

ASSIGNMENT COVER SHEET

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Unit name	ADVANCED FINANCIAL ACCOUNTING	Unit code	ACC3100
Title of assignment	RESEARCH ASSIGNMENT		
Tutor	CASSANDRA SHIEH		
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Tutorial day & time	TUESDAY 10:30AM		
Due date: 08/10/2020		Date submitted: 08/10/2020	

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Research and development expenditure

ACC3100- Advanced Financial Accounting

Poojitha Sivakumar (28802925)
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Executive Summary

The purpose of this report is to examine the current treatment of research and development cost under the IFRS and AASB. The existing standards have been critically reviewed through the use of academic literature while highlighting the effect of the current standards on the financial reports of the firm. Under the AASB 138, all research costs are expensed in the period it is incurred. Whereas, the development expenditure can be capitalized if all the six conditions are met, otherwise, it is expensed in the period it is incurred in. This leads to several academic critiques and corporate firms raising their criticisms on the detrimental effect on the financial statements of the firm. Although it is important to follow practices that are relevant and beneficial for the firm and economy, the report emphasises on the importance of reliable measurement and the consequences of relaxing the standards on the disclosure requirements. There are significantly high changes of organisations engaging in “creative accounting practices” which will be detrimental to the investors of the firm who are relying on misrepresented and biased financial reports. The recommendations that this report provides will enhance the relevance of reports while controlling the space of creative accounting.

Introduction

Research and development (R&D) play an integral role in the development of the company and maintaining their competitive edge in the dynamic business environment. Research refers to the inquiry-based processes that generate “new scientific or technical knowledge and understanding”. Development refers to the production of new or improvement of existing products, devices, and processes for commercial use through “application of research findings or other knowledge”. The following report examines the literature and highlights the current treatment of R&D expenditure and its effects on the industry’s financial statements. Furthermore, it aims to critically assess the validity of the current treatment and suggest alternative treatments of R&D cost to ensure the success of each company is reflected as accurately as possible.

Requirements under AASB 138 Research and development expenditure

The current accounting standard AASB 138 requires all the costs incurred from research and development to be expensed as it arises. This expenditure takes various forms across various sectors and industries such as software, technology and pharmaceuticals companies. However, there is an exception to when the firm can capitalise development costs, which is if it meets all the requirements of the AASB 138 intangible assets para 57. The standard states that an intangible asset can be recognised only if the future economic benefits are expected to flow to the entity where the cost of the intangible can be reliably measured. Intangible asset is a non-monetary asset which is identifiable but has not no physical substance (AASB, 2020). The issue with the research and development expenditures is the uncertainty of future economic benefits that is likely to flow to the entity, due to the uncertainty the entity will not be able to measure the expenditure reliably. Therefore, the standard requires entities to report all costs related to research and development as an expense. However, Under the AASB138, there are exceptions to when the development expenditures can be recorded as an intangible asset.

AASB138 para 57 provides a criterion with six conditions that must be met before the development costs can be reported as an intangible asset on the financial statement;

- Practical likelihood to complete the intangible asset for sale or use it
- Ability to use or sell the intangible asset
- Intention to complete the intangible asset and sale or use it

- Future economic benefits should be probable, it must have the existence of an active market or internal usefulness of the intangible asset should be proven
- Reliable measurement of the development expenditure relative to intangible asset
- Accessibility of technical, financial and other required resources necessary to complete the development for sale of internal use

The above conditions mean that if the assets acquired have been purchased for alternative uses, then it can be recorded as an asset. All the materials used during the research and expenditure should be charged as an expense while depreciation should be charged over the useful life of the asset. If the entity purchases computer software solely for research and development, then it should be expensed when incurred. Whereas, if the computer software has future use, then it should be capitalised and depreciated over the useful life of the software. If an intangible asset is purchased from a third party with future alternative uses apart from research and development, then it can be recorded as an intangible asset. Otherwise, the purchased intangible asset should be expensed as incurred.

Impact of research and development costs on the financial statements

Under the Generally accepted accounting practices (GAAP) and AASB, the current treatment requires all the research costs to be expensed, which means it will affect the profits of the entity for the period in which it was incurred in. In terms of development expenditure, if it meets all the conditions of AASB138 para 57, it can be capitalised and recorded as an asset (deferred development cost) and expensed for the period in which it generates economic benefit. While the deferred development cost exists in the balance sheet, it needs to be tested for impairment, where the estimation of future economic benefit will be matched against the deferred development costs recorded. If the carrying value is greater than the estimated future economic benefit, then the asset should be impaired. Whereas if the carrying value is less than the estimated value, no impairment is required for the period. After the impairment testing is completed, the deferred development cost should be amortized. Carrying value of the deferred development should be divided by the useful of the asset to determine the amortization for the period (Siegel & Borgia, 2007).

If the development cost does not meet the six conditions, then all of the development costs should be expensed in the period incurred. This will have a significant negative effect on the income statement for the firm where the profits will be reduced. This will affect the Return on assets and Return on invested capital.

Critiques of the current accounting treatment of research and development expenditure

The conceptual foundation for the current treatment to expense the R&D costs as they are incurred cannot be warranted. The treatment method maybe better suited to an economy which has “manual labour and static technology” (Nix and Nix, 1992, pg 53). For the Australian economy, which is so dynamic and technologically advanced, this treatment is defective. The revenues earned are not matched with the related costs, investments in research and development are a major asset but does not reflect the same in the financial reports. In addition to that, the current practice of disclosure does not reflect the increased importance of research and development costs. This leads to an unrealistic portrayal of an entity’s R&D investments and operational activities (Siegel & Borgia, 2007).

A study shows that it takes eight years on average for a company to attain profitability (Nix & Nix, 1992). R&D expenditures are investments made by the entity to secure future economic benefits, therefore, it should be recorded as assets and expensed in the reporting periods that they generate revenues in (Russell, 2015). Furthermore, the argument of uncertainty of future economic benefits can be countered, in terms of benefits from R&D expenditure. It is more relevant to capitalise the costs and allocate it rather than completely writing the cost off as an expense. However, there are difficulties in regard to measurement and disclosure. For example, in terms of employee training, not only the firm trained by but also the future firms that the employee is likely to work in will benefit from the knowledge and skills gained from the training (Zeghal & Maaloul, 2011). Since, the benefit has future use and can be transferred from one entity to another, some argue that employee training should be capitalised and allocated over the periods it generates revenue.

The values of such assets are vulnerable; firms can involve in creative accounting wherein entities are likely to use the favourable measurement techniques to capitalise their costs to benefit the financial reports. Therefore, this leads to biased and misleading data for the users of these reports (Russell, 2015). A study shows that “on average only 2 percent” of the research and development projects are successful (Nichita, 2011; Siegel & Borgia, 2007). The controversial treatment bases its arguments on relevance as the current recognition criteria does not account for the value drivers. Despite all the valid criticisms, the current accounting treatment is warranted, theoretically, of research and development costs holds more credibility.

However, AASB and IFRS should understand its impact on the financial reports and investor perceptions, hence the current standards should be reviewed and improvements on the standards should be made to better suit the new technology driven economy.

Recommendations for improvement in AASB 138

The topic of research and development expenditure has become controversial due to the initial recognition criteria (Russell, 2015). The current treatment is warranted as it has a strong theoretical foundation as it limits firms from exercising any creative accounting practices, however, the AASB could improve to better suit the requirements of the corporations. If an entity invests in research and has traceability to an intangible asset, then it should be considered as part of the cost price instead of writing it off as an expense. It is crucial for the investors to visibly see the value of the firm and not the cost of the firm alone. In terms of identifiability of link between research investments and intangible asset, AASB should develop a criterion similar to that of AASB 138 para 57 for development costs. This criterion will establish the conditions for recognition and disclosure of “deferred research costs”. Therefore, this will remove the inconsistency between timing of revenue generated and uncertainty of future economic benefits to some extent.

Conclusion

The current treatment for research and development is theoretically valid but does not take into account the requirements of the intellectual and technological growth in the economy. AASB and IFRS should review and update standards so that they are better suited to the needs of the firms. This is not to deny that with the managers given the choice of determining the expected future economic benefits of research and development costs, there is a high risk involved as managers are likely to overestimate the values. However, the introduction of a new criteria for recognising research costs as intangibles will provide a better picture of an entity’s overall value.

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