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ACCOUNTING FOR ADVERTISING COSTS – DIFFERENCES AND SIMILARITIES BETWEEN THE US GAAP, IAS / IFRS AND THE GERMAN COMMERCIAL CODE

Abstract

Advertising costs take on increasing importance. Nevertheless, accounting for these costs still involves many problems. Especially, one of the main problems is whether these costs should be treated as assets placed on the balance sheet, or as expenses appearing on the income statement. This paper reveals that in comparison with IAS/IFRS and German Commercial Code, US standards on accounting for advertising costs implicitly offer more alternative accounting treatments. Regardless of the different goals of US GAAP and IAS/IFRS, on the one hand, and German financial reporting, on the other, this paper sets forth that accounting for advertising costs is always dominated by the principles of conservatism and objectivity. This result can be explained with the agency theory.

Key words:

advertising costs, agency theory, financial reporting, German Commercial Code, International Accounting Standards (IAS) / International Financial Reporting Standards (IFRS), US GAAP.

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1. Introduction

Although advertising costs take on increasing importance, accounting for these costs still involves many problems. Specifically, one of the main issues is whether these costs should be treated as assets placed on the balance sheet, or as expenses appearing on the income statement.

Within the context of US GAAP, SOP 93-7, *Reporting on Advertising Costs*, a pronouncement included in category B of the GAAP hierarchy expressed in Statement on Auditing Standards (SAS) No. 69, provides general guidance on the treatment of advertising costs. However, some FASB pronouncements belonging to category A prescribe (stipulate) – among other things – the accounting for advertising costs for specific items or industries, for example SFAS No. 51, *Financial Reporting by Cable Television Companies*, SFAS No. 60, *Accounting and Reporting by Insurance Enterprises*, and SFAS No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*.

In this paper, these pronouncements are analyzed critically and compared with the relevant financial reporting treatment according to IAS / IFRS and pursuant to German Commercial Code. Particularly, because of the different goals of US GAAP and IAS / IFRS, on the one hand, and German financial reporting, on the other, this analysis seems to be important. The results will be explained with the agency theory.

2. The Standards Providing Guidance on the Treatment of Advertising Costs

2.1. US GAAP

2.1.1. Main Guidance: SOP 93-7

2.1.1.1. The General Rule

For financial accounting purposes, the major problem of how to handle advertising costs is the uncertainty about whether a probable future economic benefit actually exists. Accordingly, paragraph 175 of FASB Concepts Statement No. 6 states that «business enterprises … advertise, develop markets, … and spend significant funds to do so. The uncertainty is not about the intent to increase future economic benefits but about whether and, if so, to what extent they succeed in doing so. Certain expenditures for … advertising … are examples of the kinds of items for which assessments of future economic benefits may be especially uncertain».

Statement of Position 93-7 (SOP 93-7), *Reporting on Advertising Costs*, addresses this problem. As a Statement of Position, SOP 93-7 is a pronouncement included in category B of the GAAP hierarchy expressed in SAS No. 69. This SOP applies to advertising of all entities except advertising for which guidance is provided by pronouncements belonging to category A in the GAAP hierarchy of SAS No. 69[1], since category A takes precedence over category B.

Under SOP 93-7, in general, advertising costs should be expensed either as incurred or the first time the advertising takes place[2]. Examples of first-time advertising comprise the first appearance of a newspaper advertisement or the first public showing of a television commercial for its intended purpose. Usually, the two primary costs of advertising are production costs and communication costs[3]. While advertising production costs include idea development, advertising copywriting, artwork, printing, audio and video crews, actors and other related costs, communication costs are those for billboard space, television airtime, and magazine space[4].

Normally, advertising activities provide future benefits to an entity. If this were not the case, firms would not advertise their products as much as they do.[5] Hence, the guidance in SOP 93-7 is based on the premise that most advertising activities may generate probable future economic benefits which meet the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*.[6] Assets are defined in paragraph 25 of Concepts Statement No. 6 as «probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events». Paragraph 63 of SOP 93-7 states that advertising «can create assets according to that definition».

The AICPA's Accounting Standards Executive Committee (AcSEC) founded the decision about whether to expense or to capitalize advertising costs on the definition of an asset in Concepts Statement No. 6 and on the recognition criteria in Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. To be recognized, an item (and the information about it) has to meet four criteria: definition, measurability, relevance, and reliability[7]. Indeed, AcSEC points out that many kinds of advertising activities also meet the recognition criteria of measurability and relevance.[8]

According to Concepts Statement No. 5, in order to be reliable, the information must be representationally faithful, verifiable, and neutral. AcSEC con-

[1] See SOP 93-7, par. 6.
[2] See SOP 93-7, par. 26.
[3] See, for example, *Maples/Earles* (1999), p. 52.
[4] For details, see, for instance, *Maples/Earles* (1999), p. 52.
[5] See, for instance, *Stice/Stice/Diamond* (2003), p. 454; *Albrecht/Stice/Stice/ Skousen/ Swain* (2002), p. 369; *Diamond* (1996), p. 485.
[6] For a criticism of the definition of an asset in FASB Concepts Statement No. 6, see *Wolk/Dodd/Tearney* (2004), pp. 321-323.
[7] See SFAC No. 5, par. 63.
[8] See SOP 93-7, par. 69.

cludes that most advertising does not meet the recognition criteria of reliability after the first time the advertising takes place. Pursuant to AcSEC, for most advertising, the probable future economic benefits cannot be measured with the degree of reliability required to report an asset in the financial statements[9]. Therefore, most advertising does not qualify for capitalization beyond the first appearance of a magazine advertisement of the first showing of a commercial.

In addition, this general rule of accounting for advertising costs corresponds with the general rule of accounting for research and development costs which the FASB addressed in FASB Statement No. 2. Owing to the uncertainty of the future benefits derived therefrom, paragraph 12 of FASB Statement No. 2 requires that research and development costs shall be charged to expense as incurred[10]. «Because of the high degree of uncertainty of any resulting future benefit, the underlying basic principle in accounting for R&D is conservatism»[11]. Due to the fact that «advertising expenditures have the same problem as research and development costs»[12], it appears to be appropriate that these two general rules of accounting treatment are consistent.

2.1.1.2. The Exception: Direct-Response Advertising

Owing to the significant uncertainty of the future economic benefits, advertising costs generally should be expensed either as incurred or the first time the advertising takes place[13]. Nevertheless, SOP 93-7 provides one important exception: Direct-response advertising that meets specific criteria should be capitalized[14]. In order to be capitalized, direct-response advertising has to meet two conditions[15]. First, the main purpose of the advertising must be to elicit sales to customers who could be shown to have responded specifically to that direct-response advertising. To meet the first requirement, a company has to prove that customers reacted to specific direct-response advertising, since traceability of these responses to the related direct-response advertising is decisive. Revealing that customers responded to a specifically identifiable direct-response advertisement requires documentation, for instance, a record which can identify the names of the customers and the direct-response advertising which elicited the response. For example, such documentation could comprise coded response cards, coded order forms, or coupons, included with a direct-response

[9] See SOP 93-7, par. 69. For further details, also see *Tanenbaum* (1993), p. 79; *Bazley/Nikolai/ Grove* (1995), p. 331; *Nikolai/Bazley* (2003), p. 518.
[10] For details, also see *Jeter/Chaney* (2004), p. 44.
[11] *Williams/Carcello* (2005), p. 40.02.
[12] *Maples/Earles* (1999), p. 52.
[13] See, for instance, *Nikolai/Bazley* (2003), p. 518; *Kieso/Weygandt/Warfield* (2004), p. 588; *Albrecht/Stice/Stice/Skousen/Swain* (2002), p. 369.
[14] See SOP 93-7, par. 26.
[15] See SOP 93-7, par. 33.

advertisement, indicating the names of the customers and the related direct-response advertisement or a log connecting the calls and the customer names with the television advertisement[16].

Second, the direct-response advertising must result in probable future economic benefits[17]. Probable future economic benefits are expected primary revenues arising from direct-response advertising in excess of the costs to be incurred in generating those revenues[18]. Primary revenues are, for instance, revenues derived from sales to customers receiving and responding to the direct-response advertisement[19]. For instance, revenues that publishers receive from customers that subscribe to the publications are primary revenues, whereas revenues resulting from advertisements placed in the publications are considered as secondary revenues[20]. Substantiating that direct-response advertising will cause probable future economic benefits requires persuasive evidence that its results will be similar to the results of past direct-response advertising activities of the entity which elicited future economic benefits. Such evidence should contain verifiable historical patterns of results specific to the entity.

For this reason, an entity has to base its decision about whether to capitalize costs of direct-response advertising on its results with past direct-response advertising campaigns. In this context, the most convincing type of evidence in support of capitalization of direct-response advertising costs contains a prior history of similar direct-response advertising for similar products that generated future economic benefits. In order to determine whether the results will be similar, attributes to consider especially include the demographics of the audience, the advertising method, the product, and the economic conditions[21]. Certainly, in the absence of a specific entity's prior experience with direct-response advertising, industry statistics would not provide objective evidence of probable future economic benefits[22].

Furthermore, it is worth stressing that under SOP 93-7, the costs of the direct-response advertising directed to all prospective customers, not just the costs related to a portion of the potential customers that are expected to react to advertising, should be capitalized[23]. Besides, the costs of direct-response advertising should only include incremental direct costs incurred in transactions with independent third parties plus payroll and payroll-related costs for the activities of employees that are directly associated with the advertising project[24]. In contrast to this, the allocated administrative costs, rent, depreciation, and other oc-

[16] See SOP 93-7, par. 34. See *Moody* (2003), p. 20-13; *Maples/Earles* (1999), pp. 52–53; *Schildbach* (2002), p. 76.
[17] See SOP 93-7, par. 33b.
[18] See SOP 93-7, par. 36. See *Moody* (2003), p. 20–13.
[19] See Practice Bulletin 13, par. 5a. See *Epstein/Black/Nach/Delaney* (2005), p. 386.
[20] See Practice Bulletin 13, par. 5.
[21] See SOP 93-7, par. 37. For details, see *Weiss/Williams/Carcello* (2005), pp. 3.04–3.05.
[22] See SOP 93-7, par. 38.
[23] See SOP 93-7, par. 40.
[24] See SOP 93-7, par. 41. For further details, see *Nikolai/Bazley* (2003), p. 519.

cupancy costs are not recognised as costs of direct-response advertising under SOP 93-7. Capitalized direct-response advertising costs should be amortized using a cost-pool method over the period during which the future economic benefits are expected to be received[25]. Also, the amortization should be the ratio of the current period revenues for a cost pool to the total current and estimated future period revenues for that cost pool[26].

Pursuant to SOP 93-7, there are particular disclosures required, such as a description of the direct-response advertising costs reported as assets, the total amount charged to advertising expense, the accounting policy selected for advertising, the amortization period of direct-response advertising, and the total amount of advertising cost which is capitalized[27].

Principally, AcSEC bases its conclusion for capitalizing direct-response advertising costs on FASB Concepts Statements Nos. 5 and 6. In this regard, AcSEC emphasizes that direct-response advertising meets not only the asset-definition included in Paragraph 25 of the Concepts Statement No. 6, but also all the three other recognition criteria, namely measurability, relevance, and reliability[28]. Thus, AcSEC brings forward the argument that only certain direct-response advertising activities meet the recognition criteria of reliability after the first time the advertising takes place[29]. Only the direct-response advertising which meets two specific criteria constitutes the exception that may generate probable future economic benefits measurable with the degree of reliability required to report the asset in the financial statements.

2.1.2. Accounting for Advertising Costs for Specific Items or Industries

However, some FASB pronouncements provide guidance on reporting advertising for specific items or industries. Therefore, in some industries, companies have to expense all their advertising costs when they are incurred, even their direct-response advertising costs. For instance, FASB Statement No. 51, *Financial Reporting by Cable Television Companies*, specifies that all advertising related to acquiring new cable television subscribers should be expensed as incurred, regardless of its form[30]. Moreover, under FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, the whole of the incurred adver-

[25] See SOP 93-7, par. 46.
[26] See SOP 93-7, par. 47.
[27] See SOP 93-7, par. 49. For details about the importance of disclosure of information about intangibles, see *Lev* (2001), pp. 91–102.
[28] See SOP 93-7, pars. 68–70.
[29] See SOP 93-7, par. 69.
[30] See SFAS No. 51, par. 6, par. 17.

tising costs related to soliciting potential borrowers should be expensed immediately[31]. As a result, in these cases, even the entire costs of direct-response advertising also have to be expensed as they are incurred[32].

In opposition to this, pursuant to FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, stock life and property and liability insurance companies should capitalize their policy acquisition activities.[33] Yet, FASB Statement No. 60 is unclear about whether advertising is a policy acquisition activity, but the Industry Audit Guide *Audits of Stock Life Insurance Companies* states that it is[34]. Besides, according to FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, the costs which a company incurs to rent or sell real estate projects should be capitalized if they are to be realized when the corresponding project is sold or rented[35]. In addition, FASB Statement No. 67 stipulates that companies should expense the capitalized costs in the period in which the revenue is recognized[36].

2.2. International Accounting Standards / International Financial Reporting Standards

Within the context of International Accounting Standards (IAS) / International Financial Reporting Standards (IFRS), the crucial provision regarding accounting for intangibles is IAS 38, *Intangible Assets*. An intangible asset is defined in paragraph 8 of IAS 38 as «an identifiable non-monetary asset without physical substance». Under IAS 38, an intangible asset has to be capitalized if – and only if – «it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and … the costs of the asset can be measured reliably»[37].

Thus, the key criteria for recognition of intangible assets are identifiability and control[38]. Moreover, reliable measurability is also a requirement in this field. Pursuant to paragraph 69 of IAS 38, all the expenditures on advertising and promotional activities should be expensed as they are incurred. Paragraph 69 of IAS 38 states that in these cases, «expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised».

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[31] See SFAS No. 91, par. 7.
[32] See, for instance, *Maples/Earles* (1999), p. 54.
[33] See SFAS No. 60, par. 29.
[34] See Industry Audit Guide «Audits of Stock Life Insurance Companies», par. 8.30.
[35] See SFAS No. 67, par. 17, par. 20 in connection with par. 28 (Appendix A).
[36] For details, see also *Maples/Earles* (1999), p. 54.
[37] IAS 38, par. 21.
[38] See *Alexander/Archer* (2004), p. 20.06.

Besides, in the case of such intangible resources like benefits arising from advertising costs, even if the identifiability criterion is satisfied, «the criterion of controllability will most likely not be met in the absence of protection by legal rights»[39]. As a result, such intangible resources do not qualify for capitalization.

In addition, paragraph 63 of IAS 38 clarifies that «internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets». Since expenditures on internally created brands, mastheads, publishing titles, customer lists, and items similar in substance usually «cannot be distinguished from the cost of developing the business as a whole»[40], such items do not qualify for recognition as intangible assets. After all, it is worth stressing that, in this area, IAS 38 «sets a rather conservative approach to recognition and measurement of intangibles»[41].

Nevertheless, under IAS 38, there is a substantial disclosure required for each class of intangible assets[42], distinguishing between internally generated intangible assets and other intangible assets. In this context, a class of intangible assets is a grouping of assets of similar nature and use in an enterprise's operations. Particularly, examples of separate classes also include brand names or mastheads and publishing titles[43].

2.3. The German Commercial Code

Pursuant to German accounting laws, there is one decisive provision concerning accounting for intangibles: Paragraph 248 II of German Commercial Code prescribes that the recognition of non-current intangible assets which are not acquired externally against payment is not permitted. Therefore, non-current intangible assets have to be capitalized only if they are acquired from another party in return for payment. Otherwise, the costs of intangible assets have to be expensed immediately. Since, for many intangibles, neither the transactions nor the related costs can be reliably identified or estimated, this general accounting rule is founded on the principle of conservatism.[44] Moreover, this regulation is based on the fact that, intangibles mostly cannot be quantified in monetary units

[39] *Alexander/Archer* (2004), p. 20.07. Also, see *Baetge/von Keitz* (2003), p. 27; *Epstein/Mirza* (2004), p. 335.
[40] IAS 38, par. 64.
[41] *Epstein/Mirza* (2004), p. 326.
[42] For details, see IAS 38, pars. 118–122. Also, see *Lüdenbach/Hoffmann* (2003), p. 365; *Alexander/Archer* (2004), pp. 20.16-20.18; *Cairns* (2002), pp. 576–578.
[43] See IAS 38, par. 119.
[44] See *Adler/Düring/Schmaltz* (1998), commentary on par. 248 of German Commercial Code, p. 383.

with sufficient reliability. Thus, a confirmation of the value of an intangible given by the market is necessary in order for the intangible asset to be capitalized[45].

For this reason, the costs of internally generated intangible assets, such as the costs of internally developed copyrights, the costs of internally developed patents, and the costs of internally generated trademarks and trade names, have to be expensed as incurred. Owing to the fact that these intangibles are not acquired externally against payment, capitalization of the costs of these intangibles is not permitted according to paragraph 248 II of German Commercial Code. On the contrary, purchased copyrights, purchased patents, purchased trademarks, and purchased trade names must be capitalized. Accordingly, accounting for film costs depends on whether the film is acquired externally or generated internally. Subject to judgements of the German Supreme Tax Court, films are intangible assets[46]. Hence, the decisive accounting rule for non-current film assets is paragraph 248 II of German Commercial Code. Consequently, once again, the criterion «acquisition from another party by purchase» proves to be determining[47]. Thus, if a film is acquired externally against payment, the costs of this film have to be capitalized. On the other hand, the costs of internally developed films should be expensed immediately. Since internally generated films are not acquired externally against payment, capitalization of film costs is prohibited under paragraph 248 II of German Commercial Code.

As already stressed, the general rule set forth in paragraph 248 II of German Commercial Code is applicable to non-current intangible assets. In opposition to that, the costs of current intangible assets are capitalized[48]. This rule is important for companies producing such intangibles in order to sell them. In the following, the term «intangible assets» only refers to non-current intangible assets, since, for example, US accounting terminology includes only non-current assets in intangible assets[49].

Furthermore, it is worth emphasizing that paragraph 248 II of German Commercial Code is the only decisive regulation concerning accounting for non-current intangible assets. Besides, paragraph 5 II of the German Income Tax Law includes the same provision. In cases of litigation, the content of paragraph 5 II of the German Income Tax Law is interpreted by the German Supreme Tax Court. This court is the court of the last resort in this field. Owing to the authoritative principle and the reverse authoritative principle, these interpretations are also relevant to the content of paragraph 248 II of German Commercial Code.

Generally, the criterion «external acquisition by purchase» is interpreted in a very narrow way by the German Supreme Tax Court[50]. Hence, the relevant

[45] See *Förschle* (2003), p. 235.
[46] See judgement of German Supreme Court of 20.11.1970, BStBl. II 1971, p. 186; judgement of German Supreme Tax Court of 10.12.1992, BStBl. II 1993, p. 538, p. 542.
[47] See, for instance, *Winnefeld* (2002), p. 1600.
[48] See *Winnefeld* (2002), p. 406.
[49] See, for example, *Nikolai/Bazley* (2003), p. 456.
[50] For further details, see *Moxter* (1999), pp. 29-37; *Moxter* (2003), pp. 74-78.

rights related to the intangibles have to be acquired externally by purchase in order for the intangibles to be capitalized. Thus, the money must be paid from a third party in order to acquire the rights related to the intangible[51].

Subject to German Commercial Code, advertising costs generally have to be expensed as incurred. Even the capitalization of direct-response advertising costs is generally not allowed. The crucial accounting provision in this area is paragraph 248 II of German Commercial Code. Since the privileges or benefits derived from advertising are not acquired from another party in return for payment[52], capitalization is not permitted according to paragraph 248 II of German Commercial Code. Again, the decisive criterion of «external acquisition by purchase» is not satisfied. Due to principles of conservatism and objectivity, advertising costs have to be expensed as they are incurred.

Yet, there also are some exceptions to this general rule. First, the costs of advertising films have to be accounted for according to the general regulations on film costs as discussed above[53]. Second, as under SOP 93-7, tangible assets used in advertising, for example blimps or bill-boards, should be capitalized[54].

3. Critical Evaluation

3.1. US GAAP: Implicit Offer of More Alternative Accounting Treatments

As discussed above, under SOP 93-7, only the direct-response advertising that meets two specific criteria constitutes an exception which may result in probable future economic benefits measurable with the degree of reliability required to report the asset in the financial statements. Generally, according to SOP 93-7, advertising costs should be expensed immediately in view of the uncertainty of their future benefits[55]. However, specific direct-response advertising costs should be capitalized because future benefits derived therefrom are considered to be «more certain»[56].

But even with the guidance provided by SOP 93-7, considerable judgement is included in determining whether the costs of direct-response advertising

[51] See, for instance, judgement of German Supreme Tax Court of 13.12.1984, VIII R 249/80, BStBl. II 1985, p. 289.

[52] See, for instance, *Weber-Grellet* (2004), commentary on paragraph 5 of German Income Tax Law, p. 457 (Glossary, («Werbung»)).

[53] See *Niemann* (1999), p. 159.

[54] See *Weber-Grellet* (2004), commentary on paragraph 5 of the German Income Tax Law, p. 457 (Glossary, («Werbung»)).

[55] See, for instance, *Albrecht/Stice/Stice/Skousen/Swain* (2002), p. 369.

[56] *Stice/Stice/Diamond* (2003), p. 455; *Albrecht/Stice/Stice/Skousen/Swain* (2002), p. 369.

meet the criteria for capitalization. In order for direct-response advertising costs to be capitalized, the direct-response advertising has to create probable future economic benefits. Demonstrating that direct-response advertising will generate probable future economic benefits requires persuasive evidence that its effects will be similar to the effects of the entity's past direct-response advertising activities which resulted in future economic benefits. As stressed above, to determine whether the results will be similar, attributes to consider comprise the demographics of the audience, the method of advertising, the product, and the economic conditions. Nonetheless, these features are not concretized under SOP 93-7. In particular, it is not substantiated to what extent the specifications of these attributes can differ in order to assume that they are still «similar». Consequently, judgement often influences on whether the costs of direct-response advertising are capitalized. Therefore, in order to avoid capitalizing of direct-response advertising costs, an entity can (nearly) always find a reason to justify that one or several attributes are not similar, even if there are considerable similarities at first glance. Hence, even the proponents of SOP 93-7 contend that «subjective judgements ... will be required»[57]. In fact, without explicitly emphasizing that, AcSEC is permitting an accounting alternative, in particular for direct-response advertising, which meets both conditions specified in SOP 93-7.[58] Even if the effects of a current direct-response advertising activity are similar to the effects of responses to a past direct-response advertising activity, a reason can (nearly) always be found to explain that the effects of the both of these direct-response advertising activities have to be regarded as different.

Certainly, implicit offers of accounting alternatives must be criticized. Owing to decision usefulness, which is the main objective of US financial reporting, these implicit offers of alternative accounting treatments seem to be really unfavourable since they diagree with the major purpose of US financial reporting.

In contrast to that, IAS / IFRS and also German provisions concerning accounting for advertising costs include hardly any implicit offer of accounting alternatives – at least, they include less of these implicit alternatives. Since German accounting rules generally do not permit capitalization of internally generated non-current intangibles and since IAS / IFRS do not permit capitalization of advertising costs, there are only very few, if any, implicit offers of alternative accounting treatments.

Moreover, it is important to find out why only certain direct-response advertising activities are to be capitalized under SOP 93-7, whereas all other kinds of advertising do not qualify for capitalization beyond the first time the advertising takes place. Indeed, SOP 93-7 does not include an explicit answer to that question.In particular, AcSEC does not reveal that it thinks that direct-response advertising is more effective than all other kinds of advertising. Instead, restricting advertising eligible for capitalization to direct-response advertising seems to be based on the AcSEC's assumption that direct-response advertising is the

[57] *Tanenbaum/Finger* (1994), p. 38.
[58] See *von Keitz* (1997), p. 165.

only kind of advertising which makes it possible to trace the reactions of the customers to a specific advertising activity and to document customer responses.[59] It is true that SOP 93-7 contains several indications of that explanation.[60] Yet, limiting advertising qualified for capitalization to direct-response advertising that meets two requirements seems to be somewhat «arbitrary»[61].

3.2. US GAAP: The Inconsistencies between Different Sources

As already analyzed, several pronouncements within the context of US GAAP provide guidance on accounting for advertising costs. For instance, according to FASB Statement No. 51 and pursuant to FASB Statement No. 91 all advertising costs – even all the costs of direct-response advertising – have to be expensed as incurred. On the other hand, under FASB Statement No. 60 and subject to FASB Statement No. 67, companies generally should capitalize their advertising costs. As a result, there is, nonetheless, some inconsistency between these sources. In addition, there is some further inconsistency between all these pronouncements and the guidance provided by SOP 93-7.

Apart from that, it is important to find out why some FASB pronouncements require that all advertising costs should be capitalized, whereas other FASB pronouncements stipulate that all advertising costs should be expensed immediately. However, these FASB pronouncements do not include an explicit answer to that question.

Rather, pronouncements that require capitalization of all advertising costs appear to do so because there is «a clear, demonstrable cause and effect relationship between the assets acquired and the costs incurred»[62]. In opposition to this, pronouncements which prohibit capitalization of advertising costs – even capitalization of direct-response advertising costs – seem to do so «because there is no demonstrable causal relationship – the amounts capitalized would be immaterial or the cost of obtaining the information would outweigh the benefits of reporting it»[63].

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[59] See, for example, *Stice/Stice/Diamond* (2003); p. 455. *Weiss/Williams/Carcello* (2005), p. 3.04-3.05; *Albrecht/Stice/Stice/Skousen/Swain* (2002), p. 369.
[60] See, for instance, SOP 93-7, par. 33a.
[61] *Tanenbaum/Finger* (1994), p. 38.
[62] *Maples/Earles* (1999), p. 54.
[63] *Maples/Earles* (1999), p. 54.

3.3. IAS / IFRS, US GAAP, and German Commercial Code: Important Role of Conservatism in this Field

3.3.1. Conservatism and Objectivity

In SOP 93-7, AcSEC founded the general decision about whether to expense or to capitalize advertising costs – as already emphasized – on the recognition criteria in the Concepts Statement No. 5. As already stressed, AcSEC concludes that most advertising costs do not meet the recognition criteria of reliability after the first time the advertising takes place. Pursuant to AcSEC, for most advertising, the probable future economic benefits cannot be measured with the degree of reliability required to report an asset in the financial statements.[64] Therefore, most advertising does not qualify for capitalization beyond the first appearance of a magazine advertisement or the first showing of a commercial. Due to the significant uncertainty of future economic benefits, advertising costs generally should be expensed either as they are incurred or the first time the advertising takes place[65]. This general rule is in line with the traditional conservatism – meaning prudence – in financial accounting[66]. After all, it is worth stressing that «the profession has taken a conservative approach to recording advertising costs because defining and measuring the future benefits are so difficult»[67].

As the discussion of accounting for advertising costs illustrates, not only the traditionally conservative German Commercial Code, but also IAS 38 and SOP 93-7 generally favour conservatism and objectivity. Paragraph 248 II of German Commercial Code is a very conservative general rule[68], since it precludes all internally developed intangibles from capitalization. As pointed out above, subject to paragraph 248 II of German Commercial Code, the costs of internally developed intangibles have to be expensed immediately. This general rule has to be applied to all internally created intangibles. Owing to the protection of creditors, which is a significant aim of German financial reporting, the principle of conservatism is traditionally very important in Germany.

In addition, SOP 93-7 is governed by the principle of conservatism. Pursuant to the general rule expressed in SOP 93-7, advertising costs should be expensed (either as they are incurred or the first time the advertising takes place). In view of the uncertainty of the associated future benefits, capitalization

64 See SOP 93-7, par. 69. For further details, also see *Tanenbaum* (1993), p. 79; *Bazley/Nikolai/Grove* (1995), p. 331.
65 See, for example, *Nikolai/Bazley* (2003), p. 518; *Pellens* (2001), p. 180.
66 See, for instance, *Albrecht/Stice/Stice/Skousen/Swain* (2002), p. 369; *Kieso/Weygandt/Warfield* (2004), p. 588.
67 *Kieso/Weygandt/Warfield* (2004), p. 588.
68 See, for example, *Adler/Düring/Schmaltz* (1998), p. 378.

of advertising costs is generally not permitted. This general provision is very similar to the accounting regulation concerning advertising costs under German Commercial Code and also under IAS 38. As set forth above, according to IAS 38, advertising costs have to be expensed immediately. Hence, in this respect, IAS 38 is also dominated by conservatism and objectivity.

As illustrated by the discussion of the accounting standards on advertising costs not only in Germany, but also in the United States and under IAS / IFRS, the overall «rule of thumb is that, when there is significant uncertainty about whether an expenditure should be capitalized or expensed, expense it»[69]. This approach is in line with the principles of conservatism and objectivity in accounting. Moreover, it enhances comparability and consistency. In addition, it avoids reliability problems.

Yet, in spite of these advantages, this conservative approach also appears to cause some detriments. These standards favour conservatism, but as some critics argue, at the expense of matching and relevance[70]. Excluding these intangibles from capitalization «removes from the balance sheet what may be a company's most valuable asset»[71]. Consequently, this conservative solution can result in a «significant understatement of the economic assets of a company»[72].

3.3.2. Explanation with the Agency Theory

According to US GAAP and under IAS / IFRS, the information function proves to be decisive in financial reporting. In contrast to this, German financial reporting has a variety of targets: Apart from the documentation function, the information function and the measurement of income are also the crucial objectives of German financial reporting[73]. Owing to the authoritative and the reverse authoritative principle, there is a close connection between financial reporting and the balance sheet for tax purposes in Germany. Nonetheless, accounting for advertising costs is always dominated by conservatism and objectivity. Considering the differences in financial reporting goals of US GAAP and IAS / IFRS on the one hand and of German financial reporting on the other hand, this result might be quite astonishing at first glance.

However, this result can be explained with the agency theory. Usually, the intangible assets like advertising have important characteristics which distinguish them from the tangible assets: First, in general, there is a higher degree of uncertainty concerning probable future economic benefits which are created;

69 *Albrecht/Stice/Stice/Skousen/Swain* (2002), p. 369.
70 See, for instance, *Lenk* (1998), p. 182.
71 *Kieso/Weygandt/Warfield* (2004), p. 590.
72 *Stice/Stice/Diamond* (2003), p. 455; see also *Revsine/Collins/Johnson* (2005), pp. 520–521.
73 See *Pellens/Fülbier/Gassen* (2004), pp. 10-13.

second, intangible assets may have value only to a specific company; third, their value is subject to wider fluctuations because it normally depends, at least to a large extent, on competitive conditions.

Subject to the agency theory, financial statements – and parts of financial statements – can be seen as instruments to alleviate the information asymmetry between the management – as an agent – and the investor – as a principal. Owing to the necessary costs, investors are generally not able to monitor the management. Certainly, if the management is forced to publish reliable information, the possibility of income manipulation can be reduced[74]. As a result, a crucial function of balance sheet is to improve the decisions of the investors. Accordingly, the problems of moral hazard can also be diminished. In view of the prevailing information asymmetry between management and investors, the information function of financial statements can only be satisfied if the investor is able to assess reliably the published information. Therefore, reliable, standardized, and objective accounting standards are essential in eliminting the possibility of income manipulation[75].

Pursuant to paragraph 95 of SFAC No. 2, conservatism is defined as «a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered». Concerning advertising costs, conservative and objective accounting standards are decisive to provide reliable information and to prevent greater opportunities for abuse.[76] Hence, IAS / IFRS, US and German accounting standards on advertising costs are generally dominated by conservatism and objectivity. Moreover, reliability proves to be crucial in this area, since reliability is an essential prerequisite to provide confidential, believable, and reviewable information. Thus, in order to prevent income manipulation, not only German Commercial Code, but also IAS / IFRS and the US standards on accounting for advertising costs principally favour conservatism and objectivity at the expense of matching and relevance.

4. Conclusions

Within the context of US GAAP, SOP 93-7 provides general guidance on treatment of advertising costs. According to SOP 93-7, principally, advertising costs should be expensed either as incurred or the first time the advertising takes place. Nevertheless, SOP 93-7 provides one important exception: Direct-response advertising that meets specific criteria should be capitalized. Yet, some FASB pronouncements belonging to category A of the GAAP hierarchy expressed in SAS No. 69 prescribe – among other things – the accounting for advertising costs for specific items or industries, for instance SFAS No. 51, SFAS No. 91, SFAS No. 60, and SFAS No. 67.

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[74] See *Schildbach* (1989), p. 128; *Hax* (1991), p. 63; *Laux* (1999), pp. 15–16.
[75] See *Haller* (1994), p. 599.
[76] See *Hartman/Harper/Knoblett/Reckers* (1995), p. 586; *Nikolai/Bazley* (2003), p. 460.

Under German Commercial Code, there is one decisive provision concerning accounting for intangibles: Paragraph 248 II of German Commercial Code prescribes that recognition of non-current intangible assets which are not acquired externally against payment is not permitted. Subject to German Commercial Code, advertising costs generally have to be expensed as they are incurred. Even capitalization of direct-response advertising costs is generally not allowed. Since the benefits or privileges derived from advertising are not acquired from another party in return for payment, capitalization is not permitted according to paragraph 248 II of German Commercial Code. Pursuant to IAS 38, capitalization of advertising costs is not permitted too.

In comparison with IAS / IFRS and German Commercial Code, US standards on accounting for advertising costs implicitly offer more alternative accounting treatments. Moreover, there is some inconsistency between several sources within the context of US GAAP. Regardless of the differences in financial reporting goals of US GAAP and IAS / IFRS, on the one hand, and of German financial reporting, on the other, accounting for advertising costs is always dominated by the principle of conservatism. Not only the traditionally conservative German Commercial Code, but also IAS / IFRS and the US standards on accounting for advertising costs, mainly favour conservatism and objectivity at the expense of matching and relevance. This result can be explained with the agency theory.

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