Researching R&D

How to account for research and development **Interviewed by Arthur G. Sharp**

After long days in the lab and countless sleepless nights, you have developed a product that can have a real impact. Companies are expressing interest in your discovery, which creates new problems and questions about how to account for research and development expenses, whether R&D expenditures create tax credits to offset future taxable income (they can) or how the R&D expenses qualify for tax credits (they will if certain requirements are met).

As Mark Werling of Burr, Pilger & Mayer LLP notes, "As these initiatives progress, more eyes will be examining your company's financial statements and looking to ensure your compliance with generally accepted accounting guidance to help judge their ultimate investment decision."

Smart Business spoke to Werling to learn more about how R&D is defined, R&D credits, their treatment by the IRS regarding income, how to facilitate the compliance process and when to consult with qualified R&D accounting specialists.

Mark Werling
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How is R&D defined?

SFAS 2, Accounting for Research and Development Costs, defines the research component of R&D as a 'planned search or critical investigation aimed at discovery of new knowledge' that could result in a new discovery. The development component of R&D requires translating 'research findings or other knowledge into a plan or design' for a new discovery. This can include conceptual formulation, design, construction of prototypes and operation of pilot plant. Routine alterations to existing products, processes or operations are excluded from this definition. Materials, equipment and facilities used in R&D activities are expensed as incurred, including depreciation. R&D costs may include salaries and other personnel costs, contract services and a reasonable allocation of indirect corporate costs, unless they are not related clearly to R&D activities.

How does the treatment of R&D change through a product's development?

FASB defines three unique stages of development in determining the accounting treatment of R&D costs. Stage one coincides with the beginning of a product's development cycle and ends when technological feasibility is established, either upon the completion of a detailed program design or of a working prototype. Until that point, all costs related to R&D expenditures are expensed as incurred. Once technological feasibility has been achieved, the product moves into stage two and all R&D costs are capitalized and amortized according to its useful life or as a percentage of expected future revenue. Once the product is available for general release to customers, it enters stage three. All subsequent outlays are again expensed as they are incurred. Recognizing these three phases and the inflection points that separate them is key in accounting properly for R&D treatment.

What do these accounting treatments mean for a company?

Applying this methodology increases net income by capitalizing the costs during the development of the full product roll-out period and then spreading the expenses into future periods. It also prevents companies from artificially 'propping up' their net income as they pursue technological feasibility by moving too much expense off the income statement. Until a company has something that works in prototype form, everything gets expensed.

From a cash flow perspective, there is little change to the financial statements, as there is still a real capital outflow regardless of whether it is capitalized or expensed. In an acquisition scenario, a misrecording of R&D expenses could have a significant impact on the purchase price of a business. If a portion of a purchased company's value is represented by R&D assets that have no alternative future use, GAAP requires that this part of the acquisition price be written off. This could greatly impact the price that the company is acquired for. Because the SEC has made it a priority to minimize opportunities to manipulate earnings, proper valuation of in-process R&D for acquired enterprises is critical.

When are outlays considered R&D for federal tax purposes?

Outlays can be classified as R&D for federal tax purposes if they are intended to discover information that would eliminate uncertainty regarding the development or improvement of a product. As specified in Treasury Regulations section 1.174-2(a), this can include costs to create a pilot model, process, formula, invention, technique, patent, or similar property that contributes toward the development of a product. Any R&D costs should be clearly intended to establish the capability or method for developing, improving or designing the property.

Do R&D credits offset future taxable income?

If properly utilized, they will provide a tax credit of 20 percent of certain increases in qualified research expenses — with a few additional caveats. Alternatively, the taxpayer may elect to take the full R&D deduction but reduce the credit by 35 percent (the maximum corporate tax rate). There are other nuances that may require additional examination, but generally, this is how these transactions are approached. These nuances and the requirements that the research expenditures must meet to qualify for tax credits can be explained by qualified R&D accounting professionals. <<

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