

Costs and Expenses

18.2 OVERVIEW

Expenses represent the actual or expected cash outflow from selling, delivering, or producing the entity's core products or services. A cost typically is the accumulation of actual or expected outflows that will be recognized as an expense in a later period. A realized loss arises from the sale or disposition of an asset at a price lower than its carrying value or the extinguishment of a liability at an amount higher than its carrying value. An unrealized loss derives from a decrease in the value of an asset still being held by the entity (i.e., a holding loss). The term "other expenses" is used to describe the actual or expected cash outflow from transactions that are an integral part of operating a business but are not directly associated with selling, delivering, or producing the entity's central products or services.

18.3 MEASUREMENT PRINCIPLES

Measurement principles pertain to specific items. Individual sections should be consulted for a complete discussion of those items.

18.3.1 Advertising Costs

Description of advertising.

SOP No. 93-7 defines advertising as the promotion of an industry, a brand, product name, or specific products or services for the purpose of stimulating a positive image or for the purpose of creating or stimulating a desire to purchase the entity's products or services.

Examples of the principal types of advertising include:

- Directory and buyer's guide advertising
- Business and industrial publications
- Reprints of advertisements
- Television advertising
- Direct-mail advertising
- Consumer publications
- Radio advertisements
- Billboard advertisements
- Company and product catalogues
- Cooperative advertising
- Booklets for sales promotion
- Newspaper advertising
- Point-of-sale material
- Sponsorship of public events

Other than direct-response advertising.

Unless the advertising is direct-response and results in probable future economic benefits, advertising costs should be expensed as incurred or when the advertising first

takes place (e.g., the initial showing of a television commercial or the first appearance of a magazine advertisement). The costs of advertising production (e.g., idea production, artwork, printing, audio and video crews) should be expensed as incurred. The cost of communication (e.g., airtime or space) should be reported as expenses after the airtime or space has been used.

The costs of billboards or blimps that are used for several advertising campaigns should be capitalized and amortized using a systematic and rational method over the expected useful lives of the related assets. Sales materials (e.g., brochures and catalogs) may be accounted for as prepaid supplies until they are no longer owned or expected to be used, at which time they should be expensed.

Direct-response advertising.

The costs of direct-response advertising should be capitalized if *both* of the following conditions are met:

- The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising
- The direct-response advertising results in probable future benefits

Examples of evidence to support the first condition include the following:

- A coded order form included with an advertisement
- A log of a phone call to a number appearing in an advertisement
- A code on a response card included with an advertisement, or
- A coded coupon turned in by a customer

Future economic benefits of direct-response advertising are defined as probable future revenues in excess of future costs incurred in realizing those revenues. Demonstrating that direct-response advertising will result in future-benefits requires *persuasive* evidence, including verifiable historical patterns of results for the *entity itself*. Thus, industry statistics are not considered objective evidence that future benefits will result from direct-response advertising. In the absence of an operating history for a particular product, the results of past direct-response campaigns for other new products may be used to support the assertion that future benefits will be generated if it can be demonstrated that there is a high degree of correlation between test market results for current new products and new products previously sold by the entity.

For purposes of determining probable future revenues, only revenues from sales to customers receiving and responding to direct-response advertising (referred to as "primary revenues") should be considered. So-called secondary revenues (e.g., placement fees from advertisements placed in the publication) should *not* be considered.

Direct-response advertising costs that are not capitalized because it cannot be demonstrated that the direct-response advertising will result in future benefits should not be retroactively capitalized in subsequent periods if historical evidence in those subsequent periods indicates that the advertising did in fact result in future benefits.

Only the following costs of direct-response advertising should be capitalized:

- *Incremental direct costs incurred in transactions with independent third parties.* Examples include costs of idea development, writing advertising copy, artwork, printing, magazine space, and mailing.
- *Payroll and payroll-related costs of employees directly associated with direct-response activities.* Idea development, writing advertising copy, artwork, printing, and mailing are all examples of direct-response activities. The costs directly related to those advertising activities should only include that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing such activities.

Annual amortization of capitalized direct-response advertising costs should be based on the ratio of current-period primary revenue to the total of current and anticipated future-period revenue. Amortization should be computed on a cost-pool-by-cost-pool basis. The estimated amount of future revenue should be reviewed at each reporting date.

The realizability of direct-response assets should be evaluated at each balance sheet date by comparing the carrying amounts of such assets on a cost-pool-by-cost-pool basis to the probable remaining future net primary revenues expected to result directly from such advertising. For this evaluation, future net revenues are gross revenues less the probable future costs of all goods and activities necessary to earn those revenues, except for amortization of direct-response advertising. Examples of such future costs are the costs of goods sold, sales commissions, and payroll and payroll-related costs associated with the future revenues. If the carrying amounts of such advertising exceed the remaining future net revenues that probably will be realized, the excess should be reported as advertising expense in the current period. The reduced carrying amounts should *not* be adjusted upward if estimates of future net revenues are subsequently increased.

The following examples illustrate the application of SOP No. 93-7.

Example 1. Non-Direct Response Advertising

FACTS

Assume that Client Company, Inc. incurs the following costs associated with an advertising campaign:

- The Danielle/Emily band is hired to sing in a commercial to be aired only once on the 20X2 Super Bowl. The band's fee is \$1,000,000.
- Production costs of \$4,000,000.
- Network airtime of \$800,000 for a one-minute spot.

All of the foregoing costs were incurred in 20X1. The ad will run on January 25, 20X2, the day of the Super Bowl.

SOLUTION

In accordance with SOP No. 93-7, the \$1,000,000 fee for the Danielle/Emily band and the production costs of \$4,000,000 may be charged to operations *either* in 20X1 *or* in 20X2, after the ad is run. The journal entries to record such costs would be:

Advertising expense	\$5,000,000	
Cash (or accounts payable)		\$5,000,000

The cost of the airtime, however, may not be expensed until 20X2, when the advertisement runs on the Super Bowl. The journal entry on January 25, 20X2 would be:

Advertising expense	\$800,000	
Cash (or accounts payable)		\$800,000

Example 2. Direct-Response Advertising

FACTS

Assume that Client Company, Inc., conducts a direct response advertising campaign for one of its major products. Costs of the campaign aggregate \$1,500,000. Actual mailing of the three million solicitation pieces takes place on October 1, 20X1. Historically, similar direct response campaigns for the same product show that approximately .01 (one percent) of all solicitations results in orders. Approximately 80% of all such orders are expected to be placed in 20X1, with the remainder placed by mid-20X3. The selling price of the product is \$100, and its cost to Client Company is \$20.

SOLUTION

Because 80% of the costs will result in sales for 20X1, only 20% of the \$1,500,000 total cost (\$300,000) may be capitalized at December 31, 20X1, as having *future* (20X2 and 20X3) benefits.

On December 31, Client Company must evaluate the realizability of the \$300,000 deferred advertising cost. This is done by comparing the asset's carrying value with expected future benefits, as follows:

Carrying value at 12-31-X1	\$300,000
Future benefits:	
(3,000,000 pieces mailed × .01) × (gross profit of \$80 × .20)	<u>480,000</u>
Excess of future benefits over carrying value	<u>\$180,000</u>

Because recoverability is expected, no writedown of the asset is required at December 31, 20X1. Assuming that 95% of the orders placed after December 31, 20X1, actually occur in 20X2, with the remaining 5% occurring in 20X3, the 20X2 *amortization* would be \$285,000 (\$300,000 × .95).

Client Company would thus make the following journal entries:

<u>Up to and including 10-1-X1</u>		
Deferred direct response advertising costs	1,500,000	
Cash (or accounts payable)		1,500,000
 <u>December 31, 20X1</u>		
Advertising expense	1,200,000	
Deferred direct response advertising costs		1,200,000

December 31, 20X2

Advertising expense	285,000	
Deferred direct response advertising costs		285,000

December 31, 20X3

Advertising expense	15,000	
Deferred direct response advertising costs		15,000

18.3.2 Property Taxes

Generally, property taxes accrue on the date they are assessed, even if the amount is not determined until a later date. The most acceptable basis of providing for property taxes is to accrue them periodically over the fiscal period of the taxing authority. Alternatively, the full amount of the liability is recorded on the lien date and amortized over the ensuing year. The following examples illustrate each of the two methods of recognizing property taxes.

Example 3. Periodic Accrual

Facts

Assume that Client Company, Inc., receives a property tax bill on May 1, 20X1, for \$1,200,000, which may be paid in two equal installments on October 31, 20X1, and February 28, 20X2. The taxing authority's fiscal year ends on August 31, and the lien date is August 1.

Solution

On the periodic accrual basis, Client Company would make no entry when the bill is received on May 1, 20X1. On September 1, 20X1, and October 1, 20X1, the following journal entry would be made:

Property tax expense (\$1,200,000 ÷ 12)	100,000	
Property taxes payable		100,000

On October 31, 20X1, when the first installment is paid, the journal entry would be:

Property taxes payable	200,000	
Prepaid property taxes	400,000	
Cash		600,000

The \$400,000 debit to prepaid property taxes represents the excess of the amount accrued on October 31 (\$200,000).

The following journal entry would be made on the first day of November and December 20X1 and of January and February 20X2.

Property tax expense	100,000	
Prepaid property taxes		100,000

On February 28, 20X2, when the second installment is paid, the journal entry would be:

Prepaid property taxes	600,000	
Cash		600,000

On the first day of the months March through August, 20X2, Client Company would make the following entry:

Property tax expense	100,000	
Prepaid property taxes		100,000

Example 4. Liability Recorded at Lien Date

Facts

Assume the same facts as in Example 3 except that Client Company recognizes the liability at the lien date.

Solution

No entry is made until August 1, 20X1 (the lien date). On that date, the following journal entry would be made:

Deferred property taxes	1,200,000	
Property taxes payable		1,200,000

Also on August 1 and for each of the subsequent eleven months, Client Company would record the following entry:

Property tax expense	100,000	
Deferred property taxes		100,000

On each of the payment dates (October 31, 20X1, and February 28, 20X2), the following journal entry would be made:

Property taxes payable	600,000	
Cash		600,000

Note that, under each method, prepaid property taxes and deferred property taxes would appear, respectively, as current assets in the balance sheet.

18.3.3 Costs of Future Medicare Compliance Audits

The FASB Staff's position is that the mere promise by a health care provider to the U.S. government to perform future compliance audits (as part of a settlement agreement regarding allegations of Medicare fraud) does *not*, of itself, create an obligating event for the purpose of advance accrual of estimated costs of the audits. Hence, such costs may not be accrued until there is an obligation to pay them.

18.3.4 Accounting for Consideration Received from a Vendor

The EITF addressed the issue of how a customer (including a reseller) should account for cash consideration received from a vendor.

The EITF reached the following conclusions:

- Cash consideration received by a customer from a vendor should be characterized as a reduction of cost of sales. If, however, the consideration is payment for assets or services delivered to the vendor, the consideration received should be recognized as revenue. If the consideration represents a reimbursement for costs incurred by the customer to sell the vendor's products, it should be offset against such costs.
- For the consideration to be deemed payment for assets or services delivered to the vendor (and thus characterized as revenue), the vendor must receive an identifiable benefit (e.g., goods or services) in exchange for the consideration. To meet that condition, (1) the identified benefit must be sufficiently separable from the customer's purchase of the vendor's products such that the customer would otherwise have entered into a transaction with a third party to provide the benefit to the vendor, and (2) the customer can reasonably estimate the benefit's fair value. Any excess of cash consideration paid by the vendor over the fair value of the benefit received should be accounted for by the customer as a reduction of cost of sales.
- Cash consideration represents a reimbursement of costs incurred by the customer to sell the vendor's products when the cash payment is related to a specific, incremental, and identifiable cost. Excess consideration should be accounted for as a reduction of cost of sales.
- A rebate or refund of a specified amount payable pursuant to a binding arrangement that depends on the customer meeting a specified level of product purchases or on remaining a customer for a specified period of time should be recognized as a reduction of cost of sales systematically as the customer makes progress toward the specified goal (i.e., earning the rebate or refund). If earning the rebate is not probable and reasonably estimable, it should be recognized only when the milestone is achieved. Factors that could impair a customer's ability to determine that a rebate or refund is probable and estimable include the following:
 - — It relates to purchases that will occur over a relatively long period.
 - — There is no historical experience regarding similar products (or such experience cannot be applied due to changing circumstances).
 - — The product is susceptible to significant external factors (e.g., technical obsolescence, changes in demand).
- Changes in the estimated amount of cash rebates or refunds (or retroactive modifications by a vendor to a previous offer) represent changes in estimate that should be recognized as an immediate cumulative adjustment to any rebate or refund already recognized.

18.4 DISCLOSURES

There are a great many disclosures required by GAAP in connection with costs and expenses. Individual sections should be consulted for full details on a particular topic. However, the following are some of the more common sources of costs and expenses:

18.4.1 Checklist of Sources of Costs and Expenses

Cost of sales or revenue.
Substantial or unusual losses resulting from the application of the lower of cost or market rule.
Net realized losses from the sale of marketable securities.
Losses from investors accounted for by the equity method.
Losses due to impairment of asset values.
Depreciation, amortization, and depletion.
Interest.
Rent.
Advertising.
Loss contingencies.
Exchange losses in connection with foreign operations.
Losses for creditors in connection with troubled debt restructuring.
Research and development costs.
Minority interest of a consolidated subsidiary.
Pension cost and postretirement benefits.
Profit-sharing expense.
Compensation expense in connection with stock option or stock purchase plans.

18.4.2 Income Statement

The income statement may be presented either in multi-step or single-step form. The individual items to be separately identified under either form will depend on their significance for a fair presentation of the financial statements as well as on consideration of the specific disclosure requirements pertaining to particular events or transactions.

18.4.3 Items to Be Included in a Multi-Step Income Statement

The following items, where applicable, are usually identified separately on the face of a multi-step income statement:

Net sales (or revenue).
Cost of sales (or revenue).
Gross profit.
Operating expenses.
Income (loss) from operations.
Individually significant elements of other income (or in the aggregate if individual elements are not material).
Large or unusual items not qualifying as extraordinary items.
Equity in earnings (loss) of unconsolidated subsidiaries and investees.
Minority interests in the earnings or losses of consolidated subsidiaries.
Income before income taxes.
Income taxes.
Income from continuing operations.
Operating results from discontinued operations, net of income tax effect.
Gain or loss on disposal of a business segment, net of income tax effect.
Income (loss) before extraordinary items and cumulative effect of accounting changes.
Individually significant extraordinary items, net of income tax effect (and in the aggregate if considered desirable).

Cumulative effects of individually significant accounting changes, net of income tax effect (and in the aggregate if considered desirable).

Net income.

Basic and diluted earnings per share amounts.

In a single-step statement, net sales and other income are shown at the top of the statement under the caption "Revenue." Cost of sales, operating expense, and other expenses are shown under the caption "Costs and expenses." Individually significant elements of revenue and costs and expenses are also separately identified. A single-step statement generally does not specifically identify the amounts of gross profit or operating profit. However, the multi-step and single-step statements are required to be identical beginning with the caption "Income before income taxes."

18.4.4 Disclosures Related to Advertising Costs

SOP No. 93-7 requires the following disclosures:

The accounting policy for reporting advertising costs, indicating whether such costs are expensed as incurred or the first time the advertising takes place.

A description of the direct-response advertising reported as assets (if any), the accounting policy for it, and the amortization period.

The total amount charged to advertising expense for each income statement presented, with separate disclosure of amounts, if any, representing a write-down to net realizable value.

The total amount of advertising reported as assets in each balance sheet presented.

Costs incurred prior to the initial application of SOP No. 93-7 should *not* be adjusted to the amounts that would have been reported as assets had SOP No. 93-7 been in effect. Note, however, that the provisions of SOP No. 93-7 relating to amortization, assessment of asset realizability, and disclosure should be applied to any unamortized costs reported as assets before SOP No. 93-7 is adopted that continue to be reported as assets after the effective date.

18.4.5 Examples

J&J Snack Foods Corp. (2004 Form 10-K)

Example .

2. Revenue Recognition

We recognize revenue from Food Service, Retail Supermarkets, The Restaurant Group and Frozen Beverage products at the time the products are shipped to third parties. When we perform services under service contracts for frozen beverage dispenser machines, revenue is recognized upon the completion of the services on specified machines. We provide an allowance for doubtful receivables after taking into consideration historical experience and other factors.

Effective December 30, 2001, we adopted the provisions of Emerging Issues Task Force (EITF) Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor's Products." EITF No. 01-9 addressed various issues related to the income statement classification of certain promotional payments, including consideration from a vendor to a reseller or another party that purchases the vendor's products.

As a result of the adoption of this EITF, we reduced both net sales and marketing expenses by approximately \$23,212,000, \$25,344,000 and \$27,175,000 for the years ended 2004, 2003 and 2002, respectively. These reclassifications have no impact on reported operating income or net earnings or earnings per share.

We follow EITF No. 00-10, "Accounting for Shipping and Handling Fees and Costs" (Issue 00-10). Issue 00-10 requires that all amounts billed to customers related to shipping and handling should be classified as revenues. Our product costs include amounts for shipping and handling, therefore, we charge our customers shipping and handling fees at the time the products are shipped or when services are performed. The cost of shipping products to the customer is recognized at the time the products are shipped to the customer and our policy is to classify them as Distribution expenses. The cost of shipping products to the customer classified as Distribution expenses was \$33,574,000, \$27,705,000 and \$26,041,000 for the fiscal years ended 2004, 2003 and 2002, respectively.

Medical Information Technology, Inc. **(2005 Form 10-K)**

Example .

(8) OTHER INCOME AND EXPENSE

The Company sold certain available-for-sale securities resulting in realized gains of \$233,088 during 2003, \$117,500 during 2004 and \$989,543 during 2005. Other Income consists of rents, dividends, interest income and realized/unrealized marketable security gains (losses):

	2003	2004	2005
Rents	\$10,029,758	\$10,728,321	\$9,735,148

Dividends	8,792,134	10,053,939	9,882,855
Interest	1,378,502	2,129,812	3,139,610
Gains (losses)	<u>(1,446,770)</u>	<u>117,500</u>	<u>989,543</u>
Other Income	<u>\$18,753,624</u>	<u>\$23,029,572</u>	<u>\$23,747,156</u>

Other Expense consists of rental costs, charitable contributions, certain professional fees and interest expense:

	2003	2004	2005
Rental costs	\$6,390,608	\$6,469,282	\$6,789,238
Charitable contributions	520,000	600,000	835,000
Professional fees	500,000	750,000	1,660,000
Interest	=	=	<u>15,589</u>
Other Expense	<u>\$7,410,608</u>	<u>\$7,819,282</u>	<u>\$9,299,827</u>

Nestor, Inc. (2005 Form 10-K)

Example .

NOTE 15 - OTHER EXPENSE - NET:

Other expense as reflected in the consolidated statements of operations consists of the following:

	Years Ended December 31,		
	2005	2004	2003
Interest and dividend income	\$113	\$79	\$13
Interest expense	(847)	(239)	(470)
Expense relating to financing operations	---	(63)	(106)
Unrealized loss	(3)	(10)	---
Realized loss	---	(96)	---
Other income	33	---	64
Contract termination charge	---	---	(125)
Gain (Loss) on disposal of fixed assets	---	<u>(5)</u>	<u>(5)</u>
Other expense - net	<u>\$(704)</u>	<u>\$(334)</u>	<u>\$(629)</u>

Dexterity Surgical, Inc. (2006 Form 10-KSB)

Example .

NOTE B — ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Shipping and Handling: Amounts billed to customers for shipping and handling costs are included in net sales. Costs incurred for shipping and handling are included in cost of sales. Shipping and handling costs were approximately \$1,000 in 2006 and \$4,000 in 2005.

Barnes & Noble, Inc. (2006 Form 10-K)

Example .

1. Summary of Significant Accounting Policies

Advertising Costs

The costs of advertising are expensed as incurred during the year pursuant to Statement of Position 93-7, "Reporting on Advertising Costs." Advertising costs charged to selling and administrative expenses were \$27,312, \$27,846 and \$33,402 during fiscal 2006, 2005 and 2004, respectively.

The Company receives payments and credits from vendors pursuant to co-operative advertising and other programs, including payments for product placement in stores, catalogs and online. In accordance with Emerging Issues Task Force (EITF) Issue 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor," the Company classifies certain co-op advertising received as a reduction in costs of sales and occupancy. The gross advertising expenses noted above were completely offset by allowances received from vendors and the excess allowances received were recorded as a reduction of cost of goods sold or inventory, as appropriate.

Abatix Corp. (2006 Form 10-K)

Example .

(1) Summary of Significant Accounting Policies

(d) Vendor Consideration

The Company provides numerous programs to promote its vendors' products, including catalogs, the Internet and other marketing programs. Most of these programs support multiple vendors. To the extent funds received from vendors can specifically be identified with a marketing program, those funds are included in selling, general and administrative (advertising) expenses as a reduction to the cost of the marketing program. Rebates earned from vendors that are based on purchases reduce cost of sales. However, the Company calculates the amount of rebates that should be applied to ending inventory in each reporting period and capitalizes that estimate into inventory

18.5 RELATED TOPICS

Section 3 , Notes and Accounts Receivable

Section 4 , Inventories

Section 6 , Investments in Unconsolidated Subsidiaries and Less Than Majority Owned Companies

Section 7 , Property, Plant, and Equipment, and Depreciation

Section 8 , Intangible Assets

Section 10 , Notes Payable, Bonds, and Other Debt

Section 19 , Interest Cost Capitalization

Section 20 , Research and Development Costs

Section 21 , Income Taxes

Section 23 , Extraordinary Items

Section 25A , Comprehensive Income

Section 26 , Accounting Changes

Section 27 , Accounting Policies

Section 30 , Commitments

Section 33 , Contingencies

Section 38 , Foreign Operations

Section 41 , Interim Reporting

Section 42 , Leases—Lessees

Section 45 , Costs

Section 48 , Profit-Sharing Plans

Section 50 , Related-Party Transactions

Section 52 , Stock Option and Purchase Plans

Section 71 , International Financial Reporting Standards

Section 74 , Accounting for Contributions Received and Made

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