

A case study of accounting and tax treatment of celebrity endorsement contracts

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ABSTRACT

This case study involves an analysis how Generally Accepted Accounting Principles (GAAP) and Federal Income Tax law impact accounting for athlete's/celebrity's endorsement contract costs. Companies such as Nike and Under Armour pay athletes millions of dollars on long term contracts to endorse their products and to enhance their corporate images. The case examines when these costs should be expensed or capitalized on companies' financial statements and income tax returns. It also examines ancillary questions of if these costs should be considered product costs or period costs; if liabilities should be created if an athlete should bring disfavor on herself/himself; how bonus payments for extraordinary performance should be accounted for; and what financial statement disclosure of contract details should occur.

Keywords: Endorsement contracts, GAAP, tax code, capitalization, advertising expense



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INTRODUCTION

Background

Companies such as Nike and Under Armour pay athletes millions of dollars on long term contracts to endorse their products and to enhance their corporate images. The case examines when these costs should be expensed or capitalized on companies' financial statements and income tax returns. It also examines ancillary questions of if these costs should be considered product costs or period costs; if liabilities should be created if an athlete should bring disfavor on herself/himself; how bonus payments for extraordinary performance should be accounted for; and what financial statement disclosure of contract details should occur. This is accomplished in a case study format which allows students to critically examine these issues and reach their own conclusions.

Accounting for endorsement contracts is both complex and varied depending upon the specific contract language. In general, students should conclude that most of the time costs related to these contracts are expensed, although an alternative accounting treatment would be to capitalize the costs and amortize over the future anticipated benefit periods. These costs are period costs, not product costs, analogous to advertising. Liabilities for potential future losses, due to actions which may cause the athlete to be viewed unfavorably, are not likely to be accrued. Bonus payments are not accrued until the athlete's performance has achieved the specific contract goals. Most companies do not disclose contract details as this information is considered proprietary. Federal income tax treatment should require capitalization of these contracts and amortization expense should be recognized over the period the athlete performs services under the contract.

Learning Objectives and Suggested Use of the Case

The overall objective of the case is to have students analyze how Generally Accepted Accounting Principles (GAAP) and Federal Income Tax law impact accounting for athlete's/celebrity's endorsement contract costs. More specifically, the learning objectives of the case are for students to:

1. distinguish expensing versus capitalizing endorsement contract costs.
2. determine whether endorsement contract payments should be considered product costs or period costs.
3. determine if a liability should be recorded on financial statements if an athlete brings disfavor on herself/himself and vicariously, the company.
4. determine if and when bonus payments for performance must be accrued.
5. determine what endorsement contract details must be disclosed in the financial statements and footnotes.
6. determine the proper income tax treatment of endorsement contract costs.

This case is suitable for financial accounting courses at the intermediate and advanced levels for undergraduate as well as graduate students. The case could also be simplified for a lower level accounting course to give students a relatable context in which to discuss the concepts of accruing versus expensing, product versus period costs, or contingent liabilities. The case also includes a question on the tax treatment of endorsement contracts which would be

appropriate for an upper-level business tax course. Overall, the case is flexible and allows instructors to select appropriate case questions that correspond to their curricular needs.

The case discussion can be done in class or in an online environment. If desired, instructors could also assign the case as a written homework assignment and include a research element, asking students to formulate their responses by researching GAAP in the FASB Codification database or tax code using available tax research databases. Going beyond the discussion questions of the case, students could review corporate annual reports and compare differences in how companies account for these contracts, where the contracts are reported in the financial statements, and what contract details are disclosed in the footnotes. To further pique student interest or add an element of fun, students could search for specific contract provisions and terms of endorsement contracts of their favorite athletes, celebrities, or teams and share their findings with the class. Students could also share commercials or ads demonstrating the endorsement contracts at work. An online environment would work especially well for some of these additional activities.

One pedagogical benefit of the case is that it brings real life into the classroom and encourages critical thinking through examination of a topic many students are naturally interested in. Students have their favorite celebrities and may even buy the products they endorse. They understand how endorsements increase brand recognition and value. They are captivated by the scandal stories and are crushed when star athletes experience season ending injuries. While celebrity endorsements are generally understood by students, they likely have not considered how they are accounted for by corporations. A second pedagogical benefit of the case is that it is not overly complicated or intimidating, and is short enough for an in-class discussion without significant prep work by students. Yet, the case is easily scalable into a more significant class project to include GAAP or tax research, a writing element, and/or a presentation element. The authors are not aware of any other instructional cases in the accounting education literature which address the accounting treatment for endorsement contracts, even though these contracts are prevalent and reported in the annual reports of many companies.



THE CASE PRESENTED TO STUDENTS

The Case Situation

In 2017, the New England Patriots and Atlanta Falcons battled it out on the field in Superbowl LI. Atlanta led by as much as 28-3, but the Patriots managed an impressive comeback and went on to win in overtime. The game was broadcast on Fox with an estimated 111.3 million viewers worldwide.

The Patriots and the Falcons weren't the only organizations who competed in the exciting game. Corporate competitors, Nike and Under Armour battled too. The Patriot's record setting quarterback, Tom Brady, endorses Under Armour. Matt Ryan, quarterback of the Atlanta Falcons, endorses Nike.

A few weeks before the Superbowl, Under Armour announced the release of the Athlete Recovery Sleepwear otherwise known as "Tom Brady's jammy pants." Brady even sported his pajama pants at a press conference. Fans went crazy for the jammy pants and tweeted, "If you wear Tom Brady's pajama pants, you'll be able to play football like Tom Brady" and "Need a pair of Tom Brady's magic pajamas." Losing the game had double meaning for Ryan. Not only

did Ryan have to endure a second half collapse on the field, Ryan lost millions in future endorsement revenues contractually tied to winning the game.

Corporate competition between Nike and Under Armour has been brewing for some time, as both companies search for champion athletes or even teams to endorse. Companies use endorsements as a mode of advertising to increase consumer interest in products and/or services. In return for an endorsement, athletes are compensated. The compensation structure and the respective duties of the company and the athlete are written into a contract. Endorsement deals are structured in a variety of ways and can range anywhere from more than \$100 million to nothing more than free equipment. Arrangements can include base pay (up front followed by additional payments), bonus payouts for major victories or accomplishments, lifetime contracts that extend beyond the playing duties of the athlete, revenue sharing deals (royalties), or even equity stakes in the company. For example, Brady receives Under Armour stock instead of cash. The value of his Under Armour stock is estimated to have grown 800% since 2010.

Endorsement contracts give a company the legal right to use the player's name and image. The player's name and image can be used in many forms, such as print media, online or television. The contract determines if the athlete is expected to use the company's products or wear the company's logo, specify when and how the products must be used or the logo displayed, including the size and placement of the logo. If the athlete will make any personal appearances, the contract specifies the number of appearances, the time commitment required, any geographic restrictions and travel details. As a general rule of thumb, the contract contains the who, what, when, where, why and how of each obligation.

Also included in the contract are causes for termination of the endorsement contract. Athletes can succumb to injuries and ineffectiveness, significantly lowering their value as endorsers. Athletes can also find themselves embroiled in scandals, from "on-field" issues such as the use of performance enhancing drugs, to tabloid material such as drunken melees in strip clubs. Most endorsement deals include termination provisions that can be triggered if the athlete is unable to compete for a significant time for any reason and/or for "bad behavior" which diminishes the endorsement value.

Accounting for endorsement contract costs raises interesting, but often difficult, accounting questions under both GAAP and Federal tax law. Should these costs be immediately expensed on the financial statements and income tax returns or should they be capitalized and amortized over some future benefit period? Are they advertising expenses or do they become products costs only recoverable when the endorsed products are sold?

To address some of these issues, consider the following hypothetical set of facts. Assume Matt Ryan agrees to endorse Nike products in exchange for a five-year endorsement contract which begins on January 1, 2017 and expires on December 31, 2021. Ryan will be paid a total of \$50 million dollars in \$10 million dollar increments over a five-year period. In addition to the \$50 million, Nike will pay Ryan \$1 million dollars if he is the league MVP, \$500,000 if he leads the league in passing, and \$5 million dollars if he wins the Super Bowl. Ryan is eligible for these bonus payouts based on performance each of the next five seasons. The contract also specifies termination provisions stating that Ryan will not receive any remaining amounts on the contract if he dies, if he is convicted of a felony, or if he violates the substance abuse policy of the NFL.

The Case Discussion Questions

Address the following six discussion questions:

1. Should Nike capitalize the cost of the endorsement contract with Ryan and amortize the costs over the next five years or expense the payments when the payments are made?
2. Should Nike allocate the endorsement contract costs to the affected products as product costs and include in cost of goods sold, or should they consider the costs as operating expenses?
3. Should Nike carry a liability on the books in case Ryan dies, is convicted of a felony, or violates the substance abuse policy of the NFL? What if Ryan does something not included in the provisions of the contract, but that does not reflect well on a corporation's products?
4. Should Nike accrue for the bonus payouts? If so, when?
5. Should Nike disclose the specific details of this endorsement contract in the financial reports they are required to publish?
6. How do endorsement contracts fit into the Internal Revenue Code and Treasury Regulations treatment of expenses? Specifically, what is the proper income tax treatment for Nike's endorsement contract with Ryan? What journal entries would be made to reflect the proper income tax treatment over the five year period of the contract?

CASE TEACHING NOTES FOR FACULTY

Following are suggested solutions to the discussion questions. Relevant references to the FASB Codification are included in parenthesis.

Suggested Solution to Discussion Question 1

Question 1 stated, "Should Nike capitalize the cost of the endorsement contract with Ryan and amortize the costs over the next five years or expense the payments when the payments are made?" Students could identify these arguments favoring capitalization:

- Capitalization of costs is allowed when there is an economic value that will benefit future periods. Endorsement contracts certainly can have future economic benefit such as increased brand recognition and sales. In a study released by Harvard Business School, findings suggest that brands endorsed by high-profile celebrities generate on average \$10 million in additional sales annually and a nearly .25% increase in stock returns (Elberse & Verleun, 2011).
- Capitalizing the endorsement contract costs and amortizing the costs over the contract period presents a better matching of revenue and expense.
- Some product endorsements contracts may be considered executory contracts (contracts which stipulates parties have duties to perform before it becomes fully executed). Costs incurred under executory contracts generally are recognized as performance terms under the contract are met (720-35-25-6).
- GAAP does permit capitalization of advertising expense when there is a reliable and demonstrated relationship between total costs and future benefits resulting directly from the incurrence of those advertising costs (340-20-25-16).

Students could identify these arguments favoring expensing in the current period:

- Endorsement contracts may be considered a form of advertising. For most forms of advertising, a company does not expect its advertising to translate immediately into

higher revenue. While one goal of advertising is, in fact, to stimulate short term sales, advertising is often designed to increase awareness and interest among perspective buyers or simply bolster a corporation's image. Since the link between an advertising expenditure in one period and any specific consumer purchases in a subsequent period is difficult or impossible to verify, GAAP requires most advertising and other selling costs to be expensed as incurred (720-35-25-1).

- Executory contracts should be evaluated to determine whether the costs recognized under such contracts are advertising costs. To the extent that those costs are advertising costs, GAAP requires such costs to be expensed (720-35-25-6).
- If the costs are capitalized, an appropriate amortization period may be difficult to determine. For instance, what amortization period is appropriate for lifetime contracts that extend beyond the active playing duties of an athlete?

Nike states in the notes of their annual report that, "although endorsement payments are based on specific contract provisions, endorsement payments are *generally* expensed on a straight-line basis over the term of the contract. Prepayments made under the contracts are included in Prepaid Expenses or Other Current Assets" (Nike 2016).

If Nike were to expense Ryan's contract, Nike would record this journal entry on December 31 each year for five years when an endorsement payment is made to Ryan:

Endorsement Contract Expense	10,000,000
Cash	10,000,000

However, if Nike capitalized the cost of the endorsement contract, Nike would record the following journal entry on January 1, 2017 to recognize the future economic benefit of the contract (intangible asset) and the future payments to Ryan as stipulated in the contract (liability):

Endorsement Contract Asset	50,000,000
Endorsement Contract Liability	50,000,000

On each December 31 for the next five years, Nike would record this entry to amortize the cost of the contract:

Endorsement Contract Expense	10,000,000
Endorsement Contract Asset	10,000,000

And, this entry to record payment to Ryan:

Endorsement Contract Liability	10,000,000
Cash	10,000,000

Under Armour states in the notes of their annual report "that payments are based upon specific contract provisions and the payments are generally expensed uniformly over the term of the contract after recording expense related to specific performance incentives once they are deemed probable" (Under Armour 2016).

Suggested Solution to Discussion Question 2

Question 2 stated, “Should Nike allocate the endorsement contract costs to the affected products as product costs and include in cost of goods sold, or should they consider the costs as operating expenses?”

A major expense on many companies’ income statement is cost of goods sold – the cost to acquire and produce inventory sold to customers. Companies must determine which costs to “attach” to inventory, referred to as product costs. Product costs are directly connected with bringing inventory to a company’s place of business and converting inventory to a salable condition. In contrast, period costs are costs indirectly related to the acquisition or production of inventory. Period costs include selling, general and administrative, and other operating expenses. Since endorsement contracts are most often considered a form of advertising, which is a selling cost, the endorsement contract costs should be expensed as an operating expense rather than allocated to inventory and included in cost of goods sold (330-10-30-8). Nike discloses in their annual report that the costs of endorsement contracts, along with advertising and promotion costs, are considered operating costs called “demand creation expenses” (Nike 2016).

Suggested Solution to Discussion Question 3

Question 3 stated, “Should Nike carry a liability on the books in case Ryan dies, is convicted of a felony, or violates the substance abuse policy of the NFL? What if Ryan does something not included in the provisions of the contract, but that does not reflect well on a corporation’s products?”

In general, endorsement contracts are risky. Future performance is a risk. Athletes lose form, experience injury, and become involved in scandals. When Tiger Woods admitted to cheating on his wife, many sponsors dropped their contracts with Woods. Nike, who quickly ditched Lance Armstrong when he admitted to cheating with illegal drugs, stood by Woods. Their argument was that Armstrong’s integrity of performance was in question. Woods did not cheat to achieve his success in golf. One study estimates that the shareholders of Wood’s sponsors collectively lost up to \$12 billion amidst the scandal (UC Davis Press Release 2009).

Should companies record a liability for the possible risk associated with their endorsers? The definition of a liability is a probable future sacrifice as a result of a past transaction or event. GAAP requires uncertain liabilities, or contingencies, to be recorded when it is probable the future event will occur and the amount of the loss can be reasonably estimated (450-20-25-2). Mere exposure to general or unspecified business risks do not meet the conditions for accrual (450-20-25-8). Therefore, liabilities should not be carried on the books for *possible* risks related to the actions of their endorsed athletes.

Furthermore, athletes contracting with companies such as Nike, are considered independent contractors, not employees. Companies are generally not exposed to liability for acts of independent contractors as they are vicariously liable for acts of their employees (Section 409, Restatement of Torts (Second), 1965). As a result, it is difficult to imagine a circumstance in which a liability would be probable and the amount reasonably estimable arising from the act of the independent contractor athlete, which would warrant recording a liability on the company’s balance sheet. For example, although Tiger Wood’s marital indiscretions may have lessened the advertising value of his contract, they did not create a liability for his endorsee, Nike.

Termination clauses are important components of endorsement contracts to allow the companies the ability to end the endorsement relationship for a variety of reasons. Typical reasons for termination include, death of the athlete, conviction of a felony, violations of the league's substance abuse policy, failure to appear for public promotion of company products, or conduct that sheds a negative or disparaging light on either the athlete or the company. If the endorsement contract is terminated, the company's obligations cease. No further compensation would be paid to the athlete. If Ryan does something the company feels does not reflect well on their image, the contract could be subject to termination.

Suggested Solution to Discussion Question 4

Question 4 stated, "Should Nike accrue for the bonus payouts? If so, when?"

Certain endorsement contracts provide for bonuses to be paid to endorsers upon specific victories or accomplishments in their sports. If Ryan had won the Super Bowl, he would have earned a bonus worth millions. In our hypothetical example, Matt Ryan's contract included annual incentive based compensation as follows: five million dollars for a Super Bowl victory, one million dollars for Most Valuable Player award and five hundred thousand dollars for being the leading passer in the NFL.

Rafal Nadal, one of the best tennis players in the world, is also sponsored by Nike. His contracts include bonuses contingent upon winning major championships such as Wimbledon or the US Open. Both Nike and Under Armour disclose in their annual report that these bonus payouts are accrued in their financial statements only when the endorser achieves the specific goal set in the contract.

Based on our hypothetical facts, if the Atlanta Falcons had won the 2017 Super Bowl, Nike would record the incentive bonus when cash is paid to Ryan, assuming this would be soon after the win:

Endorsement Contract Expense	\$5,000,000
Cash	\$5,000,000

Suggested Solution to Discussion Question 5

Question 5 stated, "Should Nike disclose the specific details of this endorsement contract in the financial reports they are required to publish?"

Companies are required to disclose in their annual reports the total amount charged to advertising expense in a period (720-35-50-1a). There are also disclosure requirements for various types of contracts. However, there are no specific GAAP disclosure requirements for endorsement contracts. To determine what and how much to disclose, companies would likely consider what information would be helpful to investors and creditors and what can be disclosed without giving away any competitive advantage. Google searches on endorsement contracts for athletes often will produce general facts and dollar amounts, but not the specifics of the contracts.

Nike's footnotes in their 2016 annual report describes the general accounting treatment of endorsement contracts and some basics on accounting for contracts with prepayments, contracts contingent on specific achievements, contracts based on maintaining a certain level of

performance, and contracts with royalty payments. Nike also notes, “identification with prominent and influential athletes, coaches, teams, colleges and sports leagues who endorse our brands and use our products and active engagement through sponsored sporting events and clinics” is important to remain competitive in their industry and credit their recent earnings growth to, “deep brand connections with consumers...reinforced by investments in endorsements by high-profile athletes, sports teams and leagues...” However, Nike does not disclose in their annual report any specific details on their endorsement contracts with their endorsers or even the athletes or celebrities who endorse their products.

Under Armour’s disclosures of their endorsement contracts, which Under Armour refers to as sponsorship programs, are similar in detail to Nike (Under Armour 2016 10-K). One additional disclosure Under Armour provides is the expected future minimum payments for sponsorship contracts and marketing agreements over each of the next five years and an aggregate amount for beyond five years.

Suggested Solution to Discussion Question 6

Question 6 stated, “How do endorsement contracts fit into the Internal Revenue Code and Treasury Regulations treatment of expenses? Specifically, what is the proper income tax treatment for Nike’s endorsement contract with Ryan? What journal entries would be made to reflect the proper income tax treatment over the five year period of the contract?”

Internal Revenue Code Section (“Code”) 162 provides a current deduction for ordinary and necessary expenses incurred in a trade of business. Advertising expenses are specifically mentioned in Treasury Reg. 1.162-1(a) as ordinary and necessary business expenses if they are reasonable in amount and relate to the businesses’ activities, and as such, are currently deductible from gross income.

An examination of case law and regulations provide no insight on how endorsement contracts are dealt with. The Supreme Court in *Indopco v. Commissioner*, 503 U.S. 79 (1992) analyzed the deductibility of banking and professional fees incurred in a corporate acquisition under Code Section 162 as ordinary and necessary business expenses. The Court was faced with the question whether to allow a current deduction for the fees or to require capitalization of the same. It initially focused its analysis on the doctrine that current deductions are a matter of legislative grace and the taxpayer bears the burden showing the right to the deduction. 503 U. S. at 84. The Court continued by asking whether the taxpayer enjoyed some future benefit beyond the current year. If it does, capitalization of the expenditure is warranted. 503 U. S. at 87, 88. Finally, it determined the transaction produced important benefits beyond the current year and required the costs be capitalized. 503 U. S. at 90.

Although the *Indopco* case involved corporate acquisition costs and not advertising expenses, the principle announced in the case, i. e., costs which create significant long term benefits require capitalization, could well impact tax treatment of advertising costs. All advertising is intended to provide some long-term benefit to the advertiser, such as brand or name recognition. Does *Indopco* require all advertising, including endorsement contracts, to be capitalized? The Internal Revenue Service (“Service”) answered that question in Revenue Ruling 92-80, 1992-2 CB 57. In Revenue Ruling 92-80 the Service raised and resolved the question whether *Indopco* impacted the deductibility of advertising costs under Code Section 162. Without much analysis, the Service held *Indopco* does not affect the deductibility of advertising costs under Code Section 162 “even though advertising may have some future effect on business

activities, as in the case of institutional or goodwill advertising.” The Service further stated, “Only in the unusual circumstance where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising, must the costs of that advertising be capitalized.”

Does an endorsement contract, paying Matt Ryan \$50 million in increments of \$10 million for endorsing products over a five-year period, create future benefits significantly beyond ordinary product advertising and require capitalization? A strong argument could be made that such an endorsement contract does exactly that.

If the endorsement contract costs are viewed as creating an intangible asset for the company, the costs become part of the basis of the property per Code section 1012. Three alternative Treasury regulations support capitalization of these costs. If the costs are considered as amounts paid to acquire or create intangible assets, Treasury regulation 1.263(a)-4(b) mandates capitalization. Use of an athlete’s likeness in advertising products and/or his or her endorsement of specific products could be considered to create an intangible asset since the endorsement contract is generally exclusive to a company for its specific products. Second, the endorsement contract could be viewed as creating a prepaid expense for advertising under Treasury regulation 1.263(a)-4(d)(3). Third, an endorsement contract requiring an athlete to endorse products, appear at promotional events, and make advertising commercials, could also be construed to be an agreement to receive services by the company requiring capitalization under Treasury regulation 1.263(a)-4(d)(6)(i)(B).

The questions remain over what period and under what method are those costs recoverable through amortization deductions? For accrual basis taxpayer, such as publicly traded companies like Nike and Under Armour, a liability is incurred and deductible, when all events have occurred which fix the liability, the amount can be determined with reasonable accuracy, (the “all events test”) and economic performance has occurred. Treasury regulation 1.446-1(c)(1)(ii)(A). For this purpose, the term “liability” includes capitalized costs. Treasury regulation 1.446-1(c)(1)(ii)(B). The all events test would be met when the endorsement contract is executed. The issue is when does economic performance of the contract occur?

In a situation where the liability arises out of performing services to the taxpayer by another person, economic performance occurs, and a deduction is allowed, when services are provided to the taxpayer. Treasury regulation 1.461-4(d)(2). Assuming Matt Ryan provides endorsement contract services over the five-year contract period by promoting products, wearing the company’s clothing while competing, appearing at new product releases, making commercial endorsing company products, etc., the capitalized contract costs should be deductible ratably over the five-year period.

The following journal entries illustrate this process. Year 1 when contract is first entered into:

Ryan endorsement contract	\$50,000,000
Ryan endorsement contract liability	\$50,000,000

At the end each of the years 1 to year 5:

Endorsement contract liability	\$10,000,000
Cash	\$10,000,000
Endorsement contract expense	\$10,000,000
Ryan endorsement contract	\$10,000,000

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