HM TREASURY

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Financial Reporting Advisory Board Paper

Changes to the treatment of Research and Development under ESA 10

Issue:	Under the European System of Accounts 2010 (ESA10) (the framework for national accounts), which came into force for Member States in September 2014, the treatment of research and development expenditure has changed. It will be capitalised, rather than recognised as current expenditure. This change in treatment is reflected in fiscal measures which are produced consistent with the ESA10 statistical framework. This change in treatment could lead to a potential misalignment between the treatment under financial reporting and the treatment in Estimates and Budgets. This paper outlines to the Board the Treasury's intention not to amend the financial reporting treatment in light of this change.
Impact on guidance:	No
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	If the financial reporting treatment remains unchanged the change in ESA 10 will create a misalignment between financial reporting and national accounts.
Impact on Estimates?	Estimates would continue to follow Budgets.
Recommendation:	That the FRAB approve the Treasury's plans not to change the financial reporting treatment in light of changes to the national accounts treatment of research and development.
Timing:	ESA 10 came in to force in September 2014. Changes to the treatment in Budgets would most likely apply in 2016-17.

Introduction and Background

1. 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. Previously they were treated as current expenditure (intermediate consumption) but under ESA 10 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. This definition is based upon and viewed as equivalent to the definition in an OECD manual (Frascati Manual of the Proposed Standard Practice for Surveys on Research and Experimental Development), which also provides additional guidance on measuring R&D. The new (seventh) version of this manual is currently being produced and is expected to be completed in 2015.

4. Under International Financial Reporting Standards the relevant standard dealing with the research and development cost is IAS 38 Intangible Assets, which outlines, among other things, the recognition criteria for development costs to be capitalised. The FReM makes no adaptation to the initial recognition and measure requirements of IAS 38, including in respect of development costs.

5. Specifically IAS 38 defines research as:

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

6. And development is defined as**:**

   '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.'

7. IAS 38 requires that;

   *'….**no intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred'.***

8. And in respect of development cost that;

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.***

  [Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.]
- ***(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's approach to the change in treatment under ESA 10

9. The Treasury's aim is to reflect the principle elements of this change in departmental budgets, to maintain close alignment between the national accounts measures upon which fiscal performance is assessed. In accordance with the principle of Clear of Line of Sight the Treasury would maintain alignment between Estimates and Budgets, and therefore reflect this new treatment in Estimates.

10. However, given the significant difference between the capitalisation criteria under IAS 38 and the requirements under ESA 10, the Treasury does not intend to change the financial reporting. In practical terms, the current expectation is that this misalignment would have a close parallel with the treatment of capital and current grants i.e. assets would only be recognised where they met the criteria under IAS 38 and depreciation of 'assets' capitalised in budgets, but not financial accounts, would not score in budgets.

11. This misalignment between Estimates, Budgets and Accounts with be dealt with in the normal way (including through consultation with the Alignment Review Committee), in accordance with the protocol agreed with Parliament under Clear Line of Sight.

Recommendation

12. **That the FRAB approve the Treasury's plans not to change the financial reporting treatment in light of changes to the national accounts treatment of research and development.**