Marketing Accountability Standards

Brand Value Is Not a Taxation Issue

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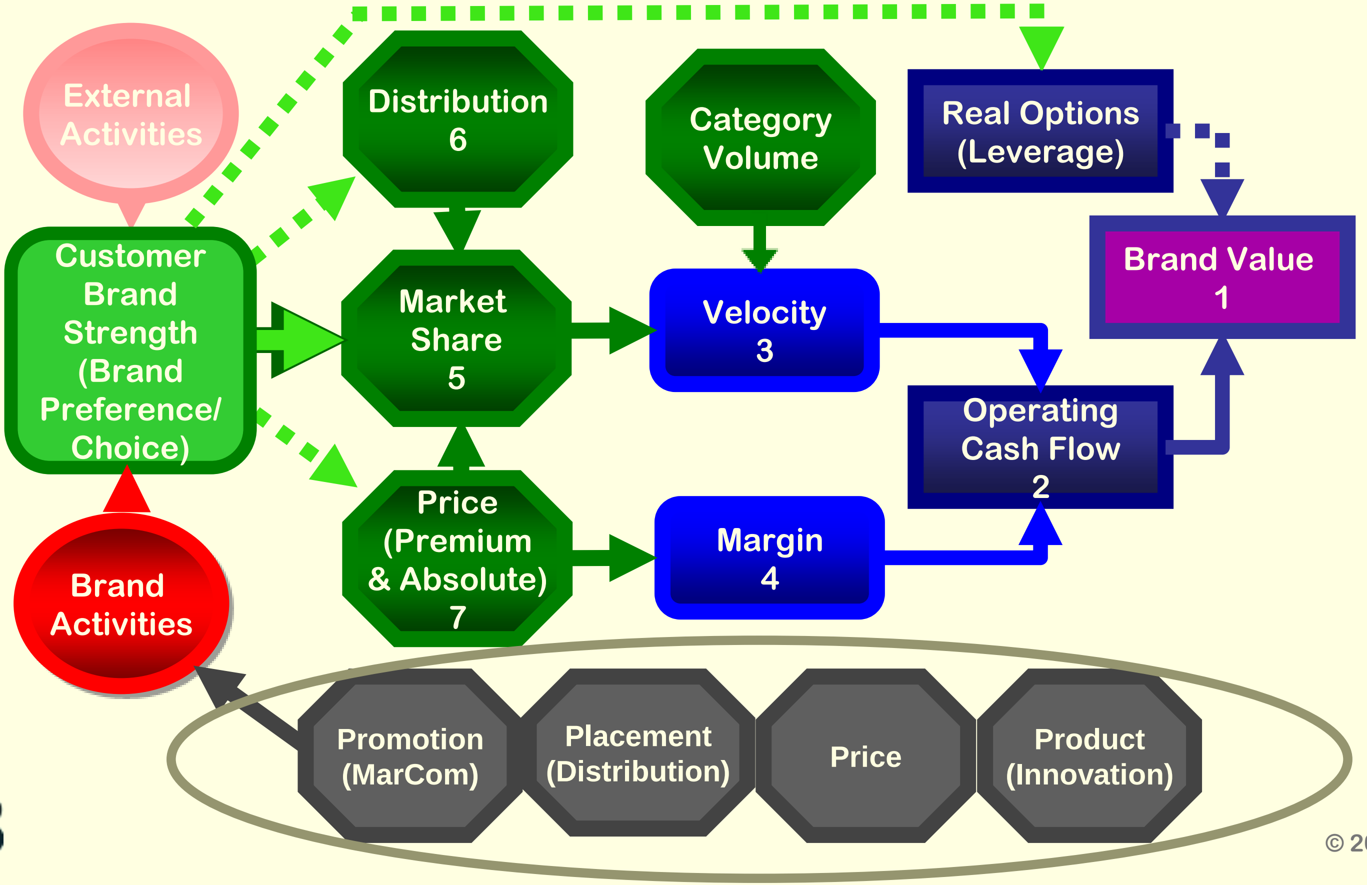
Brand Value Is Created By 4 Ps



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And Taxing Advertising (Promotion) Is Not New

- The 1775 stamp tax required payment of 2 shillings for every advertisement
- During the Civil War period there was a 3 percent tax on advertising gross receipts from newspaper and magazine ads
- However, over the last <u>100 years</u>, advertising expenditures have been treated as an "ordinary and necessary" business expense
  - Considered 'recurring in nature'
  - Benefit does not extend significantly beyond the tax year
  - Identifying a long-term benefit considered challenging
  - <u>Few</u> exceptions: package designs & certain direct response

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Recent proposals would drastically change this

- Would primarily treat advertising and marketing as long-term "brand building" investments
- Would require capitalization of some or all of expenses
- Would apply rigid, lengthy (e.g. 5, 10, 15 years) amortization periods to all advertising and marketing

Recent Advertising Taxation Proposals

- 1986 in conjunction with Tax Reform Act
  - Disallow 20% of advertising costs
- 1987 from Joint Committee on Taxation Report
  - Capitalize 20% and amortize over two years
- 1990 from Congressional Budget Office
  - Capitalize 20% and amortize over four years
- 1994 from Progressive Policy Institute
  - Capitalize 20% related to **brand building**

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More Recent Advertising Taxation Proposals

- 2013 from House Ways and Means Committee
  - Capitalize 50% of advertising costs and amortize over 10 years
- 2013 from Senate Finance Committee
  - Capitalize 50% of advertising costs and amortize over 5 years
- 2013 from a study of Non-Tax Expenditure Base Provisions (NTEBPs)
  - Even if advertising produces only current-year benefits, it is assumed that some advertising builds brand value
  - Suggestion is to capitalize some of the advertising costs and amortize over a future period (15 years, for example)

Attempts to raise more revenues from this source have continued…

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These Proposals Are Based on Assumptions

- Required capitalization for carryover effects
  - Assumes that effects of advertising expenditures last more than one year
  - Assumes that carry-over is attributed to advertising only and not other brand investments (such as product quality leading to repeat purchase)
  - Assumes that the value of these effects can be measured and predicted
- Required capitalization for “brand building”
  - Assumes long-term gains are not a sum of short-term gains
  - Assumes “brand building” benefit equates to expenditure level
  - Assumes brand value should be taxed as it is created not when brand is sold
- Assumes amortization life can be estimated and is consistent
- Political expediency (NTEBP) such as raising revenue

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Can These Assumptions be Justified?

- The makers of tax policy have noted certain theoretical frameworks in the literature to justify these changes in tax code
- Key to all these frameworks is the concept of persistence: that advertising effects do not dissipate within one year
- The most likely framework to support assumptions is hysteresis
  - Concept borrowed from other disciplines such as physics and economics
  - Applied to marketing it suggests that with a stimulus (e.g. a price cut) sales and market share go up and remain at those levels
  - Also suggests the possibility of time delays ('sleeper effect') in impact
- For advertising to exhibit hysteresis, a number of other conditions would need to be met

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Hysteresis Conditions for Long-term Impact

- Simon (1997) notes several factors must join for hysteresis to occur
  - A favorable external situation must occur, which the company must spot early and interpret correctly
  - The company has to take an unusual, innovative action to surprise its competitors and prevent or delay their reactions
  - The actions should include the full marketing artillery, such as price, distribution activities, and communication support
  - The action should be accompanied by heavy signaling, which could include bluffing to prevent quick competitive reaction
  - The company should not have any illusions about the predictability of the outcome - such actions involve high risk
  - In addition to short-term success in attracting customers, hysteresis requires long-term excellence so that the company retains new customers

Note: Advertising by itself can not create hysteresis… it is dependent on other factors for repeat purchasing.

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Repeat Purchases Driven by Other Factors

- Aaker (1995) found the largest indicator as to what a customer buys is what he or she bought the last time
- Givon and Horsky(1990) found significant purchase feedback effects, but not retention of advertising from one monthly or bi-monthly purchase period to another for the product categories examined
- Deighton, et. al. (1994) found advertising does little to change the repeat purchase probabilities of those who had just recently purchased the brand.
- Berger, et. al. (2007) found that product variety can enhance repeat purchase rate
- Wood and Poltrak (2015) found that overall, increasing loyalty and repeat buying among current brand buyers has a higher influence than advertising on long-term effects

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No Support for Time Delays in Advertising

- Jones (1995)
  - If there is no short-term advertising effect there will be no long-term effect
  - Rejection of “sleeper” effect
- Blair (2000)
  - Short-term effects are necessary for long-term effects
  - Without building brands today there is no building brands tomorrow
- Blair and Kuse (2004)
  - Not advertising (going dark) results in a quarterly loss of 0.4 share points
  - The greatest sales impact occurs during the first 4-week period an ad airs
- Hanssens (2011)
  - If advertising is not successful in year one, there will be no long-term effects
  - Good experience with the product, increases long-term potential (repeat)

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MASB Position on Ad Capitalization/Taxation

- 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
- Research in economics, marketing and accounting was examined that addresses short-term and long-term effects of advertising on sales:
  - Short-term sales effects of advertising is predominant conclusion of research, though some long-term effects are noted
  - Noted 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

Unless compelling evidence emerges, MASB recommends advertising expenditures continue to be treated as a current year expense

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Thank-you!