

Understanding Research and Development Accounting

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There's more than one way to account for Research and Development (R&D). A business using the accrual method of accounting will treat R&D costs as expenses. A business contracted to undertake R&D for another company might treat it as an operational cost. If that business retains an element of financial risk, however, both operational costs and R&D expenses can be involved.

These accounting principles do not apply to the costs associated with market research and testing, software development, or—for extractive industries like mining and quarrying—exploratory activities.

What You Need to Know

How does R&D accounting treatment apply to businesses involved exclusively in development activity?

A company that focuses on development and buys in research can treat the cost of that research as expenses, together with the cost of any activity needed to make it into a commercial concern.

How are assets which have been bought to support R&D activities treated?

If assets bought for R&D activities have further uses (either for future R&D or to support core operations), they are capitalized—in other words, recorded as a liability and depreciated over time. This applies to tangible assets like furniture and equipment as well as intangibles like patents and copyrights.

If existing products or processes are improved, does this count as R&D for accounting purposes?

Small improvements made to a product or process in order to maintain its position in the marketplace are not usually treated as R&D. However, significant improvements to quality, design or effectiveness that increase a company's profits will be treated as ongoing maintenance expenses.

What to Do

Define R&D

For the purposes of accounting, “research” can be defined as planned activity that sets out to uncover new knowledge, with the aim of significantly improving existing products or processes, or creating new ones. “Development” is the activity needed to turn this research into the new or improved product or process.

R&D—expense or operational cost?

The professional guidelines for recording R&D costs were designed with the accrual accounting method in mind. Companies using the cash basis method of accounting will record expenses arising from R&D when they are paid.

Companies undertake R&D in the expectation that it will generate significant income from new products and processes. However, the uncertainty of success means that under *Generally Accepted Accounting Principles* (GAAP), costs related to R&D are expensed in the same accounting period in which they are incurred.

When R&D activities are subsidiary to a company’s main business, the associated costs (for example, labor, materials, facilities and services bought in specially) are recorded as expenses in the statement of income. On the other hand, if a company’s main business is to undertake R&D for others, these same costs will appear in the statement under “cost of services delivered.”

When an R&D Provider is Acquired

If a company acquires another whose main business is to conduct R&D, costs are generally reported in the same way as they were by the acquired company. The exception to this is when the combined companies have other uses for assets purchased which were not available to the acquired company on its own.

Overhead and Running Costs

General administrative costs and overheads associated with R&D should be allocated in relation to the project concerned, and expensed at the time they are incurred.

Partnerships

When interested parties decide to work together on R&D, they usually form a limited partnership. The limited partners provide funding, while the general partner manages the day-to-day activities and technical aspects under contract to the limited partnership—generally at cost-plus-margin, or for a fixed fee. Costs are treated either as *cost of services delivered* or *R&D expenses*. For example, costs in relation to the general partner are typically recorded as services delivered during the period of the project, while limited partners record their investment as R&D expenses.

Sometimes the agreement is more complex, so the obligations of each partner are difficult to clarify. For example, the general partner might receive an advance at the start of the project, which is effectively a loan that reduces the price limited partners pay later for the results of the R&D. Most of the general partner's costs will be for carrying out contracted services, but a proportion will also be indirect R&D expenses—how much is directly related to whether the general partner must repay any funds to the limited partners. Any doubt is usually cleared up by the question of financial risk—for example, if a general partner has to repay funds it suggests that the risk of the venture has not been completely transferred to the limited partners.

Other Obligations

In the U.S., the terms of any agreement relating to contracted R&D services must be disclosed in company statements—as must payments received for services and costs incurred.

What to Avoid

Problems with classifying R&D

The most common mistakes made in accounting for R&D arise from its classification. For example, the accounting treatment for R&D does not apply to costs associated with market research and testing, software development, or R&D activities undertaken by extractive industries (like drilling, mining, and exploration). These activities are covered by different guidelines, although if the activities of a mining company (for example) results in new knowledge that is later used to improve processes, the costs will be accounted for as R&D expenses. Similarly, if a software company improves the efficiency of its product as a result of investment in research activities, the investment will be recorded as R&D costs.

Accounting principles do not include in their definition of R&D expenses the purchase, development or improvement of products or processes that are used in sales or administration. Therefore market research and testing—which are essentially about selling—are defined as marketing costs, which are expensed in the same period as the activities took place.

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Web Site:

U.S. Securities and Exchange Commission: www.sec.gov

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