The Impact of Advertising Expenditure on Firm Value: Analyzing Past Studies

Puneet Kaur Dhingra
Assistant Professor
Mata Sundri College for Women
Delhi University
New Delhi, Delhi, India.

Rameet Kaur Sawhney
Assistant Professor
Mata Sundri College for Women
Delhi University
New Delhi, Delhi, India.

Abstract

This paper delves to congregate the views of extant literature in the field of advertising expenditure relevance. The paper emphasizes on the relevance of advertising expenditure with respect to firm's overall value and not just profitability or sales, emanating shift to utilization of valuation models in measuring the effect of advertisement expense on a firm. The current practice which is dominantly followed by accountants all over the world is to treat advertising expenditure as an expense for the current period. But there has been growing substantiation that advertising expenditure is just not bears the tag of a current period expense but can be regarded as a long-term investment in brand equity development.

1. Introduction

A goal of the firm may be defined as a target against which a firm's operating performance can be calculated. The object specifies what the decision maker wants to accomplish. In majority cases, the objective is specified in terms of maximizing same function or variable (size, value, profit, social welfare, etc.) or minimizing same function or variable (risk, cost, etc.).

Traditionally maximization of the profit was considered as the most implied objective, but it suffered from severe short comings. Due to narrow view point of this objective, it amplified the gap between the viewpoint of the management and shareholder.

Ignorance of the shareholder's interest led to a shift from focus of firms from profit maximization to maximization of shareholder's wealth. Maximization of the shareholder's value implies that any firm should operate with the basic motive to magnify shareholder's investment returns. This concept is called Shareholders Value Analysis (SVA) and has emerged as the new premise for judging any managerial activity or decision. Thus, all activities of the firms, various department like human resource, operations, or marketing must be justified with respect to SVA. Marketing get a new direction and perspective with this shift of firm's objective from profit maximization to shareholders value maximization.

Traditional practice of concentrating on profit maximization always focused on earning of short firm profit at the cost of intangible resources of the firm which suppressed the scope of marketing looking at the flip side now, managers concentrate on achieving long term objectives thus, making committed investments which will reap profits in the future term of the business.

Spending on marketing activities will now be required to justify the value appreciation it brings to shareholders investments. This will be a little challenging as marketing effects business in tangible and intangible forms.

2. Tangible and Intangible Assets

Simon et. al. (1993) bifurcated firm value into tangible and intangible aspects profits and sales are ready examples of tangible aspects of firm of value and impacts of marketing instruments on theses tangible aspects have been validated in the short run by Lodish (1995) and in the long-term by Nijs (2001) and Simester (2009).

But in the concurrent scenario, intangible aspects reflect a large share of the firm value, as described by Sougiannis and Chan (2001) the role of brand equity in their research. Many researches point out that intangible aspects such as customer satisfaction, might be better indicator of long team financial performance than traditional accounting aspects Ittner and Larcker (1998) also suggested that they can supplement financial outcomes in internal accounting of individuals firms.

Intangible aspects which argument firm value can be divided into following classifications:

1. Market specific factors like conditions that result into imperfect competitions.
2. Firm specific factors like patents, research and development and know how expenditures.
3. Brand Equity.

Many researches have well documented the effect of market specific factors and firm value like Kamdin (1999), Chhaochharia and Grinstein (2001).

For firm specific factors, Pauwels (2004) empirically tested the positive impact of innovation on firm value sincerely Erickson and Jacobson (1992) examined the impact of discretionary expenditures like advertising and R&D, and stated that it significantly effected firm value. And brand equity is the outcome of the above two factors.

3. Advertising Expenditure

Out of the above discussed firm specific factors, the amount of corporate investment in advertising has been substantial and is excessively growing because of its direct link with the commercialization of value chain. It's an essential tool in harvesting the aggregate value of innovation and R&D, due to its imperative role in sales and marketing of every product. The extant theories on advertising are numerous and diverse. Different people have studied advertising from different perspective. Marketing people are concerned about the importance of advertising in the augmenting sales or share size of whole market. Finance people link advertising with the profitability of the business. Economists are interested in researching upon the effect of advertisement expense on market competition, concentration, consumption and prices, while policy makers focus on the social repercussions of advertising. There is an ongoing argument as to what are the benefits and cost related with advertising, expenditure, whether advertising is informative & persuasive or just a wasteful change on the earnings of the firm. Another controversy surrounds the accounting treatment of advertisement expense whether to club it as an expenditure or to value it is an intangible asset of the business.

Numerous authors have done different researchers via various approached to gather knowledge about the exact nature of advertising expenditure and its effect on shareholder's value. Some researchers like Abraham and Lodish (1990), Weiss (1969), Graham (2000), Sougiannis (1994) have measured advertising expenditure with respect to its influence on profitability of the business. While Duffy (1999), Yiannaka (2002), Palda (1965), and Abdel Khalik (1975) investigated its effect on sales generation ability of the firm. These were earlier studies, recently researchers have started adopting Valuation Models. These models facilitates establishment of relationships between existing market value of the business and intangible aspects of business like R&D expenditure and advertising expense.

The major aim of this term paper is to explore all the extant literature of researchers that established relationship between advertising, expenditure and firm's capacity to generate sales, earn profit and augment market value.

4. Accounting Treatment of Advertisement Expense

The accounting treatment regarding advertising expenditure has always been controversial. Numerous researchers in the extant literature were in support of the notion that advertising has some asset value attached to this eminent researchers whose studies backed this notion were Hirshey and Spencer (1992), Morck and Yeung (1991), Hirshey (1985), Lustgarten and Thomadakis (1987) and Chauvin and Hirshey (1993). However, there are always two sides of every coin and this existing literature also entails researchers which strongly go against the asset value argument and reinforce that the benefits derived from advertising expenditure are limited to the period during which the outflow was made. This dilemma exists due to difficulties associated with accurately determining the cost attached with advertising activities and also identifying the rewards earned in the future periods.

Since profits of the current period can be determined more easily than anticipating future profits, hence management finds its convenient to write off the expenditure attached to advertisements in the current year accounts only, also uncertainty attached with earning of future profits also makes it risky to carry over the amortization of advertising spending in the forthcoming accounting years. Investor's point of view was indicated by Han and Manry (2004) in the research stating that investors also follow this notion that economic benefits driving from the firm's advertising expenditure expire in the same year in which it is incurred. The above notions finds its premise from the arising tax benefits and conservatism.

Flipping to the contrasting side of the dilemma, many authors have present literature which supports that advertising expenditure is a strategic investment, which must be capitalized and its amortization should happen over future periods along with the current one. (Hirshey, 1982; White & Miles, 1996; Weygandt and Hershey, 1985).

In their support Barth and Kasznik (1999) in there research indicated that, investment in R&D and advertising should be labeled as intangible assets in firms balance sheet, as developed technology and values created by brand name are essential catalyst in improving firm's profitability in the future course of operations.

5. Research Gap

It has become imperative for every firm to make some advertising expenditure due to rising competition in the market place, increasing customer attention and awareness easy availability of close substitutes and high product differentiation.

Still blindly making huge expenditure on advertising is not justified till its effect on various aspects of the firm value is justified. This makes it necessary to examine the interdependency between advertising cost and firm growth.

6. Objective of the Study

Our objective here is to do comprehensive exploration research on the effect of advertising spending on various aspects of firm value through analyzing the present-day existing literature consisting of empirical researches conducted by numerous researchers on the same.

This will help us in getting a clearer and a panoptic picture of diverse linkages of advertising expenditure with firm value components, along with the ground logics behind them.

7. Advertising and Sales

Major proportion of literature review on the study of advertising is based on the presumption of advertisement spending and sales relationship as the initial point of analysis. However, this presumption makes sense and hold true but it lacks at one angle. The association between advertisement spending and sales is not just straight forward or unidimensional but multi-dimensional. It is not only advertising which impacts sales but sales also impact advertising; e.g. in proportion to sales only advertising budgets are set by the companies. Thus, there exist a simultaneity cause and effect association between advertisement spending and sales which further adds complication in the study of relationship between advertising and sales.

Hollander (1949) provided some initial evidence in his study of an ethical drug, on advertising's effects on sales for the carry over impact of advertising on sales. His observation was followed by few more researchers, Dean in 1951, Jastram in 1955, Vidale and Wolfe in 1957 which raised the lagged impact of advertising on sales. In the year 1964-1965 Kristian Palda provided a comprehensive evidence of carry-over effect of advertisement expense and provided a unique analysis of the impact of advertising on sales. The analysis was done through number of models based on multivariate regression. He concluded that advertising expenditure is a non-tangible asset which is too related to amortization, and 95 percent of the advertisement expense on an average is subject to amortization within the period of 7 years. Following the similar footsteps, few more researchers like Abdel-Khalik (1975), Peles (1970, 1971), Lambin (1969) and Simon (1969) gave the similar evidence of impact of sales on advertising.

In 1969, Clarke reviewed the studies based on econometrics with objective to understand and determine the period of cumulative advertising impact on sales. In his study, he classified and categorized about 69 studies into various categories, based on the criterion of data collection intervals adopted by these studies. In 1976, he concluded that the long duration intervals which are obtained from annual models are due to data interval bias. For a period less than 1 year, results are less prone to data interval bias and the duration of cumulative advertising impact on firm's sales is around 3 to 15 months. In 1974, Bloch in his study remarked that "despite of the conclusions and findings of the study which represented that advertising has lagged impact on sales, normal practice in accounting is to account advertising expenditure as current while calculating the net profit which results in understatement of net worth of the firm and misstatement of reported profits."

Table 1: Advertising and Firm Sales

Author	Year	Results
Palda	1964	Advertising expenditure is a non-tangible asset which is too related to amortization
Simon	1969	Concluded that effect of advertising on sales of liquor is dispersed over a long time span
Lambin	1969	Almost 50 percent of total advertising is carried over from one accounting period to another
Peles	1971	Presence of future advertising effects in cigarettes and beer but this result was not the same in Automobile industry
Abdel-Khalik	1975	Found prevalent evidence for future advertising effects in drugs, food and cosmetics but this result was not the same in tobacco and soap industry

8. Advertising and Firm Entry

Studies of advertising which viewed advertising as market power argues that consumer tastes and preferences are to a great extent influenced by advertising, and advertising leads to an addition of value to the differentiation of the product. This impacts in increased level of loyalty of consumers, and sometimes leads towards situations where customer ignore the availability of substitutes. This mechanism provides an opportunity for firms to preserve their positions by spending big amount on advertising.

Further heavy investment on advertising leads to high profitability which further strength the firm’s capacity on investing in advertising, and thus creating barriers for new players in the industry. Establishment of such barriers leads to many consequences. New firms will be compel to spend a matching level of expenditure on advertising in comparison to existing firms, thus they will invest huge amount without reaching to economies of scale. Secondly, firms which enjoy loyal customers can manipulate market by restricting their output and thus can charge high prices.

On the contrary to this, studies which were based on “advertising as information”, support the notion that role of advertising is informative and thus, facilitates competition rather than creating barriers to entry.

According to such studies advertising plays a pivotal role in providing information to the public regarding availability of different products at various prices. Thus, it promotes the price sensitive behavior of the customers, and customers buys only that product which provides best value for the price they pay. In 1992, Sudarsanam in his study concluded that advertising as informative tool loosen the loyalty ties of the customers and thus leads to reduction of existing firm's market power. Further in 1987, Schroeter provided an empirical evidence advertising leads to higher level of competition among the sellers in the market. In 1995, Ducoffe founded that there is positive correlation between advertisement spending and the value it creates.

Table 2: Advertising and Firm Entry

Author	Year	Results
Schroeter	1987	Advertising as informative tool loosen the loyalty ties of the customers and thus leads to reduction of existing firm's market power
Sudarshan	1992	Advertising leads to higher level of competition among the sellers in the market
Ducoffe	1995	Positive correlation between advertising in formativeness and the value it creates

9. Advertising and Profitability

The ongoing debate of impact of advertising on competition and creation of barriers is implicitly based on the concept of advertising expenditure's economic durability. Studies which favor creation of barriers by advertising expenditure, are based on short lived view of advertising and treat advertising expenditure as current expenditure, and thus believe that firm earns real profits due to product differentiation. On the contrary, studies which conclude that treating advertising as current expenditure reduces profits, also leads to the omission of advertising intangible asset in balance sheet.

In 1967, Comanor and Wilson carried out a study based on forty-one consumer products to relate profitability with various levels of advertising expenditure. They reported a positive impact of advertising on profit rates. They concluded that advertising leads to product differentiation which furthers results in creation of barriers to new firm entries. Following similar line, in 1999, Paton and Williams provided evidence on relationship between firm value and advertising. Their study was based on cross section data which was collected through survey of 325 advertising managers of UK based firms. They concluded that advertising is correlated to profit rates for only firm which deals in consumer goods industry.

All these studies focused only on altering profit percentages for different advertising expenditure. However, they ignored other factors which are expenses, although they reap benefits for following years as well, for example research and development investment and training cost. Several studies including Core (2003), Green (1996) and Chauvin and Hirschey (1994) proposed that these other factors also yield profits.

It is quite interesting to notice that research study using data of industry reflects a strong and positive correlation between profitability and advertising whereas studies based on firm's data shows no such association between profitability and advertising. This difference in result might arise due to probable problem of data aggregation.

Lastly, the concern relating to the direction of impact or causation between advertisement expenditure and profitability. Advertising intensity model developed based on a single equation has been criticized due to the potential endogenity of profitability and other variables. As per Wellis and Rogers (1998), ordinary least squares estimates will give biased results if profit is endogenously related with advertising intensity. Comanor and Wilsom in 1974 and Rosenbaum in 1993 made attempts to control endogeneity with the help of simultaneous estimation. In 1989, Schmalensee projected that in studies based on cross sectional industry, effective tools for endogenous variables are non-existent. In 1991, Notta and Oustapassidis argued that when instrumental variables are used steady estimates could be obtained. Major contribution was made by Notta et. al. (2001), which opinioned that a formal Hausman–Wu test can successfully indicate the usage of instrumental variable technique for satisfactory estimating the parameters of a given sample.

Table 3: Advertising and Firm Profitability

Author	Year	Results
Comanor and Wilson	1967	Found a positive relation between advertising and firm's profit, indicative of firm's market performance as well as its market power
Weiss	1969	Presence of non-significant relation between advertising and firm's profitability, if amortization of ads happen over their realistic time span
Bloch	1974	Accounting errors result in advertising being treated as an expense, instead of being used as an explanation for the resultant market power arising from product differentiation, thus undermining advertising intensity
Pitelis	1991	Empirically proved positive effect of advertising on firm's profitability
Erickson and Jacobson	1992	Found no solid evidence as to the effect of R&D expenditures or advertising on firm's ability to generate super normal profits
Sougiannis	1994	Reported a strong link between advertising, R&D expenditures, earnings and capital stock
Lev and Sougiannis	1996	Found and association between advertising expenditure and increase in net operating income
Patron and Williams	1999	Concluded a correlation between earnings and advertising for firms operating in Consumer goods industry
Notta and Oustapassidis	2001	Reported that only TV advertising results in increase in profits, for Greeks firms in food manufacturing sector

10. Advertising and Market Value

In order to avoid probable problems associated with the studies on relationship of advertising on sales and profitability, researchers (especially in USA) have experimented with a more direct approach over advertising based on market values of the firms. It is normally observed that study on advertising and profits gives biased results due to the use of unadjusted accounting profits. Thus in order to access relationship between economic variables and advertising better alternative is to use market value of firms. In 1985, Hirschey in his study concluded that "a compelling virtue of an approach based on the market value of the firm is that such an approach minimizes the effect of accounting bias".

In 1984, Hirschey and Wichern in their study argued that both types of data-accounting and market are an ideal variables of profitability and therefore he advised that comparison of both types of data can be highly recommended. Their study found significant role for leverage, research and development intensity, industry growth and television advertising a profitability determinants. In 1978, Ben-Zion was the first one who used stock market data in order to measure long term impact of spending on advertising and promotion on the market values of the companies. On the contrary in 1992, Erickson and Jacobson concluded that spending on advertising acts as a signal to the market in general that the firm has surplus funds for such activities. In 1998, a study by Srivastava provided a frameworks on channels by which advertising can create market based assets, low cost services to customers, stabilized cash flows and thus generating synergy within the organization and thus helps in improving the productivity and building competitive strength.

In 2002, Keller in his study showed that advertising builds brand loyalty which further leads to financial value due to increased cash flows because of customer loyalty and increased efficiency in marketing. In 2005, a study by Singh evidenced a positively significant association between market value added (MVA) and advertising expenditure. Thus, representing that firms having high advertising expense has greater market value added (MVA).

In 2001, Tsai found that firms facing uncertainty in markets, resort towards investing more in research and development projects rather than on advertising expenditure. In 2004, Han and Manry concluded that there exist a negative association between stock price and expenditure on advertising. These results suggest that investors are of the view point that expenditure on advertising act like other expenses and tend to expire during the current duration.

Table 5: Advertising and Firm Value

Author	Year	Results
Ben-Zion	1978	Concluded that advertising and R&D expenses which are treated as an expenditure should been as investment expenditures instead
Hirshey	1982	Market value is significantly affected by R&D and advertising expenditures
Ericson and Jacobson	1992	Reported that increase in market value is not significantly affected by either advertising or R&D expenditures
Tsai	2001	Firms operating under uncertain circumstances tend to resort to R&D expenditure rather than spending on advertising
Han and Manry	2004	Akin to other expenses, benefits derived from spending on advertising expire during the same accounting period during which the spending took place
Singh	2005	Found a positive correlation between advertising spends and firm's market value

11. Conclusion

There is general emphasis on a recent shift to the utilization of valuation models in probing the essence of advertising expenditure. As market value comprehensively captures the profitability effects in both scenarios, the present and future periods, valuation models serve as a better mode in analysing the intangible aspect of advertising splurge. It has been found that majority of evidence on value relevance aspect of advertising derives from the US, where historically there has been preeminent disclosure regarding advertising expenditure.

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