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America Online's Advertising Costs: An Asset or Expense?

America Online is a publicly traded on-line services company that was founded in 1985. The company operates in a highly technical, dynamic, and rapidly growing environment. Beginning in 1995, America Online started to rapidly increase its customer base through extensive advertising efforts. The bulk of these advertising efforts included distributing millions of computer disks containing America Online startup software to potential subscribers. Due to these extensive advertising costs, America Online began to suffer a negative cash flow from operations. At the same time, the company began characterizing these advertising expenses as deferred subscriber acquisition costs, which were recorded as capital expenditure assets on the balance sheet. The company was essentially capitalizing the acquisition costs of its new subscribers. America Online would then amortize these costs on a straight-line basis over twelve and later twenty-four months. Capitalizing these expenses and then amortizing them was an unacceptable accounting practice for America Online because it did not conform to GAAP (Generally Accepted Accounting Principles) and misled current and potential investors and creditors.

GAAP has strict guidelines regarding accounting for advertising costs. America Online, in capitalizing these expenditures, is classifying these costs as an asset. The GAAP guidelines for capitalizing advertising costs are reflected in Statement of Position 93-7 (SOP 93-7,) which the Accounting Standards Executive Committee issued in 1993. By definition, assets must be "probable future economic benefits obtained or controlled by an entity as a result of past transactions or events" (Spiceland, Sepe, Tomassini, 22). According to SOP 93-7, in order for America Online to record these costs as assets, the company would have to prove through historical evidence that the advertising costs directly yield reliably predictable future net revenues (revenues must exceed the costs of the advertising). It would be very difficult for America Online to accurately prove through historical data that advertising expenses produce direct net revenues. America Online operates in a highly volatile, emerging market that is subject to unpredictable developments. Additionally, the on-line services market is extremely competitive, so rate structures change rapidly. Current subscribers can cancel their subscription at any time as well. Thus, it is nearly impossible to forecast the subscriber retention rates and future subscription revenues that are required to provide evidence that these advertising costs directly result in predictable future revenues. Therefore, there is insufficient evidence to prove that the deferred subscriber acquisition costs are even recoverable. Since these advertising costs of acquiring new subscribers cannot be directly related to net revenues according to SOP 93-7, America Online should have expensed these costs as they were incurred and reported them on the income statement as operating expenses.

Even assuming that America Online was somehow able to present evidence that the advertising directly created reliably predictable future net revenues, and thus could classify the costs as an asset, the company would still have other accounting issues with the capitalization. Beginning in 1995, the unamortized portion of the asset was classified as a non-current asset. Classification as a non-current asset in itself was a questionable reporting technique for America Online. Non-current assets are not expected to be consumed within the year. At least a portion of the capitalized costs should have been reported as current assets, given that they were material, because America Online was amortizing the expenses on a monthly basis. Furthermore, the company was able to recover each subscriber's acquisition costs in about three months, which indicates that the company should probably have been amortizing the costs over a shorter period. This amortization method would have limited the initial revenue that the company recognized from each subscriber but would have matched revenues and expenses more accurately.

Recording these advertising costs as expenses would have been most consistent with the GAAP matching principle. According to the matching principle, expenses should be recognized in the same reporting period as the related revenues. By amortizing its capital expenditures over twelve and later twenty-four months, America Online was only recording a portion of the advertising expenses in the reporting period that they occurred and generated revenue.

The misreporting of advertising costs as assets has detrimental effects on current and potential investors and creditors since it leads to inaccurate financial statements. By capitalizing the advertising costs of acquiring new subscribers rather than expensing them as they occur, America Online was overstating its net income because it did not include the full portion of advertising expenses. Essentially, net income was overstated by the advertising costs capitalized during the fiscal year less the amortized portion of deferred subscriber acquisition costs. After viewing the income statement, investors and creditors would be led to believe that America Online suffered a substantially lower net loss from operations and thus was more profitable. Had these costs been properly recorded, the company's pretax net loss would have risen from around ($20 million) to well over ($90 million) in 1995. The capitalization also made the company appear financially stronger with inflated total assets. Deferred subscriber acquisition costs was actually the largest asset listed on the balance sheet in 1995, representing 19% of total assets. With America Online's colossal overstatement of assets, creditors might be more likely to lend money to the company, and investors may have been more willing to invest, since the company appears nearly 20% financially stronger.

America Online has grossly misreported assets and expenses by capitalizing the advertising costs of acquiring new subscribers. The company operates in a dynamic environment, which is not conducive to predicting the direct relationship between advertising costs and future net revenue. Thus, America Online's advertising costs should have been expensed as they were incurred in order to conform to GAAP and not mislead the current and potential investors and creditors.