Accounting and Business Research
Publication details, including instructions for authors and subscription information:
http://www.tandfonline.com/loi/rabr20

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Published online: 04 Jan 2011.

To link to this article: http://dx.doi.org/10.1080/00014788.2008.9663335

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A reply to Lev’s rejoinder to ‘Accounting for intangibles – a critical review of policy recommendations’

Douglas J. Skinner*

1. Introduction
Baruch Lev has written a thoughtful response to my commentary on policy recommendations for intangibles. I am glad that my paper has generated a response from Professor Lev, who is acknowledged as perhaps the leading expert on this topic, because I think the way we make progress on questions such as this is to engage in dialogue. Lev’s response does not change my views – I still believe that the case in favour of intangibles reform is underwhelming. Rather than reiterating points I have previously made, let me respond to some of Professor Lev’s specific comments and simply encourage the reader to read both pieces carefully and reach their own conclusions.

2. The role of market incentives
Lev points out that one of the themes in my commentary is a reliance on markets to solve financial reporting problems. My response to this is that, to paraphrase an old song, ‘if believing in markets is wrong, I don’t want to be right.’ I am not repentant; I do believe that markets work well most of the time. In my article I provide a number of examples of how markets seem to work well in allocating resources to intangibles-rich technology companies, in spite of what Lev would characterise as overly conservative accounting. The technology sector has boomed over the last couple of decades, in spite of apparently being hamstring by the traditional financial reporting model. Lev does not respond in detail to these arguments but rather asks why we don’t allow markets to solve all of our financial reporting problems. To some degree I agree with what seems to be an extreme position. After all, as Watts and Zimmerman (1983) pointed out some time ago, there is evidence that audited financial statements, in a form similar to what exist today, have been used for hundreds of years, and so easily predate any form of securities regulation.

My argument is also more complex than Lev’s discussion implies. From an economic perspective, I do think there is a role for regulators such as the FASB and the SEC. I agree with the position in the Garten (2001) report that regulators can help improve financial reporting for intangibles in at least two ways. First, no single entity has incentives to develop an overall disclosure framework for intangibles. Yet it seems that developing such a framework would be useful in standardising and encouraging disclosure. Second, if we do agree that firms should disclose more information about intangibles (if we can somehow ascertain that the market is supplying too small a quantity of intangibles disclosures) perhaps we should lower the costs of these disclosures. For example, if these disclosures subject firms to legal risks, perhaps some type of safe harbour can be utilised to encourage more disclosure, similar to what is already done by the SEC in the area of forward-looking statements.

3. Previous research on intangibles
Lev argues with my conclusion that there is no evidence that current financial reporting requirements result in lower valuations for companies that incur significant expenditures on research and development (R&D) and other intangibles. His claims here are again a bit too broad. Let me make two points in response to what he has written. First, I believe that it is not unreasonable to argue that studies of apparent mispricing in securities markets (i.e. of accounting anomalies) are difficult to interpret; see, for example, Kothari’s (2001) review of capital markets research. Without a well-accepted model of expected returns, it is hard to know for sure whether stocks that appear to earn excess returns are truly undervalued or whether we have failed to correctly account for risk in modeling expected returns. This is well-known and is not controversial. Moreover, it is not correct to say, as

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Lev does, that ‘this criticism … can be levelled at practically any market-based accounting or finance research.’ I think it is clear that I am only talking about a particular class of studies.

Second, Lev does not address an important part of my argument. I argue that there is little evidence that changing the way we currently account for and report intangibles would change the capital market effects described in these studies. For example, in the US, R&D is transparently disclosed to investors on the income statement. Given that information about R&D is disclosed to investors, how do we know that changing the way we account for it would affect capital market decisions? Are we convinced that by capitalising R&D expenditures (or some part thereof), capital markets would somehow get it right? This seems to imply that capital markets rely mechanically on the way that accountants account for and report various items, which is a conclusion that I see as fairly controversial given extant evidence.

4. Growth in R&D and advertising
In my commentary, I plot aggregate real expenditures on R&D, capital, and advertising to show that aggregate R&D has grown significantly over the past 20–30 years, and that this growth outstrips that of capital expenditures, which are capitalised. This seems inconsistent with critics’ claims that accounting for intangibles (the immediate expensing of R&D and advertising expenditures) has unduly handicapped investments in intangibles. Lev responds by showing that R&D and advertising intensities (expenditures deflated by sales) are basically flat, and argues that this instead is the right metric. I have a couple of observations about this. First, if we’re interested in drawing conclusions about whether overall investment in intangibles is somehow ‘too small’, it seems to me that the aggregate numbers are of interest, similar to economists’ focus on GDP. But differently, it is not clear to me why we should be concerned that R&D as a percentage of sales has stayed roughly constant over time – perhaps this is the ‘correct’ level of R&D spending by firms. Second, by deflating by sales, the trend in these ratios will be affected by changes in the underlying Compustat population. Different industries naturally have different R&D intensities, which makes trends in aggregate ratios difficult to interpret.

5. What’s to be done?
Let me address two points that Lev makes in this section. First, he agrees with those who point to the fact that market-to-book ratios are ‘too high’ as evidence that we should capitalise intangibles. My response to this argument is that the role of the balance sheet is not to arrive at a book value that tracks market value. I stand by this view even though Lev points out that the FASB takes a balance sheet approach and so would be ‘surprised’ by my view. Perhaps, but I think I am in good company in claiming that the balance sheet’s role is not one of valuation (e.g. Holthausen and Watts, 2001).

Second, he claims that there is a good deal of evidence which supports his position that intangibles should be capitalised. Without going into detail about each of these studies, suffice to say that they are principally of the ‘value relevance’ type. As is discussed elsewhere (e.g. Holthausen and Watts, 2001; Skinner, 1996), there are good reasons why drawing policy conclusions from this type of study is problematic.

6. Postscript
Lev argues at a number of junctures that I make overly-sweeping statements. Yet at the end of his article he lays the blame for the NASDAQ tech bubble, the Enron accounting scandal, and the recent sub-prime financial crisis on our ‘outdated’ accounting model. While I could address each of these claims more specifically, it seems to me reasonable to simply observe that blaming the current accounting model for all of these problems is a rather sweeping conclusion.

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