30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410   Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org   Website: www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**February 2008, London**
Project:	**ED Annual Improvements Project – Comment Analysis**
Subject:	**IAS 38 Advertising and promotional activities (Agenda paper 4K)**

BACKGROUND

1. IAS38.69 states that expenditure on advertising or promotional activities is recognised as an expense as incurred. The annual improvements ED recommended that IAS 38.68-70 be amended to clarify the meaning of 'as incurred'. The change would mean that entities receiving goods or services that will be used for advertising or promotional activities would recognise an expense when they have access to the goods or receive the services.

2. The reason for proposing the change to IAS 38 was that diversity had developed in practice. Some entities recognised the expense when advertising was delivered to customers. Others recognised it when the goods or services required to develop or produce the advertising were received. In the case of mail order catalogues, some entities capitalised the cost of the catalogues and amortised it over the periods in which they were expected to generate sales.

3. This paper analyses the comments received in respect of the ED. It includes the staff's recommendations and asks the Board whether it agrees with them.

Summary of comments received

4. 43 of the 75 letters received commented on this issue. Of those that commented, 19[1] agreed with the Board's proposal. Those that disagreed did so for various reasons:

   a. Some respondents considered that the proposed changes would result in a significant change to current practice and so should not be made as part of the annual improvements process.

   b. Some believed that mail order catalogues are a special case and are not a form of advertising. Instead, they form a distribution network similar to a shop. As such, they meet the definition of an asset that should be recognised in the balance sheet.

   c. Some respondents thought that entities that had incurred expenditure on advertising or promotional activities but had not yet delivered the associated advertisement had an asset that they may recognise – the ability to deliver an advertisement.

   d. Some supported the alternative view in the ED that the proposed change contains a logical flaw. IAS 38 only deals with Intangible Assets and the proposed amendment considers both intangible and tangible assets.

   e. A number of comment letters had specific comments on the wording of the amendment. In particular commentators expressed concerns about the use of the phrase "has access to" and the definition of advertising and promotional activities. Some respondents misunderstood the Board's intentions in using the phrase "has access to".

Summary of staff proposals

5. The staff has considered the comments received and discusses its recommendations below. In summary, the staff recommends that the Board:

   a. pursue this change as part of the annual improvements project;

[1] Of the 19 that agreed, 1 agreed with the principle but considered that the amendment should not be made as an annual improvement and 2 agreed with the principle but felt that IAS 38 should not deal with tangible assets.

b. clarify that mail order catalogues are part of advertising and promotional activities; and

c. revise the proposed wording to make clear the Board's intentions in using the phrase 'access to' the related goods or services.

6. The staff will ask the Board:

- Whether it agrees with continuing to pursue this amendment as part of the annual improvements process; and
- Whether it agrees with publishing the revised changes (as proposed by the staff) as a final amendment.

COMMENT LETTER ANALYSIS

7. Of 75 comment letters received, 19 specifically commented that they were supportive of the Board's proposal and 24 disagreed. Whilst a numerical analysis of comment letters has little value, the staff considers that the split of comments between those that support and those that oppose the proposal reaffirms the staff's understanding that practice and views in this area are divided.

8. Those that disagreed with the proposal presented a number of different arguments. The staff has discussed each of these below.

The proposed change will result in a significant change in current practice and should not be included in the annual improvements project

9. A number of respondents commented that the proposed amendment would result in a significant change to current practice and so should not be included in the annual improvements project.

> *"Since the proposal in its present form could potentially mean widespread changes in accounting practice, we believe that a more thorough due process is necessary." [CL17]*

10. One respondent suggested that the significance of the change may have been lost in the annual improvements project.

> *"In our view there is a risk that commentators will not have understood the full implications of this significant change in accounting. Accordingly, we recommend that the proposal be*

withdrawn and re-exposed separately after further consultation." [CL58]

11. Another argued that the length of time that the issue was discussed by the IFRIC and the Board indicates its complexity and the fact that it cannot be properly dealt with as an annual improvement.

> *"The IFRIC considered the matter on no less than three occasions. The IASB then considered that matter itself on three occasions before proposing the treatment set out in the proposed amendment." [CL23]*[2]

12. One respondent suggested that the issue should be referred to the IFRIC and that the IFRIC should be asked to develop an interpretation on the issue.

> *"The [respondent] would suggest that the IFRIC is asked to take on a project to consider the treatment of advertising and promotional expenditure." [CL23]*

13. Some felt that the issue was symptomatic of a much wider issue regarding the difference between an asset and an expense and that a wider project should be taken on to consider the accounting for expenses in a broader sense.

> *"We disagree with the proposed amendment and we consider it is far from a minor amendment. Indeed, the proposed changes refer to a wider issue which deals with the distinction between expenses and assets and encounters the accounting issue of prepayments…Therefore we would rather suggest that the IASB waits until a comprehensive standard on expenses is discussed and published before amending IAS 38." [CL 59]*

Staff analysis

14. The staff believes that different treatments have developed in practice in this area. Some entities believe that IAS 38.68-70 prohibits an entity from recognising an asset for expenditure on advertising and promotional activities beyond the point at which the related goods and services are received by that entity. Some believe that advertising and promotional expenditure may be

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[2] The Board did discuss this issue on three occasions. At the first meeting, the Board was unable to understand the justification for the IFRIC's proposals and asked the staff to prepare a full analysis of the issue. At the second meeting, the Board considered the issue and reached a consensus. The third meeting was called to give an opportunity for a dissenting member (who was not present at the second meeting) to present his views in a public forum.

deferred in the balance sheet until such time as the advertisement is delivered to customers. Some mail order catalogue companies believe that expenditure on catalogues may be capitalised and then recognised as an expense over the period that the catalogues are expected to generate sales.

15. The discussions held at the time that the ED was developed and the responses received indicate that there is widespread diversity in this area. The staff therefore agrees that any change to the existing literature will result in a change in current practice.

16. However, the staff considers that failing to make a change may also result in a change in practice. In particular, entities that have previously believed that IFRSs prohibit the recognition of an asset for 'unused advertising' may view the ED as evidence that the current wording is unclear and so expenditure may be deferred in the balance sheet until advertising is distributed to customers.

17. The staff therefore considers that any action taken by the Board (including inaction) may result in changes in practice.

18. One commentator suggested that the issue should be taken on as an IFRIC project. The staff notes that the IFRIC has already been given the opportunity to take on a project in this area and has declined, believing that it would be more appropriate to amend the standard. Furthermore, the Board disagreed with the IFRIC's previous tentative conclusions. The staff therefore concludes that referring the issue to the IFRIC to develop an interpretation is not a suitable alternative to amending the standard.

19. The staff considered whether the Board could deal with this issue as a separate project. The staff notes that the purpose of the annual improvements project is to avoid the need for a large number of small amendments. Taking on separate projects to consider amendments that are likely to change practice would potentially negate the benefits of having one project for all minor amendments. Furthermore, given the current workload of the Board, the staff considers that it would not be helpful (to the Board or to its constituents) to take on additional projects. This is re-enforced by the Board's decision in December 2007 not to add a project to its agenda to consider intangible assets. The staff does not therefore recommend that the Board takes on a separate project to consider advertising and promotional expenditure.

20. One alternative would be for the Board to include work on the recognition of expenses in one of its existing projects. The staff notes that the only project in which the distinction between assets and expenses generally is currently under discussion is the conceptual framework project. Once that project has been completed, the Board may take on a project to revise IAS 38 which may address this issue. However, this is unlikely to happen in the near future and will not address the issue or the related divergence on a timely basis.

Recommendation

21. The staff notes that there is significant divergence in practice in this area. Whatever action the Board takes is likely to change practice for a number of entities. In the staff's view, even a decision not to amend the standards is likely to result in changes in practice.

22. The staff does not consider that it is appropriate to pass the issue to the IFRIC or to wait for the Board to consider the issue as part of a wider project as this is unlikely to be completed in a reasonable timeframe. Similarly, with the Board's current workload, the staff does not consider that it is appropriate for the Board to take on a separate project on advertising and promotional activities.

23. The staff therefore recommends that the Board continue to pursue this amendment as part of its annual improvements project.

Catalogues are a special case / the definition of advertising and promotional activities is not clear

24. Some respondents argued that mail order catalogues are a special case. They are not a form of advertising and, as such, the revised wording does not affect their current treatment.

25. Commentators that supported this view point to the specific nature of mail order catalogues as a 'shop at home' and argue that, because of their special nature, they are not forms of advertising and promotion.

> *"As a store at home, a catalogue is neither general advertising nor promotional material. Catalogues are the central medium for generating sales and cash flows, they form the key element of the mail-order business model. Therefore, catalogue creation and distribution are not mere processes to support sales – they are the indispensible*

pre-condition for mail-order sales and represent the key competence of a mail-order company…

... [catalogues] are used in the same way as high-street stores and operate as a distribution channel. In the mail-order business model catalogue costs represent investments in the 'department store at home'" [CL4]

26. Commentators argue that one of the key differences between advertising and promotional activities and mail order catalogues is that a catalogue is necessary for any sales to occur whereas advertising and promotional activities are not necessary to make sales.

"The term "advertising and promotional activities" is not defined in IAS 38 Intangible Assets*. Several definitions of advertising and promotional activities exist in the academic literature, e.g.:*

- *"Advertising media are promotional statements relating to objects, which replace or accompany direct contact between the advertiser and the target audience."*
- *"Advertising is a form of physically non-coercive intellectual (rational) and emotional influence through which an advertiser, using special means of communication, aims to make a target audience behave in a desired way."*
- *"Advertising is understood to be an attempt at influencing the opinion of a selected group of people about a certain product through special means of communication."*
- *"In an advertising campaign, the advertiser attempts to convey a promotional message to a single or several groups of people. The aim of many advertising campaigns is to influence the selected target group's awareness, purchase intentions or image of a particular product."*

We know that a main catalogue must be presented in a specific way that encourages people to place orders. However, that catalogue is not targeted at influencing the customer, but rather at providing consumers with information on the company's products. In order for *the business model to work, a department store must be carried into the consumer's living room. There is ultimately no other way for the customer to find out about the products and services a mail order company has to offer.*

We strongly believe that the main catalogues distributed by mail order companies to their customers are not advertising and promotional activities by nature as defined in the academic literature. Therefore, we would like to recommend clarifying the term "advertising and promotional activities" in paragraph 69 and 70 of IAS 38 Intangible Assets. This definition should either explicitly scope out catalogues from advertising and promotional activities or include clear guidance as to whether catalogues fulfil the definition of advertising and promotional activities" [CL57]

27. Some respondents argued that, in the case of catalogues, an analogy to SIC 32 is possible.

> *"we believe that the wording of the proposed amendments allows for the following interpretation: SIC-32: Intangible Assets – Web Site Costs can be applied by analogy. In case of catalogue costs this would imply that they could be recognised as an intangible asset, for the following reasons: mail order catalogues generate probable future economic benefits through an integrated mail order form. Insofar they are comparable to web sites "capable of generating revenues, including direct revenues from enabling orders to be placed" (SIC-32.8). As these web sites fulfil the requirements of IAS 38.21 and IAS 38.57, this should apply to mail order catalogues also." [CL69]*

28. Some noted that catalogues or specific lines within catalogues are advertised but that this kind of advertising is fundamentally different from the production of the catalogue. Whilst such advertising expenditure should be recognised as an expense as incurred, it does not follow that expenditure developing the catalogue should also be recognised as an expense as incurred.

29. In addition to the above, some commentators noted that the reason that brands, mastheads, and advertising and promotional expenditure cannot be recognised as an asset is that there is insufficient link between the cashflows generated by

30. In the case of mail order businesses, it is possible to specifically identify the individuals who have made purchases using a catalogue. It is therefore possible to monitor precisely how an individual catalogue generates sales. Catalogues can be sold separately from the business and can be used by an acquirer to receive orders and deliver goods. It is therefore possible to distinguish the distribution network created by catalogues from the goodwill of the business.

31. These commentators therefore concluded that catalogues should not be treated as part of general advertising or promotion.

Staff Analysis

32. The staff notes that a range of different activities could be classified as advertising or promotional activities. At one end of the scale would be activities that generate brand awareness but do not directly link to a specific product or products. For example, Barclays sponsoring "the Barclays' premier league" is intended to promoted the Barclays brand rather than promote a specific product to customers.

33. The staff considers that catalogues lie at the other end of the scale of items that could be described as advertising and so may come closer to being an asset that can be separately distinguished from a business's goodwill. Features that support this argument include that :

    - Mail order catalogues are only distributed to customers who have asked to receive the catalogues or who have previously made purchases. The directional nature of this distribution means that a far higher response rate can be achieved than via other forms of advertising.

    - It is possible to specifically identify sales that have been made through a catalogue (by the use of unique reference numbers or products).

    - Experience gained over a number of years gives evidence of how sales from a catalogue will develop (and subsequently diminish) after it has been distributed.

    - Catalogues can be sold as a distribution network separate from the business.

34. The fact that mail order catalogues could be an asset is recognised in US GAAP. SOP 93-7 discusses the accounting for advertising costs. This states that advertising costs are generally expensed as incurred (for the costs of producing advertising) or the first time the advertising takes place (for the costs of communicating advertising). The only exception to this is in the case of 'direct-response advertising' which is capitalised if:

> *a. The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising.*
>
> *b. The direct-response advertising results in probable future benefits. [SOP 93-7 paragraph 33]*

35. In the case of mail order catalogues, customers can be shown to have responded directly to the catalogue and so, under US GAAP, the costs of mail order catalogues may be capitalised.

36. Whilst the staff has some sympathy with the argument that mail order catalogues could be seen as being a form of 'advertising' that gives rise to an asset that may be recognised, the staff are not convinced that a change to make IFRS similar to US GAAP in this area would be possible as part of the annual improvements process. In particular, the staff notes:

- Developing guidance that states that advertising that customers specifically respond to may be recognised as an asset could be seen as being rule based.
- Detailed guidance that distinguishes between different types of advertising and promotion may take longer to develop than is available in the annual improvements process. Furthermore, it may require re-exposure (perhaps separately from the annual improvements process).

37. One respondent argued that, for catalogues, an analogy to websites may be appropriate. Both catalogues and websites give customers the ability to browse details and pictures of products from their own homes. Both allow customers to place orders from home, and both result in products being delivered direct to the customer's home. Whilst the staff agrees that an analogy with SIC 32 is appropriate, the staff disagrees with the respondent's view that this will result in a different accounting treatment to the proposal made in the ED.

38. SIC 32.9 states that expenditure on an internally developed website may only be capitalised in the 'application and infrastructure development stage'. It requires that costs associated with developing the functionality and infrastructure that make a website operate be capitalised. Expenditure on planning, content development, and operating is recognised as an expense when it is incurred. In particular:

- SIC 32.9 (c) states that '*expenditure incurred in the Content Development stage, to the extent that content is developed to advertise and promote an entity's own products and services (eg digital photographs of products), shall be recognised as an expense when incurred in accordance with IAS 38.69(c). For example, when accounting for expenditure on professional services for taking digital photographs of an entity's own products and for enhancing their display, expenditure shall be recognised as an expense as the professional services are received during the process, not when the digital photographs are displayed on the web site.*'
- SIC 32.2(d) states that '*Content Development – includes creating, purchasing, preparing and uploading information, either textual or graphical in nature, on the web site before the completion of the web site's development.*'

39. The principle costs of creating a catalogue relate to the development of content, printing, paper and shipping to customers:

> *"Major cost components of a big book typically relate to content (approx 15%); paper and printing (approx 45%) and shipping (approx 40%)." [CL4]*

40. As discussed above, in the case of a website, SIC 32 requires that the cost of content (to the extent that it is developed to advertise and promote products and services) be recognised as an expense as it is incurred. The staff considers that, in the case of a mail order catalogue, the majority of the content is intended to advertise and promote products and services. The staff therefore believes that SIC 32 would require the majority of the cost of developing content for a catalogue to be expensed as incurred.

41. Similarly, SIC 32 states that content development includes the cost of preparing and uploading information. The staff considers that uploading content to a site is analogous to printing content in a catalogue. To the extent that the content is developed to advertise and promote products and services, SIC 32 would therefore require that it be recognised as an expense as incurred. Again, since the staff considers that most of the content in a catalogue is intended to advertise or promote the entity's products, SIC 32 would require the majority of this expenditure to be recognised as an expense as incurred.

42. The remaining major costs of a mail order catalogue relate to the costs of delivering the catalogue to customers. Since the staff has concluded above that SIC 32 would require most of the expenditure to develop the catalogue to be recognised as an expense as incurred (as it is advertising expenditure), it would be inconsistent to treat the costs of shipping the catalogues (ie delivering the advertising) differently.

43. Furthermore, costs of delivering content to customers could be considered to be analogous with web-hosting costs. SIC 32.5 states that such expenditure is recognised as an expense as incurred.

44. The staff therefore concludes that accounting for mail order catalogues using SIC 32 would result in an accounting outcome that is almost identical to the Board's proposal. This is because most of the costs associated with mail order catalogue production relate to the development of content to advertise or promote products. Unlike a website there is unlikely to be a significant cost relating to the development of infrastructure.

45. Whilst the staff agrees with the respondent that making an analogy to website costs in SIC 32 is appropriate, the staff concludes that this results in an accounting treatment that is consistent with the proposal in the ED.

46. The staff notes that the majority of respondents who supported the view that mail order catalogues are a special case came from one jurisdiction. The staff is aware that capitalising and amortising catalogue costs has not been viewed as an acceptable treatment under IFRSs by some of the large accounting firms in some other jurisdictions.

47. Because developing an exception for mail order catalogues would require the development of a detailed exception and because it would be hard to draw a line

between advertising that may be capitalised and advertising that may not, the staff proposes that no exception be made for mail order catalogues. Instead, the staff proposes that a statement be included in the final amendment that mail order catalogues are a form of advertising. The staff also proposes that, to avoid confusion, this be supported by a discussion in the Basis for conclusions as to why this treatment is consistent with the requirements of SIC 32.

48. This approach is consistent with IAS 38.BCZ45-BCZ46 which state that the IASC decided not to distinguish between types of advertising in determining that costs of advertising activities should be expensed as incurred.

Expenditure on advertising and promotional materials that have not yet been delivered to a customer is an asset

49. 7 commentators held the view that advertising and promotional materials that have not been delivered to a customer are an asset. In reaching this conclusion, the respondents first separated the asset that arises when the advertising or promotional material is acquired from that which arises when the advertisement is aired.

> *"In this proposal, the IASB has bundled any potential benefit arising from the advertisement or promotional activity with the benefit or right to goods and services acquired for use in advertising or promotional activities. We consider that any potential benefit arising from advertising or promotional activities is a separate intangible asset from the asset that the entity acquires when it acquires goods or services for use in advertising or promotional activities.*
>
> *We consider that an entity that acquires goods or services acquires benefits or rights to those goods or services which are separate from the potential benefits arising from the advertising and promotional activities. In terms of services, the intangible asset that is to be recognised is the right to those services where they have been acquired but have not been "consumed" or used in the advertising and promotional activities. As such, we do not agree with the IASB's proposal to prohibit the recognition, as an intangible asset, services it receives in respect of advertising and promotional activities." [CL6]*

50. Supporters of this view argued that the definition of an asset is met up to the point at which the advertisement is delivered to customers:

> *"[In the case of travel brochures printed by a travel company] there would seem no reason why the brochures should not be recorded as an asset before they are distributed to travel agents; the definition of an asset in paragraph 49 (a) of the Framework appears to be met, as the printed brochures are controlled by the travel company, and benefits are expected to be derived from them." [CL40]*

Staff Analysis

51. Paragraph 49 (a) of the Framework defines an asset as '*a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity*.'

52. The staff considers that an entity that has acquired goods or services to be used for advertising or promotional activities has a resource (be it a catalogue, digital photographs, a DVD, or another good or service). The resource is controlled by the entity as a result of past events (it is likely to be protected by copyright and restricted from falling into other parties' hands). The entity presumably anticipates using the resource to perform advertising which it expects will result in future economic benefits flowing to it (as that is the purpose of advertising).

53. The staff therefore concludes that an entity that has incurred expenditure for goods or services to be used for future advertising or promotional activities is likely to have an asset.

54. The staff next considered whether that asset meets the criteria to be recognised in the entity's financial statements. Paragraphs 89 and 90 of the *Framework* state:

> *An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.*
>
> *An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead such a transaction results in the recognition of an expense in*

the income statement. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the entity or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the entity beyond the current accounting period is insufficient to warrant the recognition of an asset.

55. In the case of advertising that has taken place, the Board has already decided in IAS 38 that entities cannot conclude that it is probable that benefits will flow to the entity. IAS 38.63 states "*Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.*" IAS 38.64 explains that this is because such expenditure "*cannot be distinguished from the development of the business as a whole.*"

56. This view is explained in the Basis for Conclusions. IAS 38.BCZ45 states that the IASC believed that such assets "*would rarely, and perhaps never, meet the recognition criteria in IAS 38. However, to avoid any misunderstandings, IASC decided to set out this conclusion in the form of an explicit prohibition*."

57. BCZ46 states "*IAS 38 also clarifies that expenditure on research, training, advertising and start-up activities will not result in the creation of an intangible asset that can be recognised in the financial statements. Whilst some view these requirements and guidance as being too restrictive and arbitrary, they are based on IASC's interpretation of the application of the recognition criteria in IAS 38. They also reflect the fact that it is sometimes difficult to determine whether there is an internally generated intangible asset distinguishable from internally generated goodwill*."

58. The staff believes that it is clear that the IASC, when developing IAS 38, considered that advertising did not give rise to an asset. However, comment letters indicate that differing views may exist as to whether this requirement applies to expenditure on advertising and promotional activities before that advertising has taken place.

59. The staff has considered three different assets that may exist during the production of an advertisement:

a. A ‘prepayment’ may exist if an entity pays a supplier in advance to develop advertising or promotional materials.

b. A right to use those materials will exist from the time that the entity receives them until it distributes them to its customers.

c. A customer related intangible asset may exist after the advertisement is aired.

60. The staff believes that the standard clearly states that, after an advertisement is aired, no customer related asset may be recognised. Similarly, there appears to be widespread agreement that, before an entity has received advertising or promotional goods or services that it has paid for, it has an asset. That asset is the right to receive goods or services.

61. The staff has therefore focused on the asset that may exist between the receipt of advertising and promotional materials and the delivery of an advertisement to customers. The staff has assumed that the goods or services have no use to the entity other than as advertising or promotional materials. If the goods have an alternate use, it may be that they could be treated as some other type of asset. For example, the staff understands that, in some jurisdictions, catalogues are routinely sold to customers for a nominal sum. If this is the case then the catalogues could arguably be accounted for as inventory (albeit with their carrying value restricted to their sales price).

62. In the situation in which goods or services have been received, all that the entity can do with them is use them to advertise to customers. This advertising will develop some kind of customer related intangible that (as discussed above) will not qualify for recognition under IAS 38.

63. The staff has considered the benefit of having received goods or services that are to be used for advertising or promotional activities. One benefit is that the entity that has received the goods or services may use them to perform advertising activities. In other words, the entity does not have to incur further costs to advertise. That benefit will lead to the creation or enhancement of a customer related intangible assed.

64. As discussed above, the reason why advertising, once performed, does not give rise to an asset that may be recognised is that it is not possible to separate the

customer relationship that it creates from the goodwill created by the business generally. The staff does not therefore believe that the fact that unperformed advertising may give rise to a customer intangible is sufficient reason for the unperformed advertising to be recognised as an asset of the business.

65. In other words, as the only use of the unperformed advertising is to create or enhance a customer intangible by advertising and IAS 38 states that it is not possible to recognise an asset in respect of that customer intangible, it is not possible to recognise the unperformed advertising as an asset. It is effectively work in progress to create a customer intangible asset that does not meet the criteria for recognition.

66. The staff therefore concludes that unperformed advertising does not qualify for recognition as an asset under IAS 38.

Some advertising and promotional activities give rise to tangible assets

67. The alternative view expressed in the exposure draft argued that not all advertising and promotional expenditure gives rise to intangible assets. Some gives rise to tangible assets. Ten respondents agreed with this argument.

68. In contrast, all three mail order catalogue businesses that commented argued that mail order catalogues should be accounted for as intangible assets using IAS 38.

> *"Although catalogues possess a physical substance (ie the paper they are printed on) this physical element is secondary to their intangible component because the physical substance only forms the supporting medium. [CL4]"*

69. The staff considers that considering catalogues as intangible assets is consistent with IAS 38.5 which states:

> *This Standard applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (eg a prototype), the physical element of the asset is secondary to its intangible component, ie the knowledge embodied in it.*

70. The staff also notes that, whilst some advertising and promotional materials may be placed on a physical asset, in most cases it is the intellectual property that is the most important feature, the same as software. For example, in many cases TV or cinema advertisements will be placed on DVD, Blu-Ray, or tape which are physical assets but the content remains the most important feature. No-one would argue that a photo editing program is a tangible asset because it is delivered on a CD.

71. In considering how to respond to these comments the staff noted that, even if the advertising takes the form of physical assets, it will not meet the definition of inventory or property, plant and equipment. There is not therefore a standard into which guidance on the accounting for such assets would naturally fit.

72. One respondent suggested that the Board's proposed changes should be incorporated in the *Framework*:

> *"We believe that the proposed amendments to IAS 38 provide valuable guidance for determining when an expense is incurred, however we believe that the guidance proposed by the Board would be better suited to the Framework for the preparation and presentation of financial statements or IAS 1 rather than IAS 38 in order that it may be applicable to all expenses and not only that expenditure incurred on an intangible items." [CL21]*

73. The staff considers that:

- it is helpful to have the guidance for all advertising and promotional expenditure in one place;
- all advertising and promotional expenditure should be accounted for on a consistent basis regardless of whether it is a tangible or intangible asset;
- there isn't a clear standard that would naturally cover all such expenditure; and
- IAS 38 states in its introduction that it deals with advertising.

74. The staff therefore recommends that the Board should include all of its guidance on advertising and promotional activities in IAS 38.

'Access to the goods'

75. When the Board discussed its exposure draft, it decided that the timing of delivery of advertising or promotional goods or services should not affect the timing of the recognition of the related expense. For example, if a catalogue company arranged for its supplier to print its catalogues and those catalogues had been printed, the catalogue company should not be able to change the timing of recognition of the expense by altering the timing of delivery of the catalogues.

76. To avoid this type of consequence, the ED refers to the point at which an entity can access goods rather than when they are delivered. Many respondents felt that the word "access" was confusing and asked for clarification of the meaning of this phrase. Some appeared to misunderstand the Board's intentions and believed that an entity would gain access to goods when they were received:

> *"we do not believe that the proposed amendment in IAS 38.69 to replace "as incurred" with "has access to those goods" or "when it receives those services" is any clearer than the existing terminology. For example, in the design of a magazine or television advertising campaign a number of services are procured over what can be a lengthy period. These services may include graphic design, artwork, photography, modelling / acting, film production, editing, etc. The end product may be the photographs or a film strip or other storage device on which the advertisement is contained. Should the expense be recognised as the services contributing to the end product are carried out or when the photographs / film strips are delivered to the purchaser? If the supplier does not deliver the physical products to the purchaser but instead holds them for distribution to the magazine publisher or television broadcaster, when is the expense recognised?" [CL14]*

> *"under the proposals, the timing of delivery from the printer would have a substantial effect on the timing of the recording of an expense by the [travel] company. If the brochures were delivered on 31 December 2007, they would be expensed in that financial year; if they were delivered on 1 January 2008, they would be expensed in the*

following financial year, despite there being no substantive difference in the two transactions (other than the timing of delivery being different by less than 24 hours)" [CL40]

77. The staff considers that the fact that many respondents believed that the proposed change may give rise to exactly the type of manipulation that the Board was trying to avoid indicates that the wording used in the proposed amendment does not achieve the Board's wishes. The staff therefore concludes that the Board should amend its proposals to better describe its intentions.

78. One commentator suggested that the solution to this issue would be to replace the notion of "access" with a notion of "control":

> *"clarification is needed about what 'access' means in this circumstance because in many cases an entity may not ever obtain 'physical access' to the goods. For example, when an entity buys catalogues but does not physically receive the catalogues because the supplier delivers them on behalf of the entity. The entity will never gain physical access to the goods yet it has received the benefit from them. Further, an entity may instruct a supplier not to deliver the goods to them because they would like to have them stored at the supplier, which would mean that the entity does not* have *physical access to them. We therefore suggest that the wording is amended to refer to either the 'right to access the goods' or when the entity has 'control' of the goods." [CL50]*

79. The staff has considered three options that may improve the wording previously published:

    a. A revised wording based on control or rights to access (as suggested by CL 50) could be developed.

    b. An expanded wording similar to that used in SIC 32 could be developed. This would need to consider both goods and services so, for example, may state that expenditure on services shall be recognised as an expense as the professional services are received during the process and expenditure on goods shall be recognised as those goods are produced.

c. A detailed explanation of the reason why the Board chose to use the phrase “access to” goods could be included in the basis for conclusions.

80. The staff considers that approach c would have the advantage of requiring the fewest changes to the standard. However, in some jurisdictions, the basis for conclusions is not considered alongside the standard. Including guidance in the basis for conclusions would mean that the standard would not be clear as a standalone document. For that reason, the staff does not believe that this approach is appropriate.

81. The staff also has concerns that wording based on control or rights to access could be misinterpreted. For example, some may argue that control of goods passes when they are delivered to the customer. In the same way, rights to access could be disputed if, for example, the goods were stored at a supplier’s site.

82. Wording that would reflect approach b could be inserted at the end of paragraph 69. For example:

When accounting for expenditure on goods to be used for advertising and promotional activities, access to those goods is received when the goods have been produced by the supplier and the entity could obtain delivery of them in return for payment.

83. The staff considers that it will be hard to clearly state the principle to be applied in a few words. Instead, the standard could be made clearer by amending the proposed wording to refer to rights of access, inserting an additional sentence similar to that above to explain what the Board intends to mean by the phrase and including an expanded description in the basis for conclusions.

84. Whilst this approach will require the insertion of the most words, the staff believes that it is the only way to ensure that the Board’s intentions are made sufficiently clear to avoid misunderstanding.

Other comments

85. A number of commentators raised points that are not discussed above. The staff does not intend to discuss all of these in detail. Instead, a brief summary of each of these points is set out below together with a brief staff response. If the Board

would like to consider any of these comments in greater detail, the staff will prepare a paper for the March Board meeting.

86. One commentator argued that the Board's conclusions failed to correctly match the recognition of the expense with the recognition of revenue.

> *"There is a basic requirement to ensure correct matching of expenses that impact more than one period - both in terms of making a valid forecast of profit or loss for investors as well as internally for a value based management of the company." [CL26]*

87. Paragraph 97 of the *Framework* states '*an expense is recognised …to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.*' The staff considers that assessing whether advertising qualifies for recognition as an asset is the primary determinant in assessing when the expense should be recognised – not matching the expense with the related income.

88. One respondent did not agree with the Board's proposals in respect of the recognition of a prepayment:

> *"[The respondent] does not agree with the proposal as it is likely to be interpreted as permitting inappropriate deferral of expenses. It is difficult to understand how an asset can be recognised for the prepayment when the "goods" to be received do not themselves meet the definition of an asset." [CL54]*

89. The staff considers that the critical difference between advertising and promotional materials that have been received from a supplier and an advance payment for such materials is that the materials can be used for no other purpose than to advertise. An entity that has made an advance payment could ask the supplier to cease production and claim a return of payment or could ask for services for an alternative purpose.

90. Another respondent believed that the recognition of a prepayment should not be permitted but should be required.

> *"we think it should be made clear that recognition of a prepayment as an asset is not only permitted when payment for goods or services has*

been made in advance of the entity gaining access to those goods or receiving those services, but rather required." [CL11]

91. The staff notes that this point was considered before the ED was published. At that time it was felt that it would be wrong to mandate recognition of an asset as this may result in the recognition of an asset that had become impaired or ceased to meet the recognition criteria. The staff therefore concludes that it is appropriate that the amendment is limited to stating that entities are permitted to recognise a prepayment.

92. One comment expressed concern that the proposed amendment was not consistent with current standards and, in particular, IAS 17 Leases.

> *"BC 4 analyses payment in advance for goods and services as an asset which is the right to receive those goods or services. We believe that such an analysis may not be consistent with current standards that deal with a right of use that is not considered as an asset (IAS 17 – Leases for example)" [CL59]*

93. Another comment letter suggested that the Basis for conclusions should be amended:

> *"We do however believe that it would be useful if, either in the main text of the standard or in the Basis for Conclusions, there was a discussion about the fact that there can be no asset once the advertising goods or services have been received because there is no alternative economic benefit to be derived from the items. Many preparers of financial statements want to know why consumables, such as stationery, are recognised as an asset until consumed, but the proposed clarification requires catalogues and brochures to be expensed before they are distributed to customers. It would be useful if the standard explained that before the stationery is used, it has an alternative economic benefit – it can be sold, therefore, it can be recognised as an asset. However, the printed catalogues and brochures have no alternative economic benefit, therefore, they do not meet the definition of an asset." [CL32]*

94. The staff considers that such a discussion would have three key advantages:

- It would reflect some of the Board's considerations when the ED was developed.
- It would add additional clarification to the words in the amended standard.
- It would help to address the comment above about the perceived inconsistency with IAS 17.

95. The staff therefore proposes that a strengthened Basis for Conclusions be included with the final amendment to fully explain the Board's rationale in reaching its decisions. This revised basis for conclusions will be circulated as part of the ballot draft if the Board agrees with the staff recommendation to continue to pursue this amendment.

CONCLUSION, RECOMMENDATION AND QUESTION FOR THE BOARD

96. The staff recommends that the Board does not change its decision about when an expense should be recognised and that it finalise its amendment as part of the annual improvements process.

97. In reaching this conclusion, the staff recommends that the wording originally published be clarified by:

- Stating that, in the case of a supply of goods, an entity shall recognise an expense when it has the <u>right to</u> access those goods.
- Introducing an explanatory paragraph stating that:
    - In the case of services, the entity recognises the expense as the services are performed. For example, in the case of photographs, an expense is recognised as the photographs are taken, not when they are displayed in an advertisement.
    - In the case of goods, a right to access is received when the goods have been completed by the supplier.
- Incorporating a strengthened basis for conclusions stating that one of the reasons that advertising and promotional material cannot be recognised as an asset is that it has no alternative use. Thus, stationary to be used for

advertising may be recognised as an asset until such time as it is printed on at which point it no longer has an alternate use.

- Stating explicitly that catalogues are a form of advertising.