New rules bring consumer and trade promotions to harsher light

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by Julian Chu

New accounting guidelines set forth by the Financial Accounting Standards Board over the past year will force consumer product manufacturers to classify much of their consumer and trade promotion expenses as a reduction in revenue. What are the strategic and operational implications of these changes for CPG firms?

Note: The information presented in this Briefing reflects interpretation of FASB rulings by IBM business consultants. It was not prepared by a Certified Public Accountant and should not be taken as guidance or advice with respect to the subject matter.

Issue

A move for consistency

The Financial Accounting Standards Board (FASB) recently made several decisions that have received relatively little attention in the marketplace, yet could have far-reaching implications for consumer product manufacturers.

Beginning in 2002, much, if not most, of the funds that manufacturers spend on consumer promotions (e.g., coupons and rebates) as well as trade promotions (e.g., slotting fees – see figure below for more details) can no longer be buried in COGS or the G&A line. Rather, these amounts will need to be classified as a reduction in revenue. In other words, they will come right off the manufacturer’s top line.

The impetus for the FASB’s actions was the wide variation in accounting practices among manufacturers both across and within product categories like consumer electronics and groceries. The new rules are intended to standardize the way different companies account for promotional expenses, allowing their financial statements to be compared more easily. Those companies that have engaged in significant promotional activity will
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see their officially reported size, in terms of revenues, substantively reduced.

Whether and how Wall Street will react to these changes is beyond the scope of this briefing. We focus instead on what strategic and operational implications may arise for consumer packaged goods firms (CPGs) in particular, as the industry transitions to a new way of looking at consumer and trade promotions.

Overview of CPG trade promotions

Manufacturers offer various forms of “value”...

- Slotting fees
- Buydowns
- Cooperative advertising programs
- Off-invoice discounts
- Favorable payment terms
- Market development funds
- Bracket allowances

...in return for retailer promises and actions...

At corporate level:
- Prioritize in merchandising plan
- Buy in advance of demand
- Set favorable prices
- Distribute new products

At retail level:
- Assign favorable aisle and shelf placement (e.g., end caps)
- Include in store-level merchandising (e.g., ads, displays, coupons)
- Set favorable prices

...in hopes of generating incremental volume and profit

Gross incremental volume

Cannibalization

“Pantry loading”

True incremental volume
- Additional volume from current customers
- New customers

Source: IBM Strategy & Change analysis.

Analysis

A double whammy

Three separate, but related decisions were issued by the FASB recently, each dealing with a different category of manufacturer promotions. In sum, CPG firms will need to revise the way they account for both consumer and trade promotions at essentially the same time. While their bottom lines will not be directly affected, slow-growing CPG firms...
will suddenly seem smaller than they used to be, and potentially even more sluggish in terms of revenue growth.

The FASB’s rulings aim to establish consistent industrywide practices for the accounting of certain types of promotional activity. Those that fall under the defined criteria must be classified as reductions in revenue, not as cost of goods sold or marketing expenses. A more detailed description of each decision follows:

1. **Consumer sales incentives** – Going forward, promotions that enable consumers to either a) receive a price reduction for a product at the point-of-sale, or; b) receive a price reduction by submitting a whole or partial refund claim should be classified as a reduction of revenue. This includes most coupons and rebate programs in use today.

2. **Time or volume-based incentives** – This ruling addresses promotions where the customer (who could be a distributor, retailer, or an end consumer) receives a rebate or refund if the customer reaches a specified cumulative level of purchases with the vendor, or remains a customer for a specified period of time. This includes slotting fees or other considerations that are payable on a contingency basis, dependent on the retailer achieving a specified level of purchases from the manufacturer.

   In the future, CPGs must account for the potential rebate by systematically allocating its cost to individual underlying transactions as a reduction in revenue. In other words, for a US$100 item where the customer can receive a 10 percent rebate once a certain volume is reached, US$90 should be recorded as revenue and US$10 as a liability.

3. **Trade promotions** – The third ruling addresses a variety of “considerations” paid by a manufacturer to resellers of its products, be they cash payments or credits that can be applied against amounts owed to the manufacturer. “Reseller” includes both typical retailers, including those that purchase products of the manufacturer from a distributor, and companies that use the manufacturer’s products as inputs/components for their own offerings (e.g., a computer system assembler). Examples of the promotional considerations covered by this ruling include:
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- **Slotting fees** – Payments to “obtain space” on a retailer’s store shelves, whether physical or virtual. These can include payments related to brand development or new product introduction (e.g., for favorable in-store positioning, end-cap placement, or additional shelf space). These fees can be incurred (1) before the products are sold to the retailer, (2) on a regular schedule, or (3) periodically as negotiated between the two parties.

- **Cooperative advertising programs** – Where a manufacturer agrees to reimburse the retailer for a portion of the advertising costs incurred by the retailer.

- **Buydowns** – Where a manufacturer agrees to reimburse a retailer for shortfalls in the sales price received by the retailer for the manufacturer’s products.

Generally, all buydowns and most slotting fees as described above should be recognized as reductions in revenue. Other trade promotions that should be treated in this manner include “off-invoice” deductions and reimbursement of promotion-related retailer payroll costs.

The FASB ruling does make room for exceptions, in part due to strong pushback from CPG and other manufacturers. In order to be classified as an expense, the promotion must meet two conditions: a) the manufacturer receives an identifiable, sufficiently separable benefit in return for the consideration, and b) the manufacturer can reasonably estimate the fair value of that benefit.

For instance, an advertising-related payment made by a CPG firm to a retailer can be classified as an expense if the retailer provides documentation of that advertising (helping to satisfy the first condition) and the manufacturer can quantify the fair market value of the benefit gained from the payment.
Summary of FASB rulings on consumer and trade promotions

<table>
<thead>
<tr>
<th>Date of Ruling</th>
<th>Scope and New Guidelines</th>
<th>Implementatio Schedule</th>
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<tbody>
<tr>
<td><strong>Consumer Sales Incentives</strong></td>
<td>Record coupons, rebates, and refund reduction in revenue</td>
<td>Q1 2002</td>
</tr>
<tr>
<td>May 2000</td>
<td></td>
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<tr>
<td><strong>Time or Volume-Based Incentives</strong></td>
<td>Allocate the cost of time or volume-based cash rebate or refund programs as a reduction in revenue for each underlying transaction</td>
<td>Q2 2001</td>
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<tr>
<td>Jan 2001</td>
<td>Includes contingently payable slotting fees</td>
<td></td>
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<tr>
<td><strong>Trade Promotions</strong></td>
<td>Recognize buydowns, most slotting fees, and some cooperative advertising programs as reduction in revenue</td>
<td>Q1 2002</td>
</tr>
<tr>
<td>Apr 2001</td>
<td>Exceptions meeting certain criteria can be classified as expenses</td>
<td></td>
</tr>
</tbody>
</table>

Source: FASB EITF 00-14, EITF 00-22, and EITF 00-25.

Potential drag on revenue growth

As noted above, there is no impact on a CPG firm’s net operating margins as a result of these accounting changes. However, since the cost of much, if not most, consumer and trade promotions will henceforth be taken out of the top line, CPG executives must consider what impact these marketing activities will have on overall company revenue growth and financial market perceptions. The importance of this issue is heightened in particular by the relentless growth of trade promotion spending as a proportion of CPG revenues (see figure below).
Let’s make this real. Take, for example, a hypothetical CPG firm that typically achieves 3 percent average annual revenue growth. Assume further that the company follows industry rules of thumb that state half the marketing budget is devoted to trade promotions and about a quarter of it goes to consumer promotions. Assuming the market budget is currently equivalent to 23 percent of gross revenues, that means the firm is spending 11.5 percent of revenues on trade promotions and 5.8 percent of revenues on consumer promotions (17.3 percent in total).
The key question is how fast are these promotion expenditures growing? If they're only growing by 3 percent a year, there's no net impact on the overall revenue growth rate. But say hypothetically both trade and consumer promotions grow by 5 percent the following year. If baseline revenue growth stays at 3 percent, the net effect is to reduce the actual reported revenue growth by over 40 basis points, to 2.58 percent. If things continue this way, all other things being equal, in four years the compound annual growth rate will be down to 2.55 percent.

Even if we conservatively assume only half of trade promotions are subject to the new classification rules, and only three-quarters of consumer promotion costs are similarly treated, the impact on overall revenue growth is still significant – up to 25 basis points over the next four years. And if the growth rate in promotion spending creeps up to 7 or 8 percent or more, the impact over time is all the more dramatic.

Impact of Accounting Changes on Reported Revenue Growth

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>CAGR 2001-02</th>
<th>2005</th>
<th>CAGR 2001-05</th>
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<tbody>
<tr>
<td>Baseline Revenues</td>
<td>100.0</td>
<td>103.0</td>
<td>3%</td>
<td>112.6</td>
<td>3%</td>
</tr>
<tr>
<td>Trade Promotion</td>
<td>11.5</td>
<td>12.1</td>
<td>5%</td>
<td>14.0</td>
<td>5%</td>
</tr>
<tr>
<td>Consumer Promotion</td>
<td>5.8</td>
<td>6.0</td>
<td>5%</td>
<td>7.0</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Net Reported Revenues</strong></td>
<td><strong>82.8</strong></td>
<td><strong>84.9</strong></td>
<td><strong>2.58%</strong></td>
<td><strong>91.6</strong></td>
<td><strong>2.55%</strong></td>
</tr>
</tbody>
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Note: This analysis assumes a hypothetical CPG firm with financial data indexed to baseline (pre-accounting change) 2001 revenues = 100.
Source: IBM Strategy & Change analysis.
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Dramatic shift in business practices unlikely?

The preceding analysis clearly shows that CPG executives need to take an even closer look at how quickly their consumer and trade promotion costs are increasing. More importantly, they need to understand whether or not these activities are adding incrementally to revenue growth.

In spite of this issue, or perhaps because they already realize it, industry observers believe that CPGs are unlikely to significantly alter how they deal with consumer or trade promotions. In some cases, CPGs have already shifted to the reduction-of-revenue accounting procedures, and thus have already factored them into their business planning. The general counsel of one industry trade group noted that “about half of the companies in the industry are already doing this. Those that haven’t will just restate their financials and continue doing business as they have.”

Some reasons for this include the fact that many of these practices are deeply entrenched in the industry. For instance, as major retailers continue to increase in scale and negotiating power, slotting fees and other trade promotions may increasingly be an unavoidable cost of doing business. If anything, the restatement of financials will make CPG firms look all the smaller compared to the largest retail players.

In addition, “many CPG account managers are measured on volume, not dollars or profits”, stated the CEO of a provider of trade management solutions to CPG firms.

Until such practices are changed, those employees charged with front-line management of trade relationships will be less concerned with the true ROI of trade promotions. “The rule changes in and of themselves are not a panacea for getting CPG firms to focus on ROI; they’re just another good reason for them to do so,” she added.

The Retail and Consumer industry leader for a major auditing firm noted that several CPG companies were disturbed with the new guidance. In particular, they view cooperative advertising as a marketing expense focused on the consumer, as opposed to a trade promotion payment to the retailer. In addition, they were concerned about the significant work that will be required for large multinational CPG companies to retroactively reclassify these costs for, in some cases, the past ten years.
Despite the unfavorable reaction, he was not aware of any CPG companies that plan to change the way they plan and execute their trade marketing programs. However, some companies are assessing whether their current programs can meet the newly established exception criteria for classifying the costs as a marketing expense. This will require them to work closely with their retail partners to obtain the proper documentation.

Implications

The importance of understanding ROI

Whether or not the accounting changes themselves will spur CPG manufacturers to re-think how they manage consumer and trade promotions, they do underscore the importance of accurately assessing the ROI of these activities. What is really driving the 4 percent sales lift in product X this month? Is it a particular FSI program or the purchase of favorable end-cap placements? What was the impact of the summer-long TV brand marketing campaign? Recent industry surveys have found that as much as 70 percent of CPG firms don’t know if their promotions are effective.

If CPG executives had better knowledge about the net impact of each promotional activity, they could more effectively allocate their dollars to those initiatives that drove the highest return, in terms of incremental sales. Given the large and increasing sums of money devoted to these programs, the growing negotiating power of major retailers, and now the direct impact such expenditures may have on top-line growth, the need for improved ROI analysis is becoming critical.

To address this issue, vendors such as Gelco Trade Management, ChiCor, and J.D. Edwards continue to build improved promotion effectiveness analysis functionality into their solutions. For example, Gelco’s Promotion Evaluation Solution, currently in development, will combine manufacturer shipment, trade spending, and consumption data such as that provided by IRI and AC Nielsen to allow CPG firms to analyze individual promotional events, view sales activity over time, and identify the overall impact of promotions.
A unique opportunity for competitive intelligence

A secondary effect of the new FASB rules will be potentially to give industry observers and competitors the opportunity to get an “inside” view of what, up until now, has been an area where hard data is difficult to come by. In reclassifying their prior-year financials, CPG firms might reveal certain information about the level of spending they have devoted to consumer and trade promotions in recent years. For example, Kimberly Clark’s 2000 10-K noted that “coupons and similar discounts…were approximately US$186 million, US$204 million and US$158 million in 2000, 1999 and 1998, respectively.” Industry competitors will have an one-time opportunity in the next few quarters to obtain benchmark data on the aggregate value of their competitor’s promotional spending.

However, any potential insights that might be gained from those reclassifications will be limited if such programs have already been partially classified as a reduction of sales in the past.

Some news reports have also implied that these types of disclosures will provide the Federal Trade Commission (FTC) with the data needed to validate smaller suppliers’ complaints that excessively high slotting fees stifles competition in the retail channel. However, while the Commission is “certainly aware of the accounting changes,” said an FTC official who has worked on the issue, “we are already engaged in discussions with retailers to obtain more detailed information on slotting fees.” According to this official, “[retailers] now understand we’re serious” and have been cooperating with the agency to enable the FTC to develop a more detailed study of the matter. Thus, it would seem that the accounting changes themselves are unlikely to drive further regulatory action beyond what is already taking place.

That said, this series of events should give CPG executives pause to reconsider how broader industry trends will impact the management of trade and consumer promotions. How will decision-making processes need to evolve? What new information gathering, analysis, and collaboration capabilities are required? How can these business requirements be met through current and future IT initiatives? These actions by the FASB give industry leaders yet another reason to seek creative, effective solutions to their trade customer and consumer management challenges.
About the author

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