Off-balance sheet R&D assets and market liquidity

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Abstract

Statement of Financial Accounting Standards (SFAS) No. 2 (FASB, 1974, para. 12) mandates that all research and development (R&D) spending be immediately expensed. Lev and Sougiannis (1996, p. 134) indicate that off-balance sheet R&D assets (as a proxy for the future payoffs from R&D spending) provide investors with reliable and relevant information. However, usefulness is a necessary but not a sufficient condition for financial reporting regulation (Lev, 1988, p. 2). Rather, regulators have a mandate to maintain public confidence in the securities markets as a level playing field by mitigating information asymmetry or ex ante inequity ( Levitt, 1998, p. 79). In this study, we document the information asymmetry effects associated with off-balance sheet (unrecorded) R&D assets using a market microstructure methodology. Collectively, the evidence suggests that a potential harm (lower market liquidity) is associated with the current accounting treatment of R&D spending. © 2001 Published by Elsevier Science Ltd.

1. Introduction

By requiring that corporate research and development (R&D) spending be immediately expensed, Statement of Financial Accounting Standards (SFAS) No. 2 (FASB, 1974, para. 2) potentially creates a mismatch between costs and subsequent benefits. Potentially, these off-balance sheet (unrecorded) R&D
benefits could generate ex ante inequity in the capital markets in the form of an information gap (asymmetry) between informed investors and other investors. The prior literature (e.g., Brennan and Subrahmanyam, 1995, p. 361) indicates that trading by informed investors (i.e., investors with access to private information or the analytical ability to extract private information from publicly available data) can impose “significant liquidity costs on other market participants due to adverse selection.”

The purpose of our paper is to examine the information asymmetry effects associated with off-balance sheet (unrecorded) R&D assets. In particular, our study seeks to examine a potential harm (lower market liquidity) associated with the current accounting treatment for R&D expenditures.¹

Lev and Sougiannis (1996, p. 134) indicate that R&D capitalization would provide investors with “statistically reliable and economically relevant information.” However, usefulness is a necessary but not a sufficient condition for financial reporting regulation (Lev, 1988, p. 2). Rather, regulators (such as the Securities and Exchange Commission) have a mandate to maintain public confidence in the securities markets as a level playing field by mitigating information asymmetry or ex ante inequity (Levitt, 1998, p. 79).

As noted by Glosten and Milgrom (1985, pp. 72–74), information asymmetry can lead to adverse economic consequences in the form of higher bid-ask spreads. Higher spreads have been shown empirically to be associated with higher stock returns (which implies a higher cost of capital), a finding consistent with the notion that investors have to be compensated for holding less liquid stocks (Amihud and Mendelson, 1986, p. 246). We utilize the adverse selection component of the spread and the quoted depth as observable proxies for information asymmetry.

In this paper, we utilize intraday stock transactions data to measure the average adverse selection component of the bid-ask spread and the quoted depth during 1995 and 1996 for our sample firms. Our approach is based on theoretical models which indicate that the market maker (dealer) is not in the business of conducting private information search and is therefore at a disadvantage relative to information motivated traders; consequently, faced

¹ We thank an anonymous reviewer for pointing out that the potential harm, i.e., the economic costs and social costs, associated with how accountants treat R&D spending has not been satisfactorily addressed in the prior literature. On the subject of unrecorded R&D assets, Rimerman (1990, p. 82) notes that these “intangible, unmeasured assets have great importance in an economy increasingly dependent on expertise, data and technology, an economy in which an expanding service sector does not rely on fixed assets as the primary generator of revenue” (p. 82). Similarly, Swieringa (1998, p. 47), a former member of the Financial Accounting Standards Board, suggests that the current financial accounting model (which is reflective of traditional organizations that invest heavily in tangible fixed assets) is increasingly outdated in the context of increased investments in intangible, knowledge-based assets.
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