



Contents lists available at ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

journal homepage: www.elsevier.com/locate/adiac

Does the classification of intangibles matter? An equivalence testing

Indra Abeysekera *

CQUniversity - Sydney Campus, 400 Kent Street, Sydney, NSW 2000, Australia

ARTICLE INFO

Article history:

Received 30 June 2015

Received in revised form 27 February 2016

Accepted 29 February 2016

Available online xxxxx

Keywords:

Analysts

Disclosure

Intangibles

Transparency

ABSTRACT

Many studies confirm that intangibles have future economic benefits included in them. This study examined whether analysts consider intangibles to be similar in economic value, regardless of the accounting treatment assigned to them. It conducted four experiments by providing 26 analysts with future earnings potentials, and asking them to forecast stock prices for three companies over three firms' continuous years. One firm had an internally produced brand, the second company had a bought brand, and the third firm had an internally produced brand and bought brands. These three firms were used in four forecasting environments designed for this study. Each forecasting environment constituted an experiment. Each forecasting environment differed, with capital market information specific to each firm. Provided with this information, the analysts forecast stock prices for the three firms in each of the four experiments. Comparing the forecast stock prices, the study found that the two brand classes had similar influence on analysts' stock pricing forecasts, to infer them as equivalent in economic value, in each of the four forecasting environments.

© 2016 Elsevier Ltd. All rights reserved.

1. Introduction

Penman (2009) argues that although accounting is criticised for showing some intangibles only on the balance sheet, such criticism has little basis as the income statement can help in ascertaining the value of intangibles. Penman points out that the value of intangibles can be measured directly or indirectly by capitalising the earnings, because the difference between market value and book value is the same across reporting periods. Longren (2009) extends this proposition by proposing top-down residual methodology (TDRM) as a technique to measure the value of intangibles. Beginning with the market value of the firm, the TDRM removes the value of tangibles and measurable intangibles from it to arrive at the value of unmeasurable intangibles. Longren notes that a perceived difficulty is obtaining market value of measurable assets, which can increase the variation in measurement error. Such measurement error can be decreased by ascertaining the discounted cash flows or capitalised earnings. Hunter, Webster, and Wyatt (2012) show that the distinction between measurable and non-measurable intangibles is supportable on the basis of property rights, but not on economic grounds. This raises the question—regardless of the technique used to measure the value of intangibles—of whether analysts will conclude that that intangibles shown on the balance sheet and those not shown on the balance sheet because of accounting rules, but having the same earnings potential, have an equivalent value.

Many research studies show that firms investing in intangibles such as brands and staff increase productivity (OECD, 2011). However, firms

often disclose about these intangibles with narratives and visuals in annual reports and other public documents. For instance, a firm can make comments about its brands, and how it serves consumers by consistently meeting their expectations. Brands are a source of competitive advantage to sell products and services across geographies. Many studies have shown that intangibles such as brands contain future economic benefits (for a review, see Zeghal & Maaloul, 2011). Nevertheless, it is seldom that firms disclose expected earnings arising from such intangibles in annual reports.

If a firm makes a separate acquisition of an intangible (i.e., “bought”), the cost will be capitalised (IAS 38, paras. 25–31) whereas if the cost pertains to an internally produced intangible, the cost is often expensed as incurred (IAS 38, paras. 51–64). However, when an intangible is bought separately, the uncertainty about future economic benefits is generally lower (e.g., an already developed brand) compared to an intangible currently being developed (e.g., brand being developed), which to some extent justifies the different accounting treatments. Luft and Shields (2001) found that intangibles being entirely expensed decreased individuals' capability in accurate profit predictions as it diminished the self-insight, consistency, and consensus among individuals. Thus, the two classes of intangibles may not fully comparable in forecasting future economic benefits arising from them, and this needs to be investigated.

The impact of the treatment of intangibles in financial accounting and reporting can lead to a difference in how analysts notice financial performance and economic wealth in firms from annual reports (Demers, 2002). This is because accounting explains that expenses have no separably identifiable future economic benefits, whereas assets do. Empirical evidence, however, shows that intangibles have future

* Tel.: +61 417 405 399.

E-mail address: indraabeysekera@gmail.com.

economic benefits, whether the cost of an intangible is an expense or an asset (Penman, 2009).

Since expensing intangibles can decrease the accuracy of future predictions of profits (Luft & Shields, 2001), firms can help analysts to overcome this difference in view stemming from the principles of accounting, by disclosing future economic benefits in narrative and visual forms. Such reporting, although it helps users to understand that intangibles have future economic benefits, does not quantify those benefits. This study conducted four experiments to find out whether firms' providing earnings forecasts about intangibles can resolve the difference in view about intangibles produced within the firm and intangibles bought from outside. The participants chosen for these experiments were analysts because they would be able to respond to the scenarios provided using their real-life experience.

This study expected analysts to decide the value of an intangible by its future economic worth rather than by using the principles of accounting, because of their practical experience in evaluating firm performance. Analysts would then decide that the class of intangibles has no practical implications. If an intangible produced within the firm and a bought intangible have identical expected earnings, then analysts should treat them as similar in producing economic worth when forming their stock pricing forecasts.

This study tells whether firms' providing expected cash flow forecasts about intangibles can remove differences in views about classification of intangibles possibly held by analysts. Second, it tells policy makers to think about whether firms should provide earnings forecasts of internally produced and bought intangibles. Third, it shows an application of equivalence testing.

2. Research Methodology

2.1. Participants

The 26 analysts who took part in the study were analysts working in stockbroking firms licensed by the Colombo Stock Exchange in Sri Lanka. Seven were females. All participants routinely analyse information about firms and make stock forecasting decisions in their jobs. Most analysts had remained in the role for an average of three years (standard deviation 3.59). Hunton, Libby, and Mazza (2006), and Libby, Bloomfield, and Nelson (2002) encourage using experienced people as participants, as they have learned the costs and benefits of making decisions, but experience alone and analysts' forecast accuracy have yielded inconclusive results in prior studies. Although Clement (1999) found analysts' firm-specific experience to be related to forecasting accuracy, Jacob, Lys, and Neale (1999) found no such relationship. The participants in this study with job titles comprised 19 analysts, two analyst research managers, four heads of research analysts, and one analyst CEO. All participants were involved in analysing stocks and forecasting stock prices in their firms. Except for three who have a high school certificate, the participants have one or more formal-education qualifications: 13 participants have a bachelor's degree, six have a master's degree along with a bachelor's degree, 16 have a professional accounting qualification only or with degree qualification, and two are chartered financial analysts with degree qualification.

2.2. Procedure

Following the protocols of the ethics approval from the tertiary institution, the researcher administering experiments visited workplaces of participants and conducted the experiments in-house in 2008. This study tested analysts' stock price forecasting response to the brand classes over three continuous years using experiments. The experiments provided cash flows and earnings information over the next five years where analysts needed to forecast stock prices for the

next three years (Collins, Kothari, Shanken, & Sloan, 1994; Lundholm & Myer, 2002).

Experiment One allowed participants to consider any reasons influencing stock price forecasts. Experiment Two gave dividend yields of firms, but other than that, allowed participants to consider any factors that can influence stock pricing forecasts. Experiment Three gave market-to-book value, but other than that, allowed participants to consider any other reasons that can influence stock pricing forecasts. Experiment Four provided market-to-book value and dividend yield simultaneously, but other than that, participants could consider any other reasons that can influence stock pricing forecasts. The reasons not controlled in experiments can randomly influence analysts' view about future economic benefits in intangible classes, and stock pricing forecasts (Fig. 1). In each of the four experiments, participants made stock price forecasts for three firms, for three future years. Previous studies show that as the forecasting year becomes further away from the current year the forecasting accuracy decreases (Collins et al., 1994; Lundholm & Myer, 2002).

Before taking part in experiments, the participants read the cover sheet. It explained the activities involved in the experiments, and the tasks participants should complete. It also explained the firms' financial year ended on 31 December 2007. The cover sheet told participants that each firm recorded earnings of 50 million Sri Lankan Rupees (Rs.) (profits after tax) for the year ended 31 December 2006, and Rs. 50 million for the year ended 31 December 2007. The 31 December 2006 annual report became publicly available on 1 April 2007, and the stock price soon after its release was Rs. 65. The 31 December 2007 annual report became available on 1 April 2008. The stock price soon after the release of the annual report was Rs. 100 and the market capitalisation was Rs. 250 million for each firm. On 1 April 2008, analysts began forecasting stock prices for the three future years.

The study required participants to take part in all four experiments. Each experiment had information about three firms. Firm One had an internally produced brand, called Brand A. Firm Two had a bought brand called Brand B. Firm Three had an internally produced brand (Brand A), a bought brand (Brand B), and a bought brand now sold (Brand C). Each firm had an expected profit after tax of Rs. 65 million a year, in each of the next five years. Firms Two and Three had bought brands. Their useful lives were not given to participants. Participants could assume any useful or indefinite life. Participants could assume amortisation and/or impairment expense for bought brands in Firms Two and Three. Similarly, participants could assume any other factors not mentioned in the experiment (example, industry membership) that could contribute to differences in future earnings. On the other hand, if analysts believed that future cash flows were the only basis to determine worth of intangibles, then other factors would have little influence in varying the forecast stock prices.

Firm One (Brand A) and Firm Two (Brand B) are sufficient to test the influence of brand classification on analysts' stock pricing forecasts. This study however, included Firm Three (Brands A, B, and C) to enable a cleaner test of the underlying theory (Libby et al., 2002).

Each participant received an envelope containing the cover sheet outlining the information and details of Experiments One to Four. The participants read the cover sheet first, and undertook each experiment in the order provided. Participants needed to identify whether firms should expense, capitalise, or expense and capitalise the intangibles for the year ended 31 December 2007, for the three firms in each experiment. This ensured that analysts had understood the manipulated levels of the variable of interest in this study. Firm One had an internally produced brand needing to be expensed, Firm Two had a bought brand needing to be capitalised, and Firm Three had internally produced and bought brands needing to be expensed and capitalised. On the last sheet participants listed their qualifications, methods used to forecast stock prices, and their understanding of the statement of cash flows in the annual reports. This study used a five-point Likert scale for the last activity. The question asked about analysts' understanding of the

Download English Version:

<https://daneshyari.com/en/article/7339954>

Download Persian Version:

<https://daneshyari.com/article/7339954>

[Daneshyari.com](https://daneshyari.com)