

The accounting treatment for research and development



Under IAS 38 Intangible Assets, the accounting treatment for research and development is different. It depends on whether the expenditure is incurred from research or development. In the Ruritanian Accounting Standard, research expenditure is charged to the statement of comprehensive income and development cost is to be capitalized as a part of intangible assets. Broadly speaking, it is common treatment in most of companies. However, this accounting treatment is not perfect. We will discuss the advantages and disadvantages of this standard.

Firstly, in the Ruritanian Accounting Standard, the definition of research and development costs have been given and set out the conditions that need to be satisfied in order to expense or capitalize. Research expenditure is not related directly to any of the company's products or processes whilst it conforms to a search process. In the research phase, an entity cannot demonstrate that it will become an intangible asset and generate probable future benefits. Otherwise, expenditure is recognized as development costs as an intangible asset. It is a similar definition in the IAS 38. However, the activities related to research and development but are not included neither research nor development phase are not classified in the standard. There is a situation existed in the research and development process, for instance, troubleshooting in connection with breakdowns during commercial production. IAS 38 does not provide a guidance of these activities but apparently it would be useful in deciding whether expenditure can be capitalized under the rules identified in the standard. Moreover, expenditure cannot be classified into these two categories due to the complex nature of new equipment programmes, it is not possible to distinguish reliably

between research and development activities until relatively late in the programme.

Secondly, in the early standards, development expenditure could be capitalized only if it will make a profit. IAS 38 states that profitable development expenditure must be capitalized whereas SSAP 13 has given the options of either capitalizing the expenditure or charging as an expense. The IASB's Framework for preparation and presentation of Financial Statements says ' an asset is recognized in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably'. However, in the Ruritanian Accounting Standard, we give an advice of capitalizing all the development costs as an intangible asset rather than the options. There are some uncertainties on whether project can be completed successful and the costs of developing the product. On most of the conditions, people are always optimistic when developing the product and consider it will have future benefit. In practice, many problems are encountered during the process and the cost is much greater than estimates before. So, the development costs can be not estimated reliably till the completion.

Thirdly, according to measuring the profit, it will have a difficulty in estimating future sales and future costs. Once the development has accomplished, the sales need to be checked if the sales of the product will be profitable. Two factors are related to sale value that is the selling price of each product and quantity sold. It is uncertainty about those figures. For instance, for some high technology products, selling price might be high
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initially and then will substantially decline as competitors occurs. It is called marginal costs. There is a relationship between quantity sold and selling price that the lower selling price is, the more increase sales will be. So, it will cause the problem in estimating future costs. It is uncertain that a product will be profitable and it will have inaccuracies in estimating the costs. Also, it may be difficult to satisfy the standard of being an asset and should not be recognized in the financial position. In a word, to capitalize total development costs still exist to some extent inaccuracy when the situation above occurred.

Lastly but not the least, a new treatment will arise from purchased goodwill in a business combination. The research and development part of subsidiary will be purchased and account for the intangible assets in the financial statement of parent company. There are two choices that are impairment and amortization. In IAS 38, it amortized the expense and impairment of intangible asset by using the reducing balance method. In the Ruritanian Accounting Standard, it is consistent with IAS 38 standard. However, there is a trend on impairment rather than amortization in the listed companies. Apparently, companies want to maximum their reported profit and amortization will reduce profit. One of the significant reasons is that if the 'future economic benefit' of the goodwill is greater than its original cost, and thus will avoid a charge to the income statement. Under IAS 38 an intangible asset with an indefinite life is not amortized but to incur an annual impairment check which the impairment is less than its carrying value. It seems to be similar to other treatment of purchased goodwill.

In summary, there are many advantages in the Ruritanian Accounting Standard and help to solve the principal problem in the existed accounting standard. Meanwhile, it eliminated some aspect inconsistent with accounting policy. It is unavoidable to have drawbacks in identify the research and development costs and whether to treat it in the finance position or income statement. Those problems still need to be discussed in the future.