HM TREASURY

Financial Reporting Advisory Board Paper

Changes to the treatment of Research and Development under ESA 10

Issue:	At the Board's meeting in June 2015 the Treasury presented a paper on the European System of Accounts 2010 (ESA10) treatment of research and development costs. ESA 10 became applicable in Member States from September 2014. The Treasury confirmed that it had no plans to change the financial reporting treatment of research and development in light of this change, but that under the principles of alignment, it would seek to implement the change in departmental Estimates and budgets. The Board asked for further information on the approach taken to alignment and further indicative values for the likely scale of the change. This paper addresses that request.
Impact on guidance:	Yes – the 2016-17 CBG will be updated for the change
IAS/IFRS adaptation?	No
Impact on WGA?	No
IPSAS compliant?	Yes
Interpretation for the public sector context?	No
Impact on budgetary regime?	Yes – all research and development costs will be capitalised
Alignment with National Accounts	Under the proposed approach, budgets and estimates will remain substantially aligned with National Account. Resource accounts and National Accounts will not be aligned.
Impact on Estimates?	Estimates would continue to follow Budgets.
Recommendation:	That the FRAB note the approach taken to alignment and the indicative scale of the change.
Timing:	ESA 10 came in to force in September 2014. Changes to the treatment in Budgets will most likely apply from 2016-17.

Background

1. The paper presented to the Board in June 2015 summarised the changes under ESA 10 in respect of research and development costs and how these differ to the requirement under IFRS. The new version of the European System of Accounts (ESA 10) became applicable in Member States from September 2014. One the changes under this new framework is to change the treatment of research and developments costs. Under ESA 95, most research and development were treated as current expenditure but under ESA 10 they will be treated as capital expenditure.

2. Research and development is defined under ESA 10 as:

   '**creative work undertaken on a systematic basis to increase the stock of knowledge, and use of this stock of knowledge for the purpose of discovering or developing new products, including improved versions or qualities of existing products, or discovering or developing new or more efficient processes of production'.**

3. As this is a change to the ESA framework it will be reflected in National Accounts and Public Sector Finance statistical releases (that report on key measures of deficit, debt and public sector investment). It will therefore be reflected in spending and fiscal aggregates on which the Government manages economic and fiscal performance. The change will result in R&D spending contributing to Public Sector Gross Investment.

4. Under International Financial Reporting Standards the relevant standard dealing with research and development costs is IAS 38 Intangible Assets. The FReM applies this standard with no adaptation to the initial recognition and measure requirements. It requires therefore that research costs[1] are expensed and only development costs[2] that meet specific criteria[3] are capitalised.

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[1] *'original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding'.*

[2] *'the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.'*

[3] *An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:*

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.
(b) its intention to complete the intangible asset and use or sell it.
(c) its ability to use or sell the intangible asset.
(d) how the intangible asset will generate probable future economic benefits.
(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Treasury approach to misalignment

5. As the ESA 10 change directly impacts on National Accounts and fiscal aggregate measures it creates a misalignment between the measures on which aggregate public spending is managed by the Government and the Supply Estimates on which Parliament votes. The Treasury believes it is therefore desirable to implement the ESA 10 change (or the key elements of it at least) in departmental budgets and Supply Estimates, to maintain a high level of alignment between macro-level spending totals published at fiscal events and the spending totals approved by Parliament.

6. However, if the FReM were to be changed in an attempt to align all 3 frameworks (expanding the scope of R&D costs that could be capitalised for financial reporting so it was consistent with ESA 10) it would represent a significant conceptual departure from IFRS and be inconsistent with other assets recognised on the Statement of Financial Position. R&D spending (as defined by ESA 10) does not always give rise to a resource within the control of the (public sector) reporting entity. The Treasury therefore does not intend to make any changes to the financial reporting treatment of R&D.

7. The Treasury intends to apply an approach analogous to the existing misalignment between Supply Estimates and financial reporting for capital grants. This similarly is about the composition of spending (the level of capital versus current spending) rather than the total level of spending.

8. The Treasury proposal is therefore:

   - To include in capital budgets (and in capital totals in Supply Estimates)
     i) All development costs that meet the capitalisation criteria under the FReM (IAS 38)
     ii) And all other research and development costs (other than depreciation[4]) that meet the capitalisation criteria under ESA 10.

   - To include in resource budgets (and the resource total in Supply Estimates)
     i) Depreciation only on assets recognised under the FReM (i.e. for financial reporting purposes).

   [A decision tree, extracted from additional guidance produced for departments, is held at Appendix 1]

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[4] Depreciation costs for central government as reflected in National Accounts are not drawn from central government budgetary data. The adjustment to reflect depreciation costs that should be capitalised as R&D will be done outside of budgets.

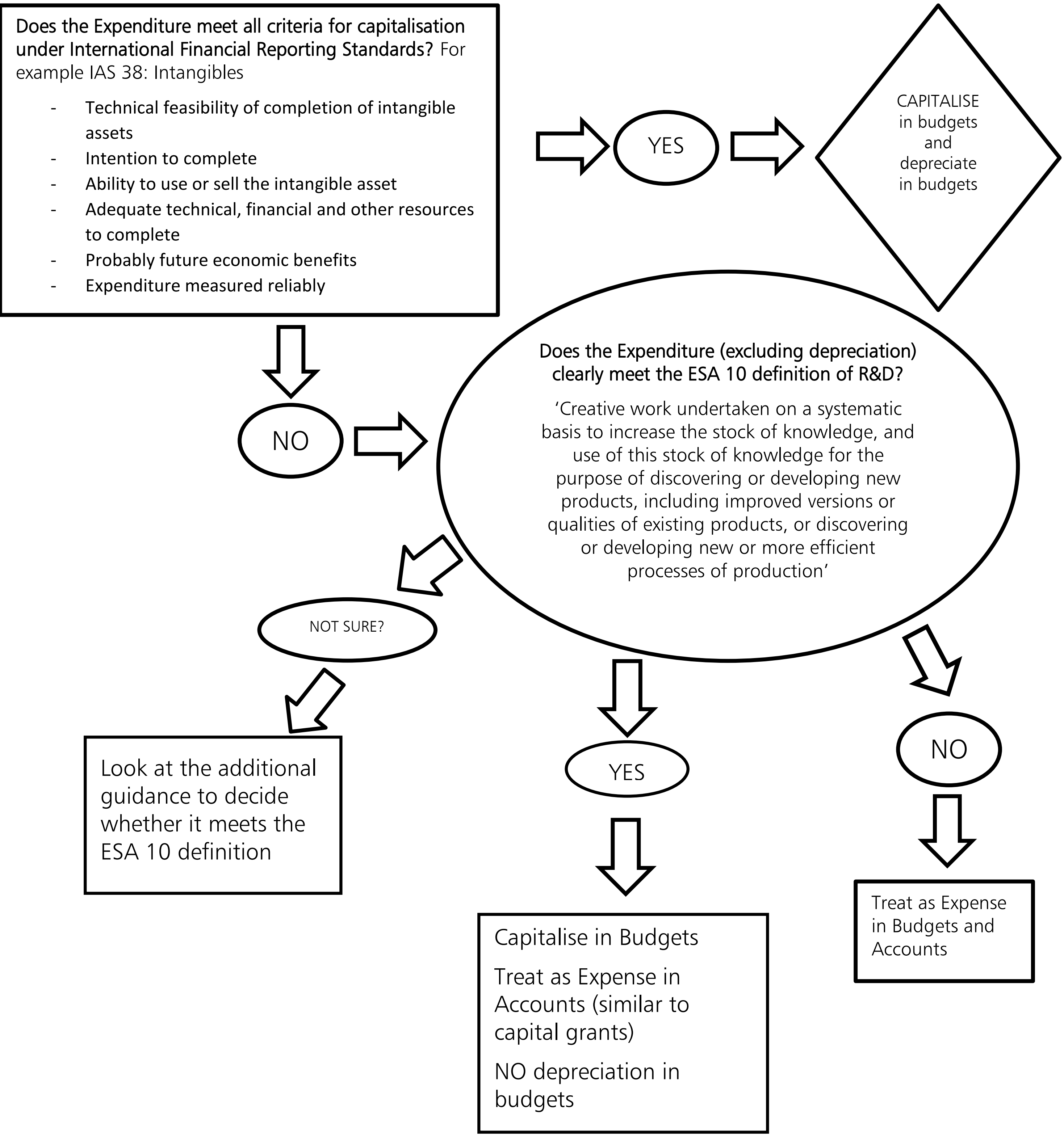
9. Initial indications are that the change in budgeting treatment will mean circa £8bn of expenditure currently treated as resource being scored as capital. However, subject to Parliamentary approval for including the change in the 2016-17 Main Estimates, better data on the scale the change will become available as departments prepare for the 2016-17 Main Estimate process.

10. The Treasury has gained support from the Alignment Review Committee for the above approach, and the Treasury intends to write to Parliament, in line with the principles of the protocol agreed under Clear Line of Sight, to its seek support for the intended budgetary changes so that it is likewise applied in the Supply Estimates.

Recommendation

11. **That the FRAB note the approach taken to alignment and the indicative scale of the change.**

Annex 1 - Decision Tree for Capitalising Research and Development Costs in Budgets



In all instances the treatment in Estimates is the same as the treatment in Budgets. Depreciation is recognised in Budgets only on assets that are recognised in Accounts.