

Accounting for R&D and Innovation: Creating Value in your Company

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Accounting for Research and Development (R&D) is a crucial consideration for many businesses as it fuels innovation and future growth. However, how R&D investments are accounted for can significantly impact a company's financial statements, particularly the Profit & Loss (P&L) statement and the calculation of Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA).

Please note that this document is for guidance purposes only and cannot be considered accounting advice.

The P&L (Profit & Loss) Statement

The P&L is often a key performance driver in business valuation, with investors, shareholders and potential acquirers focusing on revenue growth, net profit (net income) alongside cash flow projections and the make-up of the balance sheet.

In this article, we will consider three factors for R&D in the P&L:

1. How to account for R&D undertaken in the delivery of products / services?
2. R&D as an operating expense and capitalizing R&D assets
3. Increasing net income by maximising on non-dilutive R&D and Innovation incentives

Profit & loss statement layout

Gross revenue	Money from sales
Discounts and returns	Discounts and product returns
Net revenue	Gross revenue – discounts and returns
Cost of goods sold (COGS)	Costs to make products
Gross profit	Net revenue – COGS
Operating expenses	Expenses of running the business
Operating income	Gross profit – operating expenses
Non–operating expenses	Not directly related to core business
Net income	Operating income – non–operating expenses

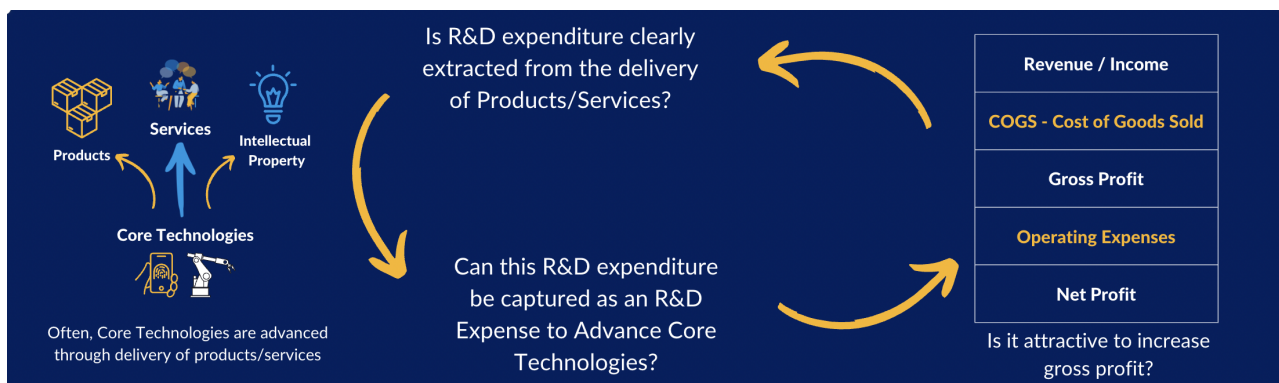


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How to Account for R&D in the delivery of products and services?

One key challenge in this area is extracting R&D costs from the delivery of products and services in the business. Often, companies invest in R&D through the delivery of their products and services, leading to instances where R&D expenditure may be captured in the Cost of Goods Sold (COGS).

This can distort the true picture of a company's financial health. Including R&D expenses in COGS could decrease the gross profit, giving a misleading impression of the company's profitability. It's important to remember that R&D is not a cost of goods sold, but rather an investment into the future of the company.



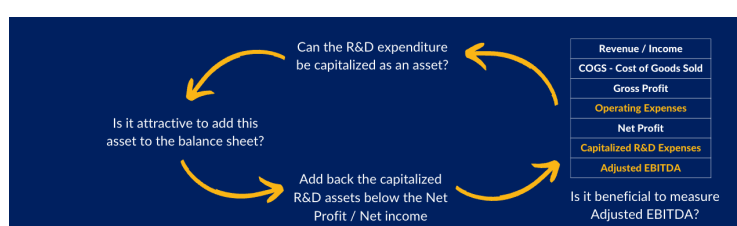
Is your R&D expenditure appropriately captured? See the diagram above for some further context.

R&D Expenditure as Operating Expenses and Capitalized Assets

Typically, R&D costs are treated as operating expenses and are therefore deducted from the company's Gross Profit in the P&L statement. This is in line with the matching principle in accounting, which stipulates that expenses should be recorded in the same period as the revenues they help to generate.

However, some companies choose to capitalize R&D expenses, recording the expenses as an asset rather than an immediate cost.

This approach can lead to an increase in adjusted EBITDA, as capitalized R&D costs are added back to net income when calculating EBITDA. If EBITDA is a key measure for your business (in cases of investment valuation or acquisition), this may be a strong case for capitalizing your R&D assets, as long as the strategy is backed by strong economic substance.



Capitalizing R&D for Adjusted EBITDA

While this practice can enhance the company's apparent profitability (Adjusted EBITDA) in the short term, it does not change the company's cash flow.

Recognizing expenses as R&D costs allows them to treat them as a capital investment (Capex), which are gradually depreciated over time. This means that they are added to the company's assets in the Balance Sheet.

Due to the impact & variables involved with capitalizing R&D assets, it's crucial to consider the implications of capitalizing R&D costs on the overall financial performance of the company. Speak with your accountants when preparing your management accounts, to get a good perspective on how your business should approach this topic.

Increasing net income by maximising non-dilutive supports

While R&D tax credits are a Corporation Tax incentive (meaning they reduce your tax on profits), Grant supports are direct supports which reduce your R&D operating expenses.

Maximizing both will show your investors, shareholders that you have a strong, capital efficient and strategic approach to investing in your R&D.



Conclusion

In conclusion, while R&D investments are crucial for a company's growth and innovation, the way these expenses are accounted for can significantly impact the company's financial performance. It's essential for investors and stakeholders to understand these accounting practices to make informed decisions.

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