the expenditure as expense when it receives the services (IAS 38.69).

ANALYSIS OF THE DIFFERENCES AND THEIR CONSEQUENCES

To demonstrate the financial consequences of the regulatory differences, in the following we discuss different examples of advertising costs and their accounting in the financial statements of media companies.

The lifecycle of advertising and promotion takes place in stages (see illustration 1) and different regulations become relevant in various stages. The lifecycle of advertising activity spans from the placement of the advertisement order, through the development of the materials, to the delivery and communication of advertising content, and ultimately to the future economic benefits connected to the advertising activities. The timeframe in which advertising activities progress through the lifecycle can differ significantly and can span from one day to more than a year, depending on the product, external pressure or other factors. The future economic benefits often flow to the company with a time lag (Flesher, et al., 2002) and therefore can flow to the entity even more than one year after the advertisement was conveyed to potential customers. This becomes ever more evident since the trend goes away from traditional advertising and marketing expenditure patterns to ongoing expenses for communication platforms operated by the companies themselves. Marketing moves towards an ongoing communication with the customer.

The placement of advertising orders and the delivery of advertising to the company by a third party becomes redundant in the case of advertising production for own

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2 The amortisation ratio equals the current period revenues for the direct-response advertising cost-pool over the total of current and estimated future period revenues for this direct-response advertising.
use, which has become increasingly common e.g. in the motion picture industry. To illustrate the regulation, in the following discussion we group advertising costs related to the purchase of advertising goods and services and advertising costs arising from the internal production of advertising material.

**Illustration 1: Lifecycle of advertising and promotional spend**

**ADVERTISING PURCHASE**

With respect to advertising purchase it is important to distinguish between advertising content and advertising communication (time and space).

**Advertising content**

As mentioned above, IAS 38.69 stipulates that all advertising and promotional costs are to be expensed when the enterprise has a right to access the purchased goods like catalogues or audio-visual material, or has received the purchased services, e.g. design development and production of a TV spot. The focus hereby lies in the purchase of advertising content from external contractors. If the company makes payments prior to the right to access the goods or the fulfilment of services, these prepayments incorporate a right of contract fulfilment and can be recognised as intangible assets until the contract is fulfilled by the third party (IAS 38.70). With respect to the lifecycle of advertising and promotional spend (illustration 1), the recognition of an expense under IFRS therefore would occur between step 2 and 3.\(^3\) Internally generated costs related to the development of advertising, e.g. planning and communication with agencies, have to be capitalised when incurred as there is no obligation from a third party and IAS 38 prohibits the capitalisation of internally generated, advertising related, intangible assets.\(^4\)

Like IAS 38, AcSEC SoP 93-7 does not permit the capitalisation of internal development cost; they have to be expensed as incurred. The purchase of advertising material, however, is not discussed directly. As paragraph 26 of the statement of opinion states in general, that advertising costs either have to be expensed as incurred or at the first time the advertising takes place, the authors conclude that the regulation includes an accounting choice in that respect. Either way, the difference in accounting treatment can lead to considerable differences in total expense for the period, if the advertising budget is significant. In case of a prepayment, the first alternative would lead to an earlier expense compared to IFRS; at some point between step 1 and 3. The latter would lead to a later expense at beginning of step 4. Supposed, the reporting date falls between the steps in the

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3 In its discussion on the May 2007 Meeting (IASB, 2007b) the IASB concluded that there is a difference between the right to access a good and receiving a good, as issues such as shipping should not affect the time of expense recognition.

4 According to the IASB, the only value of advertising is to enhance the corporate brand value or customer relationships. As both of these values may not be capitalised under IFRS, advertising does not qualify for recognition either.
lifecycle, these dissimilarities can lead to significant differences in recognised expenses and consequently to different performance measurements.

**Tangible elements**

Another discrepancy occurs in cases if purchased goods, such as catalogues or brochures, include tangible and intangible elements. Where the US regulations allow for such material under possession of the company to be accounted for as prepaid supplies that are expensed in relation to use, and written off when superseded or otherwise diminished in utility (Securities and Exchange Commission, 2001), IFRS require the company to write down these costs when the company gains the right to access these goods. The reasoning of the IASB is that the only value of advertising (including catalogues and brochures) is to enhance the corporate brand value or customer relationships. As both of these values may not be capitalised under IFRS, advertising does not qualify for recognition either. However, this topic was extensively discussed in the IASB June 2007 Meeting (IASB, 2007c), and clearly not all members of the board share this view. The Board concluded that, in case of an alternative use (probably tangible in nature), the capitalised prepayments would only have to be written down until the fair value of the alternative use.

**Intangible assets acquired separately**

Both regulatory systems generally stipulate that intangible assets acquired separately or in a business combinations fulfil the recognition criteria because the purchase price reflects their probable future economic benefit and the value is measurable reliably with the purchase price (IAS 38.25-26; IAS 38.34; FAS 141.17; FAS 142.9).

Nevertheless, IAS 38 does not, under any circumstances, permit the capitalisation of advertising material. This suggests that even separately acquired intellectual property rights, e.g. for a song that will be used for advertising purposes only, cannot be capitalised.

In our view, one needs to distinguish between two ways of purchase. If an intellectual property right is acquired and owned by the company and if the company has the right to sell the asset, then this asset has a value alternative to the probable future benefits from the advertisement and should be capitalised. However, if a company acquires only the rights to use the intangible asset, e.g. the right to use a song for a certain campaign, these costs would need to be expensed under IAS 38 at the moment the company owns the right to access the song. Yet, it is our contention that this narrow form of regulation is inconsistent with the general accounting treatment for acquired intangible assets.

In addition, it is our contention that IAS 38 contains another inconsistency with respect to IFRS 3 *Business Combinations*. Brands and customer relationships acquired in a business combination shall be recognised as intangible assets independently from goodwill at their fair value (IFRS 3.13). Consequently, in a business combination, all intangible assets such as intellectual property rights acquired for advertising – spots, music, pictures or designs – have to be capitalised at fair value. However, the standard does not contain sufficient guidance on how to estimate these fair values. Arguably, this is inconsistent with IASB’s stand that brands and
customer relationships cannot be measured independently from the business as a whole. Even though a purchase price for the business as a whole is paid, the purchase price allocation will be very difficult and complex.

*Advertising communication*

Contrary to purchased advertising content, purchasing media time and space for the purpose of communicating the advertisement to the (potential) consumer can be recognised over the time that the advertising takes place under IFRS. The IASB in its May 2007 Meeting (IASB, 2007b) acknowledged the IASB staff’s proposition that the advertisement, before it is aired, constitutes a capitalisable right in form of the advertising spots not yet communicated to the customers (IASB, 2007a). The related expenses are regarded as prepayments that shall be expensed over the period the advertisement is conveyed to the public. Thus, if a company e.g. buys three TV slots, each time the advertisement is aired, one third of the capitalised costs has to be expensed.

This treatment is in line with US regulations (AcSEC SoP 93-7.44).

**ADVERTISING DEVELOPMENT**

From the perspective of an advertising content producer, two cases have to be distinguished. A company can either produce the advertising content for own use or for the purpose of selling the content to other companies.

Internal costs for producing advertising for own use have to be expensed as incurred under both regulatory systems (IAS 38.69 and AcSEC 93-7.43).

Suppliers of advertising content, however, fall under different regulations because the advertising content produced is not connected to their own brand and customer relationships but is merely a product for sale.

IAS 2 *Inventories* defines inventories as assets that are held for sale in the ordinary course of business, materials or supplies in the process of production for such sale, or materials or supplies to be consumed in the production process or in the rendering of services. In the scope of IAS 2 there are products that are for short term sale. If a company routinely sells advertising content (tangible and/or intangible) and if the material therefore can be seen as held for sale in the ordinary course of business or in the production for such sale, the material therefore has to be capitalised as inventory, measured at the lower of cost (full cost approach) or their net realisable value. The asset then is recognised as an expense together with the corresponding revenue from the sale. This accounting treatment is consistent with the regulations under US-GAAP (FAS 151 and ARB No. 43, Chapter 4).

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5 IAS 11 *Construction Contracts* would be relevant in cases of long-term costumer specific productions (typically more than one accounting period). IAS 11 contains regulations for preferential revenue recognition.

6 IAS 2.6 defines net realisable value as “the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.”
CONCLUDING REMARKS

Our analysis indicates that differences in accounting for advertising expenditures exist and that they are mainly rooted in differing underlying assumptions and aims of the two standards boards. Direct-response marketing as the most obvious divergence, but also differences in the point in time when advertising cost need to be expensed, can lead to significant differences. Thus, in industries with high advertising expenditure, the comparability of operating profits can be significantly decreased.

Additionally, it is our contention that the existing regulations under IAS 38 in relation to acquired intangible advertising assets are inconsistent with the general handling of acquired intangible assets. Furthermore, we find the basic assumption in IAS 38 that future economic benefits from internally generated brands and customer relationships are not separable from the business as a whole to be inconsistent with the need to separate those kind of assets from goodwill in a business combination.

The restrictive regulations on capitalisation of internally generated intangible assets under IFRS and US-GAAP have been subject to critique in the last years, especially in the context of intangible dependant industries like the media industry. For practitioners as well as scholars it has shown difficult to understand why assets held for the purpose of advertising can only be recognised as intangible assets until the company gets access to the material or uses it for the first time, respectively; even though the only reason for incorporating those costs are to obtain benefits after using the advertisement.

Even within the IASB and the FASB, discussions are taken up about how appropriate the existing regulations on intangible assets are to ensure true and fair view in accounting treatment. As part of a joint convergence project, the two boards plan on making substantive improvements to the current regulations; the significant limitations regarding the recognition of intangible assets arising from internally generated brands, mastheads, publishing titles, customer lists and similar items are explicitly mentioned as part of the project plan (IASB, 2007d). This, in our view, is a due and necessary step into the right direction.

Nevertheless, the underlying problem of measurability of future economic benefits will remain problematic in most cases (e.g. Ferguson, 2008; Murby, 2007). Especially in the context of the change in marketing practice and the new digital possibilities in the advertising world, existing valuation models are not sufficient to capture the probable future benefits reliably. Future research will be needed to solve the conflict between relevance and reliability.
REFERENCES


REGULATIONS

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