Do Accounting Rules Discourage Research & Development?

Businesses spend billions of dollars trying to develop new and better products, These outlays are referred to as research and development (R & D) costs. Accounting rule makers have struggled with how best to classify such expenditures. Should they be treated as expenses or assets? The classification of an outlay as an expense or an asset depends upon how long the firm will benefit from the outlay. If the benefit will be for more than one accounting period, it is classified as an asset. If the outlay provides economic benefit for less than a year it is generally classified as an expense. Tangible assets such as machinery and equipment produce income over several years. These tangible assets usually have easily ascertainable costs, which are spread over the assets' estimated useful lives in the form of depreciation expense. On the other hand, one month's rent payment is an expense because the outlay entitles the firm to only one month of economic benefit. Now consider the following example of an R & D cost. Example. Mizer Pharmaceutical has in the last five years spent $65 million on research and testing of a male enhancement pill that actually works and can garner FDA approval. The five years of research and development outlays has lead to the development of an effective pill that they will market and patent under the trade name Mirakle Grow. Market research indicates that it will generate at least $1 billion in sales annually as long as they hold the exclusive patent. Since the R & D outlays have lead to the development of a pill that will generate significant revenue over several years you would expect that the outlays would be classified as assets rather than period expenses. Well you would be wrong. In fact, accounting rules require that R & D costs be treated as expenses rather than assets even though these outlays clearly are intended to benefit future accounting periods. There are two reasons why accounting rules treat R & D outlays as expenses. First it is a cruel fact of life that not all R & D outlays lead to the development of marketable products. In fact, a relatively low percentage of such outlays lead to successful products. For example, it may turn out that the Mirakle Grow drug has adverse side effects that would preclude FDA approval. A second problem in treating R & D costs as assets involves deciding their useful life. Assuming that successful R & D costs can be identified, over what period of time do we spread or amortize these costs? If the R & D costs lead to a patent we could simply use the life of a patent as our guide. But what really matters is the life cycle of a successful new product, not the period of patent enforceability. Who knows how long a period that should be? In the case of Mizer's male enhancement pill it is entirely possible that an alternative pill developed by a competitor could provide stiff competition to Mirakle Grow. If this occurs demand for Mirakle Grow might peter out in a much shorter period of time than the life of the patent. If accounting rules allowed the treatment of R & D costs as assets, management would be sorely tempted to record both unsuccessful and successful outlays as assets. This would lead to the overstatement of assets, the understatement of expenses and in turn the overstatement of income. Even if management were neutral and fair minded it is often impossible to predict which R & D costs will lead to successful products and which will not. Unintended Consequences Accounting rule maker's decision to not treat R & D costs as assets probably has undesirable consequences for firms and society as a whole. In the current environment in which publicly traded firms are managed there is great pressure on managers to insure that stock prices are maintained. CEO's of large corporations are partially compensated and evaluated based upon their firm's stock price. In turn, stock prices are greatly affected by the current and near term reported earnings of the company. Under current accounting rules a CEO interested in short-term earnings will avoid long term R & D commitments because they will depress current earnings and hence the stock price. However the long-term prospects of a business may be enhanced significantly by increased expenditures on R & D. So the accounting treatment of R & D probably serves as a disincentive to make such outlays despite the fact that such outlays might be in the long run best interest of the firm. Society is probably also better off if companies increase their R & D outlays. So the current R & D rules may be bad for businesses and bad for society as a whole. The rules may prevent individual firms from overstating income and assets in the short run but reduce the income of the firms and the well being of society in the long run.

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