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Perspective on Ad Capitalization and Taxation

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About MASB

The **Marketing Accountability Standards Board** began as a visionary initiative by industry professionals and academics who saw an opportunity to increase the contribution of the marketing function through the development of standards for marketing performance measurement and processes that link marketing activities to financial performance.

After comprehensive review of current practices, needs and accountability initiatives sponsored by industry organizations, it was determined that while marketing was not ignoring the issues surrounding metrics and accountability, the practices and initiatives underway were narrow in focus, lacking integration and generally not tied to financial performance in predictable ways.

"As it was for product quality in manufacturing (with ANSI & ISO) and financial accounting and reporting (FASB & IASB), marketers taking the lead in this will gain sustained competitive advantage." – Dr. Joseph Plummer, MASB Founding Director

MASB is THE independent, cross-industry forum that sets the measurement and accountability standards that visionary leaders in Finance and Marketing rely on to guide investment decisions for enterprise value.

MASB Members

Establishing MASB in 2007 was viewed as the seminal opportunity to approach the measurement foundation of accountability and continuous improvement at the highest level. Membership crosses all industries and includes marketer companies, business schools, industry associations, media providers, media & advertising agencies, measurement providers and independent consultants that believe in linking marketing actions to financial performance.

"There is one group exclusively devoted to marketing measurement…predictive of financial return…and all marketers who are serious about meeting the accountability mandate should get involved." – Bob Liodice, CEO, Association of National Advertisers

MASB members belong to an elite, forward-thinking community of marketer companies, measurement providers, industry associations and business academics committed to linking marketing actions to financial return.

MASB Summits

Each February and August, MASB gathers top Finance and Marketing thought leaders for its **Marketing Accountability Summit** with project updates from members and guest speakers addressing the latest topics. For more info, visit **themasb.org/masb-summits**.

MASB is a 501(c)(3) nonprofit organization dedicated to establishing marketing measurement and accountability standards across industry and domain for continuous improvement in financial performance and for the guidance and education of business decision-makers and users of performance and financial information.

Abstract

The authors review the current treatment of advertising expenditures for financial accounting and taxation.

In general, expenditures that have a short-term life of less than a year are treated as current expenses while expenditures that have a long-term life of greater than a year are capitalized and amortized over the useful life. Advertising expenditures are treated as short-term and expensed in the current year. Several proposals have been made to change the treatment of advertising to treat all advertising as having some long-term effect on sales. We examine research in economics, marketing and accounting that has addressed the short- and long-term effects of advertising on sales.

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Perspective on Ad Capitalization and Taxation

Introduction

For tax purposes, advertising expenses are generally deductible as ordinary and necessary business expenses in the year in which they were paid or incurred. Expenditures associated with the development or creation of an asset having a useful life beyond the current year generally must be capitalized and recovered over the useful life. Over many years, there have been proposals to change this treatment of advertising expenditures through outright elimination of advertising deductions related to certain products or to permit deduction of some advertising expenditures, requiring capitalization of the balance which is amortized over a defined future period. Such changes have great significance to the advertising community. This paper will examine the current treatment of advertising expenditures, marketing research related to this issue, and some very recent proposed changes. Possible strategies to counter the suggested changes will then be presented.

Current Tax Practice

For Federal income tax purposes, advertising and marketing expenses are generally deductible on a current basis as ordinary and necessary business expenses. This treatment is prescribed because advertising expenditures are recurring in nature or because the benefit does not extend beyond the tax year. Treasury Regulation 1.162-20(a)(2) provides, in part, that expenditures for institutional or goodwill advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenditures provided the expenditures are related to patronage the taxpayer might reasonably expect in the future.

As to capitalizing rather than expensing, Section 263 and Section 263A of the Internal Revenue Code provide that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property. For example, package design costs generally have useful lives of greater than one year and are generally capitalized under Section 263. The government's position is that package design costs more closely resemble nonrecurring promotional or advertising expenditures that result in benefits to the taxpayer that extend beyond the year the expense was incurred rather than institutional or goodwill advertising that is written off immediately.

Package design costs do not include coupon insets or refund offers, nor does it include costs that are unrelated to the package design itself, such as a change in ingredients. On the other hand, in RJR Nabisco, package designs were held to be expenses since future benefits were deemed not significant beyond those traditionally associated with institutional goodwill advertising. In some other marketing expenditure areas – such as free samples, new channels of distribution and catalogs – the deductibility or capitalization decisions by the courts generally hinged on the question of future benefits. Decisions were for each treatment.

Current law and interpretations favor deductions rather than capitalization for advertising costs. The decision in Indopco held that for capitalization, a significant long-term benefit must result from the expenditure. In the case of advertising, it has been quite challenging to measure a significant long-term benefit. In Rev. Rul. 1992-80, the IRS stated that the Indopco decision does not affect the treatment of advertising as a business expense which is generally deductible under section 162 of the code. As mentioned previously, this includes the expenditures for institutional or goodwill advertising that keeps the taxpayer's name before the public. They are generally deductible as ordinary and necessary business expenditures provided the expenditures are related to patronage the taxpayer might reasonably expect in the future.

The tax laws in other countries, including the UK, Germany, France, and Japan, permit the deduction of advertising and marketing costs. Canada in general permits the deduction but does have restrictions on the deductibility of some advertising expenses for non-Canadian directed advertising. China allows the deduction of advertising costs but limits the deduction to 15 or 30 percent of the percent of sales revenue, depending on the product being advertised, and permits a carryover to a future year of any amounts not deducted.

The Link to Financial Accounting

It should be noted that income subject to taxation in the United States and most other countries must be computed under the method of accounting on the basis of which the taxpayer regularly computes his income, as long as the books clearly reflect income. There are exceptions reflected in the law when the government attempts to encourage or discourage social, economic and behavioral or other policy objectives. In these cases, financial accounting treatment of an item of income or expenditure may differ. The tax treatment of advertising and other marketing expenditures conforms for the most part to the required treatment under generally accepted accounting principles (GAAP) and coincidentally to the treatment under International Accounting Standards (IAS) as reflected in International Financial Reporting Standards (IFRS). For accounting purposes, it is held that advertising costs incurred in anticipation of future probable economic benefits are usually expensed currently because the benefit period is presumed to be short, or the periods in which economic benefits might be received or the amount of economic benefit cannot be determined easily and objectively. (FASB 720-35-05-3)

The Financial Accounting Standards Board (FASB) provides a framework for expensing or capitalizing advertising costs, i.e., creating an intangible asset. The framework divides advertising into two alternative treatments: expense or capitalization. The general rule is that the costs of advertising should be expensed either as incurred or the first time the advertising takes place. This general rule is subject to the exception of direct-response advertising.

The costs of direct-response advertising are capitalized if two conditions are met. First, the primary purpose of the advertising must be to elicit sales to customers who in the past have responded specifically to the advertising. In order to conclude this, there must be a means of documenting the response, including a record that can identify the name of the customer and the advertising that elicited the direct response.

Second, the direct-response advertising results in probable future benefits. Demonstrating this requires persuasive evidence that its effects will be similar to the effects of responses to past direct-response advertising that resulted in future benefits. The attributes to consider in determining whether the response is similar include the demographics of the audience, the method of advertising, the product, and the economic conditions.

In the absence of a specific entity's operating history, industry statistics are not considered objective evidence that advertising will result in future benefits. If the entity does not have operating histories for other new products or services, statistics for the other products or services may be used if it can be demonstrated that they are likely to be highly correlated to the statistics of the particular product or service being evaluated. Direct-response costs that cannot be demonstrated to result in future benefits are expensed.

The costs of direct-response advertising whose primary purpose is to elicit sales to customers who respond specifically to the advertising, resulting in probable future benefits, should be capitalized and amortized over the years of probable future benefits. The probable future benefits of direct-response advertising are net revenues (revenues less costs). That future benefits exist requires persuasive evidence from historical patterns within the entity. Industry statistics are not considered objective evidence. The entity may however use statistics from similar products or services when the statistics for the similar product are likely to be highly correlated to the statistics of the product or service being evaluated.

Other amounts spent for tangible assets are also capitalized and amortized. Examples include billboards and blimps. Tangible assets are not created when costs are incurred to produce film or audio tape used to communicate advertising. Brochures and catalogs may be accounted for as prepaid advertising and these costs would be treated as advertising expense or capitalized depending on whether these are direct-response advertising or not. One additional example includes advertising expenditures classified as start-up expenses. Start-up expenses are those incurred prior to the beginning of normal operations. Such expenditures are capitalized and amortized.

In summary, both for financial accounting and taxation, current expenditures for advertising and marketing are generally presumed not to create assets. An asset will be recorded on the books if it can be demonstrated that economic value is created. From a pure economic perspective, current tax deductions generally have more value than deductions in the future. On the other hand, for financial reporting, firms might prefer to report higher current earning by forgoing current deductions, even if creation of assets was a possibility. Accounting rules generally preclude creating intangible assets unless it can be shown that future economic value is inherent in these expenditures.

Proposals for Change

Max Geller's book, ***Advertising at the Crossroads***, includes a brief history of advertising taxation which began with the 1775 stamp tax (just prior to the American Revolution) that required a payment of two shillings for every advertisement. Geller points out that another attempt to tax advertising took place during the Civil War when Congress imposed a three-percent tax on gross receipts from newspaper and magazine ads.

Geller was an active participant in the advertising debate in the early 1950s. During this period, there was a focus on managing the business cycle with a proposed advertising tax, primarily to fight inflation by reducing advertising expenditures and hence curbing consumer demand. Geller proposed to integrate advertising expenditures with national welfare by limiting their deductibility. He advocated Congressional control over advertising to affect the level of consumer spending desired. These proposals never took root. In summary, in the 1950s, Congress debated using the deductibility of advertising costs as an economic stabilizer during a period of high demand and inflation in order to restrain increased consumption.

There have been many additional proposals over the past 30 years to either limit or disallow the deduction of advertising to help achieve various social policy goals, such as targeting advertising for tobacco products, teenage smoking, alcoholic beverages, violent TV programming, fast food, "junk food" and prescription medicines.

A proposal under consideration in the Tax Reform Act of 1986 to disallow 20 percent of advertising costs was a major threat to the immediate deductibility of all advertising costs. This was viewed primarily as a revenue enhancing proposal. This proposal, however, was not part of the final legislation.

A Joint Committee on Taxation report in 1987 proposed disallowing 20 percent of advertising expenditures and amortizing the balance over two years. This proposal was primarily to raise government revenues, estimated at $37.9 billion over three years. This was a major change in focus from prior proposals, which were for social and economic reasons rather than to raise revenue. The proposal would also deny the deduction for advertising for, or promotion of, alcohol and/or tobacco products. Aside from the social policy goals, there were four accounting or economic arguments for these proposals and five arguments against.

The four principle arguments for the proposal were as follows:

- The benefit of amounts paid for advertising extends beyond the year of the expenditure. Deferring some portion of advertising costs to a later year results in a more proper matching of expenses with the income generated by them.
- Advertising expenditures do not lend to increased competitiveness; they merely shift consumer buying practices. A tax subsidy for these expenditures is not justified.
- Permitting a current deduction for advertising costs creates a preference for businesses that invest in advertising over businesses that invest in tangible assets or other intangible assets, the costs of which must be depreciated or amortized.
- Since it is difficult to determine precisely what portion of advertising costs benefit a particular year, it is appropriate to provide an assumed allocation of the benefit of such costs by statute.

The five principle arguments against the proposal were as follows:

- Advertising costs are costs of selling a product in the current taxable year and do not create a separate and distinct asset having a life that extends beyond the end of the year. They should be fully deductible in the year incurred.
- Severe definitional and administrative problems result in trying to differentiate between advertising and promotional expenses, on the one hand, and fully deductible selling expenses on the other hand.
- Even if some portion of advertising costs theoretically benefits future taxable years, it's only a *de minimis* amount. It is impossible to verify the degree of proper allocation of the benefits to future years.
- It is not appropriate to restrict the deductibility of advertising expenses while retaining expensing for similar expenditures such as research and development.
- Advertising provides a valuable service by providing price and product quality information to help consumers make informed choices.

In 1990, the Congressional Budget Office, in the document *Reducing the Deficit,* listed the deduction for advertising as a revenue option estimated to generate $28 billion over five years by limiting the deduction to 80 percent of the expenditure with 20 percent amortized over four years.

In 1994, a Progressive Policy Institute report, *Cut-and-Invest to Compete and Win: A Budget Strategy for American Growth*, proposed that 20 percent of advertising expenditures be capitalized as related to brand building. Also in 1994, a proposal was floated by Senator Paul Wellstone (D-MN) and Representative Jim McDermott (D-WA), joined by 89 representatives and five senators to capitalize 20 percent of advertising costs to fund a proposal for single-payer health care reform. None of these proposals gained much traction.

In late 2013, the advertising industry was stunned by draft proposals to be introduced as part of tax reform legislation by Representative Dave Camp (R-MI), chairman of the House Ways and Means Committee, and Max Baucus (D-MT), chairman of the Senate Finance Committee, to limit deductions for advertising. The House Ways and Means Committee provision would allow advertisers to deduct only 50 percent of all advertising expenses in the first year and amortize the remaining 50 percent over 10 years. The Senate Finance Committee proposal allowed a business to deduct 50% of its advertising costs in the first tax year and amortize the remaining 50% over 5 years. There is no empirical basis for either the capitalization-expense allocation or the amortization life.

These proposals were taken as a serious threat and immediately attacked by the Association of National Advertisers, the American Advertising Federation and the Advertising Coalition, among others. The objections warned of dire consequences to the U.S. economy. In addition, it is noted that some in Congress appeared to be more concerned with raising revenue in order to reduce the corporate tax rate to 25% than with the dynamic impact the advertising industry has on the economy. Data from the advertising media community show that almost 15 percent of U.S. jobs are connected with advertising and $6 trillion of the U.S. economy is generated by advertising.

An additional development relates to the classification of items on the table for tax reform discussions. In the past, revenue-raising proposals focused on tax expenditures – revenue losses due to special exclusion, exemption or deduction from gross income, special credits and preferential rates of tax or deferral of tax liability. A new classification has now been developed for other sources of revenue which would come from within the current income tax structure.

Non-tax expenditure base provisions (NTEBPs) are defined as provisions that reduce tax liability but do not represent a deviation from the normal income tax. Examples of business NTEPBs include deductions related to advertising costs, employee training costs, state and local taxes, interest expense, meals and entertainment, and amortization of acquired intangible assets.

It is proposed that NTEBPs should be examined if they do not accurately define income in the traditional economic sense, are subject to substantial abuse, have both business and personal components, or conflict with other policy goals. Most NTEBPs would not fall within this classification. As mentioned, one business NTEBP is advertising costs. Even though advertising costs are deducted currently, as if they produced only current-year benefits, it is assumed that some advertising builds brand value. It is very difficult to assess which advertising produces long-term benefits. One suggestion is to partially capitalize some of the advertising costs and amortize them over a future period (15 years, for example) and expense the rest.

Additional taxation of advertising proposals has recently surfaced but not become law. Ohio Republican Gov. John Kasich's proposed 2013 budget would subject sales of print, billboard, radio and TV advertising to a 5 percent sales tax. The hope was that this tax could lead the way to cut personal and business income taxes. Minnesota Democratic Gov. Mark Dayton budget proposal called for extending the state sales tax to advertising, among other services. Another rumored proposal to tax advertising through a broadened sales tax was from Louisiana Republican Gov. Bobby Jindal in order to eliminate personal and corporate taxes.

Prior Research on the Economic Life of Advertising

Many agree that the benefits of advertising expenditures generally are limited to the period in which the expenditures are incurred. The FASB certainly concurs. The principle reason for this treatment is the complexity and cost of such estimation of future benefits and the duration such benefits will last. This treatment is supported by research that shows that in many cases advertising benefits only the current period.

A recent study by John Wills and Mike Denning summarized a number of studies that dealt with the economic lives of brand and trademark-related intangibles, including Darral Clarke's survey of approximately 70 previous studies on the duration of the impact of advertising, conducted in the 1960s and 1970s. Clarke found that the vast majority of studies suggested that 90 percent of the impact of advertising occurred within a relatively short period of time. The median duration was approximately 20 months.

A subsequent analysis by Robert Leone attempted to correct a bias in the Clarke study. From annual observations and Leone's revised estimates, duration intervals ran nearly a year shorter than Clark's numbers for the annual studies. Leone concluded that advertising's effect on sales lasts for months, as generally supported, rather than for years. Arrow and Stigler reviewed work subsequent to Clark's and it was determined that much of the research they examined was flawed by data interval bias and other technical and conceptual problems. After correcting the data in prior studies, they concluded that the economic life of marketing intangibles is often no more than one year and that advertising-related intangibles are short-lived – measured in months rather than years.

Steve Kerho estimated the impact of advertising by media. His study found that, depending on the media employed, the 90 percent duration intervals as defined by Clark suggested life estimates from three to 27 weeks. The U.S. Treasury Department also shared a short-term view. In testimony before Congress, it was stated that "the average economic lifetime of many assets created with marketing expenditures is probably fairly short (a year or less).

On the other hand, many hold that advertising may contribute to the generation of intangible assets that have a life beyond the period in which the advertising expenditure is incurred. In some of the studies mentioned, the effect of some advertising expenditures carried over beyond the year of the expenditure. Different products produced different effects. Even if some of the expenditures do contribute to the generation of intangible assets, there is no agreement as to what the useful life might be or how to measure it.

Lostumbo and Sengupta reviewed relevant literature on the economic useful life of marketing intangibles and critiqued prior research on this subject. After examining studies on the short-term and long-term effects of advertising, they concluded that there are short-term and long-term effects of advertising on sales. The long-term effect is found to be approximately two times the magnitude of the short-term effect and is found principally in the second and third year after the advertising spend is incurred. The authors point out that Wills and Denning cited studies that did not address the potential carryover effect of advertising, that is, the amount of incremental sales due to an increase in advertising that are seen in the first year and are still seen in subsequent years. They pointed out that Wills and Denning overlooked these studies. They also did not mention Dominique Hanssens' MASB practitioner paper: "Studies conducted by Information Resources, Inc ... in 1995 and 2007 demonstrate that on average, the advertising-to-sales impact over three years is double the impact of year one, and the advertising-to-profit impact is triple the impact of year one."

This short-term/long-term line of research basically concludes that the effect of advertising lasts for up to three years, and that if advertising is not successful in the first year then there will be no long-term effects.[24] Hence, in all likelihood, these lasting effects attributed to advertising are simply the result of product purchase and favorable usage experience in the first year leading to additional purchases in succeeding years.

A summary of advertising and sales relationship studies found in recent literature is in **Appendix A**.

Conclusions

Several arbitrary amounts have been proposed for the percentage of advertising expenditure capitalized, ranging from 20 to 50 percent with amortization periods from two to 10 years. There is too little research to support these numbers. They are driven by a view that the tax on advertising will raise revenue and not by the view that any changes should not distort the proper measurement of taxable income thereby putting the advertising community in a less competitive position than other businesses. Any arbitrary rate used to capitalize advertising costs or prescribe an amortization period that does not represent an economic useful life of such asset violates the matching principle fundamental to measurement of income. In addition, a one-size-fits-all approach as to a capitalization percentage and amortization period has the potential to penalize firms that rely on short-term advertising that has no carryover effects. Such arbitrary percentage estimates of the amount of advertising that should be capitalized and the amortization period are not supported by marketing research that shows that there are different short-term and long-term effects of advertising on sales across products, firms, industries and advertising media.

The majority of the conclusions from the studies shown in Appendix A hold that advertising has a short-term effect on sales and should be expensed as incurred. Several studies show long-term sales effects of advertising, with a life of advertising not lasting beyond the second year. Some research on in-market studies finding long-term effects of advertising concluded that the evidence was not convincing enough to recommend a coherent FASB capitalization policy. Most studies conclude that much more research needs to be done to determine any long-term effects of advertising. And even if long-term effects of advertising-to-sales do exist, the sales attributable to such advertising may be too small and too costly to measure.

We propose that it is not necessary to pass new legislation to conform tax laws to advertising practice or to generally accepted accounting principles (GAAP). For tax purposes, rules for expensing (IRC section 162(a) ordinary and necessary business expenses) and capitalizing expenditures such as advertising (IRC 263 and IRC 263(A)), are already included in the Internal Revenue Code and Regulations and under judicial decisions previously cited. For financial accounting purposes, expenditures associated with the development or creation of an asset having a useful life beyond the current year generally must be capitalized and recovered over the useful life, provided these links are demonstrated.

Unless more compelling evidence emerges, the Marketing Accountability Standards Board (MASB) also recommends that advertising expenditures continue to be treated as a current year expense.

Summary

While currently advertising is treated as short-term and expensed in the current year, several proposals have been made to tax all advertising as having some long-term effect on sales.

The research in economics, marketing and accounting that addresses short- and long-term effects of advertising on sales indicates that:

- The effects of advertising are predominantly short-term, though some long-term effects are noted.
- Notable long-term effects are attributable to experience with the product in the short-term and later repeat purchasing.

Not enough evidence of any long-term effect of advertising has been demonstrated to recommend a new tax or financial accounting policy.

FOOTNOTES

1 IRC section 162(a)

2 See Alabama Coca-Cola Bottling Company, T,C.M. 1969-123

3 Revenue Ruling 68-360, 1968-2 C.B. 197

4 Rev. Rul. 89-23, 1989 C.B. 85.

5 RJR Nabisco, Inc. 76 TCM 71 (1998).

6 Free samples were expensed in Northwestern Yeast, 5 BTA 232 in that the court would not allocate the effects on current and future business, and capitalized in Marko Durovic, 542 F. 2d 1328 (1976) under the presumption that the expenditures created an asset with a future useful life; new channels of distribution were held to be expenses in Briarcliff Candy Corp, 475 F. 775, CA-2 (1973) Costs of catalogs were expenses in E.H. Shelton & Co. 214 F2d 655 (1954) under the presumption that the catalog was essentially advertising without reasonable certainty of benefits in future years, and capitalized in Best Lock Corp. 31 T.C. 1217 (1959) in that the Tax Court did not follow the Sheldon case and held that the catalog had a life of more than one year. Revenue Ruling 68-360, 1968-2 C.B. 197 also required capitalization of catalog costs as cited previously.

7 503 U.S. 79

8 1992-2 C.B. 57

9 See, Maples, Larry and Earles, Melanie, "When Should Advertising Be Capitalized," *Journal of Accountancy* (May 1999).

10 IRC section 446

11 FASB 340-25

12 Geller, Max A., **Advertising at the Crossroads: Federal Regulation vs. Voluntary Controls**, Ronald Press Co., 1952.

13 Joint Committee on Taxation, <u>Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means</u>, U.S. Government Printing Office, 1987, pp. 138-139

14 Goldwein, Marc, Stone, Jessica, and Rosenberg, Adam, "Beyond Tax Expenditures," *Tax Notes* (July 15, 2013)

15 Ana Radelat, "Revenue-Hungry States Set Sights on Taxing Ads," *Advertising Age,* February 25, 2013.

16 Wills, John and Denning, Mike, "The Economic Life of Advertising: A Survey of the Evidence," Tax Management Transfer Pricing Report, 21 TMTR 11/15/2012

17 Clarke, Darral G., "Economic Measurement of the Duration of Advertising Effect on Sales," *Journal of Marketing Research,"* XIII (November 1976), 345-357.

18 Leone, Robert P., "Generalizing What is Known About Temporal Aggregation and Advertising Carryover," *Marketing Science* 14 No. 3 (1995), G141-G150.

19 Arrow, Kenneth A.; Stigler, George; Landes, Elizabeth; and Rosenfield, Andrew, *Economic Analysis of Proposed Changes to the Tax Treatment of Advertising Expenditures,* Lexecon, Inc. 1990.

20 Hirschey, Mark, "Intangible Capital Aspects of Advertising and R&D Expenditures," *Journal of Industrial Economics* Vol. XXX, No. 4, June 1982, pp. 375-390.; Hirschey, Mark, and Weygandt, Jerry, J., "Amortization Policy for Advertising and Research and Development Expenditures," *Journal of Accounting Research,* Vol. 23.1, Spring 1985 , pp. 326-335.; and DeKimpe, Marnik, and Hanssens, Dominique, "The Persistence of Marketing Effects on Sales," *Marketing Science* 14 No. 1 Winter 1995, pp. 1-21.

21 Kerho, Steve, "How Long Does Advertising Have an Impact," fastcompany.com.

22 U.S. Department of the Treasury, "Report to the Congress on Adjusting the Excess Passive Assets Rules and the Passive Foreign Investment Rules to Account for Marketing Intangibles," 11/22/94.

23 Lostumbo, Nicola and Sengupta, Arpan, "The Long-Term Effects of Advertising Expenditures: Examining the Evidence," Tax Management Transfer Pricing Report, 22TMR, 12/04/2013.

24 Abraham, Magid M. and Lodish, L.M., "Advertising Works: A Study of Advertising Effectiveness and Resulting Strategic and Technical Implications," *Information Resources, Inc*. 1989. Abraham, Magid M. and Lodish, L.M., Lubetkin, B., "A Summary of Fifty-Five In-Market Experimental Estimates of the Long-Term Effect of TV Advertising, *Marketing Science,* 1995. Assmus, J.U., Farley, U. and Lehmann, D. "How Advertising Affects Sales: Meta Analysis of Econometric Results, *Journal of Marketing Research,* 1984. Givon, M and Horsky, D., "Untangling the Effects of Purchase Reinforcement and Advertising Carryover," *Marketing Science*, 1990.

25 Hanssens, Dominique, "What is Known About the Long-Term Impact of Advertising," MASB Practitioner Paper , 2011.

Appendix A -- Summary of Prior Research

Author(s)	Objectives	Methodology and Data	Results and Conclusions
Abdel-Khalik (1976)	The main objectives were to derive a measure of advertising effectiveness, use that measure in the amortization of promotional costs, and show that differential treatment of advertising is warranted for different firms. Different accounting treatment and promotional costs of firms in varous industries were studied to determine whether a single and uniform accounting method for promotional costs is congruent with the basic accounting model.	A Koyck distributed lag model was applied to data from *Advertising Age* from 1955 through 1972. There were five grouping of companies in food, auto, tobacco, soap & cleansers, and drug & cosmetics.	For companies in the food industry and drug and cosmetics industry the indication was that advertising should be treated as an investment and amortized over 5.5 years. For companies in the soap & cleansers, tobacco and auto industries, there was no carryover effect of advertising indicating a short-term effect that should be written off in the current year. The author also commented that there is strong evidence that the duration of the effectiveness of advertising and of promotional efforts vary considerably between different firms in different industries.
Arrow, Stigler, Landes and Rosenfeld (1990)	Review of existing literature on the long-term effects of advertising on sales.	Reviewed and critiqued studies by Clark (1976), Abdul-Khalik (1975), Picconi (1977), Falk and Miller (1977), Ayanian (1983), Bloch (1974), Hirschey (1982) and Hirschey and Weygandt (1985) and Bublitz and Ettredge (1989)	This analysis supports Clark and is critical of Abdul-Khalik, Hirschey and Hirschey and Weygandt. The study concludes that economic evidence does not support the view that advertising is long-lived. The studies examined are deemed so fraught with errors than one cannot rely on their findings.
Assmus, et al (1984)	The authors attempt to assess what has been learned from econometric models about the effect of advertising on sales.	Short- and long-term advertising and model fit are analyzed for 128 econometric models reported over 22 studies involving the impact of advertising on sales. Analysis was done on estimated parameters reported in 22 studies published before 1981. Studies were identified by reviews by Clark (1976), Dhalia (1978) and Leone and Schultz (1980).	Overall, the studies seem to produce estimates which are plausible and which differ surprisingly little over product classes. The pattern of results was similar to those in Clark (1976).

Bublitz and Ettredge (1989)	The authors study the duration of benefits from advertising by using a market-based research method to measure the longevity of advertising and R&D. Stock returns and disaggregated earnings data was used to address the longevity issue.	market-based research method to measure the longevity of advertising and R&D. Stock returns and disaggregated earnings data was used to address the longevity issue. Annual advertising and R& D data from firms with a four-digit standard industrial classification industries from 2000 through 3999. COMPUSYAT data was used for the years 1973-1983 and CRSP data for 1969-1984. The test period was 1974-1983.	For 11 of the 12 tests presented, advertising is presented as an expense, implying that advertising in these cases is short-term. The results do not support those results of Hirschey (1982) or Hirschey and Weygandt(1985).
Clarke (1976)	A survey was taken of the economic literature to determine the cumulative effect of advertising on sales.	The author examined 70 published econometric studies of advertising effect. They compare the	The conclusion that advertising's effect on sales lasts for only months rather than years is strongly supported. Monthly, bimonthly, and quarterly results show a duration of advertising effect on sales of 3 - 15 months.
Dekimpe and Hanssen (1995)	The paper introduces persistence modeling to derive long-term marketing effectiveness from time-series observations on sales and marketing expenditure.	Two research questions were asked-- 1. What is the long-term effect on sales of advertising expenditures 2. What is the effect of print and TV/radio advertising. Data was from chain of home-improvement stores. It consisted of 76 monthly observations of sales, gross margin, advertising budget, and expenditure on print and TV/radio advertising.	1. Impact of advertising shocks extend well beyond the three periods the model selected. Agreed that Clark's 90% of the measurable effects of advertising are consumed within a few months the author's findings suggest that Clark's conjecture may be valid in stable environments but not generalized to evolving markets. 2. Print advertising is more effective for short-term promotional goals. TV/radio is more effective for long-run sales.

Appendix A -- Summary of Prior Research (cont.)

Eng and Keh (2007)	The objective of the study was to examine the effects of advertising and brand value on the firm's future operating and market performance.	Regression model using variables derived from *Financial World*. Variables included advertising expense, brand value, sales, advertising expense/brand sales, brand value/total assets, ROA, returns, brand sales, brand-operating income, brand sales and brand income percentage. Published data from *FW* from 1992 through 1996 was used and a sample was drawn from this period. Obtained were a total of 1,390 firm-year observations for brand value, brand sales and brand.	Carryover effects of advertising can impact ROA for up to four years. This implies a carryover effect from advertising. Results indicate that advertising and brand value do not have much impact on stock returns however advertising and brand value jointly have a positive impact on stock returns. In general, these results suggest that the market does not see advertising spending or brand value as creating growth in future firm value.
Falk, Haim and Miller (1977)	The study reports findings of amortization of advertising expenditures of different firms in the same industry.	A lag distribution model based on the Almon polynomial model. The firms selected for the research were the four auto manufacturers in the United States and the U.S. distributors of imported passenger cars. There were 25 firms examined.	For 10 out of 25 firms examined, no lagged effect of advertising expense was determined to be significant. Influence of advertising did not extend beyond the current quarter. For six forms there was a two quarter lag and five firms experienced advertising impact on sales one quarter beyond the period in which the advertised message was communicated. Four firms had effectiveness of advertising on sales beyond two quarters and two had effects that lasted until the fourth quarter. The results in Peles (1970) and Abdul-Khalic (1976) were consistent with the duration of advertising on sales, since in general the effect does not last beyond four quarters in this industry. Also, the pattern of advertising effect on sales is not the same for all firms in the same industry.

Appendix A -- Summary of Prior Research (cont.)

Givon and Horsky (1990)	The research examines the dynamic effects of frequently purchased product categories of purchase reinforcement and advertising carryover. The paper attempts to parcel out the relative effects of both forces simultaneously.	Aggregate model of a single-purchase-period market share and multi-purchase-period market share to test purchase reinforcement and advertising carryover. Data set was 42 bimonthly observations of food products and 28 monthly observations of dishwashing detergent, chocolate biscuits, and toothpaste.	In all cases there was little retention of advertising over time. In half the cases this coincided with zero or insignificant lagged effect of current advertising. For the product categories examined the authors found significant purchase feedback effects.
Hanssens (2011)	The author's research objective was to examine evidence that marketing has both a short- and long-term impact.	The author used case studies, for example Oscar Mayer Lunchables, Starkist "Tuna in a Pouch", Prego, Citrucel; and various studies Lodish, et al (1995) and Hu, et al (2007)	Results—Long-term advertising impact develops as a result of six main factors. Factors 1-3: immediate effects, carry-over effects, and purchase reinforcement (primarily results of consumer's response to advertising and the product. Factors 4-6: Feedback effect, decision rules and competitive reactions. Productive advertising has an immediate impact on sales. Without the short-term impact, there is no long-term impact. Prior studies demonstrate that on the average, the advertising-to-sales impact in years 2 & 3 is double that of year 1. The size and duration of the long-term impact is determined primarily by the persuasiveness of the ad, together with effective delivery and purchase reinforcement.
Hirschey (1982)		Valuation model to consider the intangible capital aspects of advertising and R&D through the use of a market valuation approach. Sample was 390 firms from 12 major product groups of *Fortune 500* for 1977.	Research suggests that the average yearly rate of amortization of advertising capitalized is 3.47 years and for television advertising 4.7 years. However, author states that because the intangible capital effects of advertising may stem from medium-associated influence of television advertising, the expensing versus capitalization is far from clear.

Hirschey and Weygandt (1985)		An econometric model was used to test whether advertising and R&D expenditures have a positive effect on the market value of the firm. Variable were taken from a sample of 390 firms from 20 major product groups of *Fortune 500* for 1977.	Results suggest a one- to five-year life for advertising amortization (economic amortization for advertising in the 10 to 20% range in the nondurable goods sector and 30 to 60% range in the durable goods sector). "We believe further research on the factors affecting these estimates is necessary before sufficient information is available to develop an appropriate accounting policy."
Hu, Lodish, Kreger (2007)	Hu, Lodish, Kreger (2007)	This paper includes an update on the meta-analysis study by Lodish and colleagues on BSCAN and also reports and analyzes results from the MMT tests. The analysis is based on a new set of 241 TV advertising tests completed by IRI between 1989 and 2003.	This paper includes an update on the meta-analysis study by Lodish and colleagues on BSCAN and also reports and analyzes results from the MMT tests. The analysis is based on a new set of 241 TV advertising tests completed by IRI between 1989 and 2003.

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