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Adam Smith
Business School



REPORTING OF R&D: DISCLOSURE WITHOUT RECOGNITION?

SUMMARY REPORT – AN OVERVIEW OF INSIGHTS AND RECOMMENDATIONS

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About this report

Insight to inform better reporting of research and development (R&D)

This report summarises the major findings in the research report, *Reporting of R&D: Disclosure without Recognition?* (hereafter, 'the research report'), and considers the practical implications of these findings for several groups of stakeholders. The research was conducted by ACCA and the Adam Smith Business School at the University of Glasgow.

This report also sets out recommendations for better reporting of R&D. These recommendations are targeted at organisations undertaking R&D, the professional accountants servicing them, those charged with governance, the auditors, standard setters and policymakers, and the users of annual reports. The proactive actions by all stakeholders will support the production of decision-useful information and improve the overall quality of corporate reporting by organisations that are undertaking R&D.

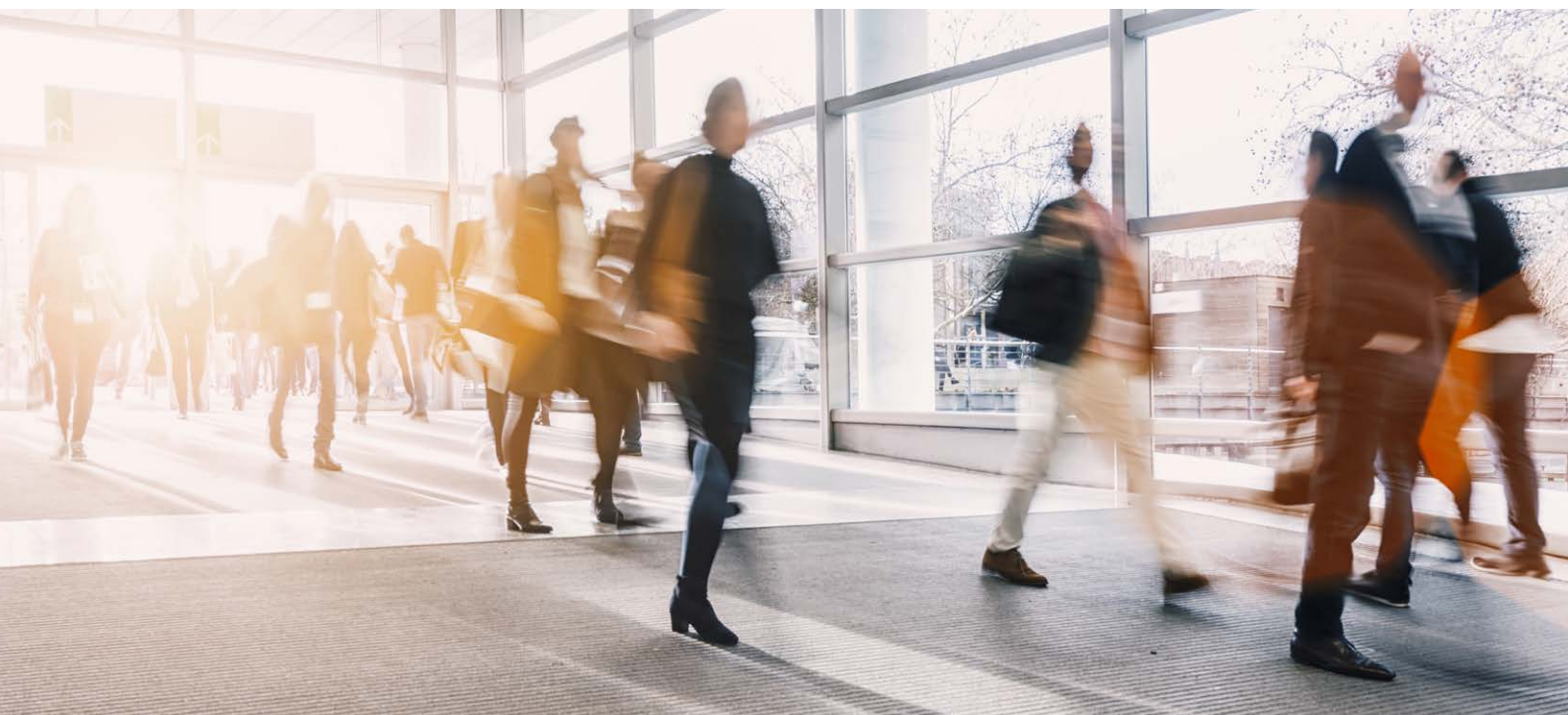
At-scale research informs practical insight for organisations and professional accountants

This research was conducted in two phases. In Phase 1, a desk-based analysis was carried out to gather financial data from listed organisations in 40 countries/locations that have either adopted or converged their national accounting standards with the International Financial Reporting Standards (IFRS) Accounting Standards. A total of 71,787 samples of financial data for financial periods from 2017 to 2021 were gathered,¹ representing financial data from the financial statements of 18,580 organisations. This phase identified the proportion of samples that are either R&D active or R&D inactive.

For the purpose of this research, the term 'an R&D-active organisation' refers to an organisation that reports either an R&D asset and/or an R&D expense separately in its financial statements. By contrast, an organisation that has not reported any R&D asset and/or R&D expense separately in its financial statements is regarded as 'R&D inactive'.

In Phase 2, a total of 12,890 annual reports were obtained in a systematic manner² for a subgroup of all the samples. The annual reports were split into narratives ('front-end') and financial statements ('back-end'). Following this, the analysis captured the number of times R&D-related terms appeared in either the narratives or the financial statements, and their location. A list of 149 R&D-related terms provided the benchmark.³ For this exercise, 12,029 (93%) of the 12,890 annual reports have used at least one R&D-related term from our list. At least one R&D-related term was detected in 11,113 narratives and 10,054 financial statements.

Details about the methodology used in this research, and the major findings are available in Chapters 2 and 3 of the research report.



1 Refer to Chapter 2, section 2.1 in the research report for details of the methodology used to select samples of financial data.

2 Refer to Chapter 3, section 3.1 in the research report for details of the methodology used to select annual reports of listed organisations.

3 Refer to Appendix 4 in the research report for the list of R&D-related terms employed in this research.

Foreword



Mike Suffield

Director – Policy & Insights,
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Continual improvement is not limited to human beings. Research and development helps progressive organisations create new value, and enhance or sustain existing value, from its resources and capitals: from manufactured, intellectual and human capitals to social and relationship capitals. We commonly refer to these as ‘plant and equipment’, ‘tools’, ‘jigs’, ‘know-how’, ‘processes’, and ‘systems’ used in the production of goods and delivery of services. In addition, R&D may preserve the natural capital and/or attract financial capital to the organisation.

Given the potential value generated by R&D, stakeholders value information about the significance of R&D to an organisation’s current and future business models, and the related material financial, social, and environmental impact.

This presents an opportunity for professional accountants to prepare and communicate decision-useful information to various internal and external stakeholders, including users of annual reports.

Unfortunately, the requirements of current generally accepted accounting practice (IFRS – IAS 38 Intangible Assets) leave much of the R&D disclosure outside numerical information to the discretion of the reporting organisation. In practice, this reduces comparability across organisations and creates an information gap between narrative and numerical reporting.

This ‘information gap’ becomes more of a concern where there are a large number of organisations making many narrative R&D references that suggest innovation without numerically reporting R&D expenditure. These annual reports are therefore sending mixed and confusing signals to users about the existence, and more importantly, the significance of R&D to the organisation. If so much effort is employed in narrative reporting, why not disclose the R&D expenditure? Is this a simple compliance issue or is there more to it than meets the eye?

While there are several plausible reasons for this phenomenon, the problem is not as straightforward as it appears.

This report summarises the major findings from our research, and discusses the likely reasons for current problems in recognition and disclosure, as well as the practical implications for organisations, their stakeholders and users of annual reports.

We encourage all stakeholders to take proactive actions to close the information gap that this research highlights, and to improve the overall quality of corporate reporting by organisations undertaking R&D. Recommendations to remedy the current situation are presented towards the end of this report to inspire further actions.

Executive **summary**

Intangible assets, such as research and development (R&D), are becoming increasingly important to driving the future earnings of many organisations. Despite the importance of R&D to organisations, this research found that over half (53%) of its entire sample of organisations did not report any R&D asset and/or R&D expense separately in the financial statements and therefore, are classified as ‘R&D inactive’.

If so many organisations really do not pursue innovation, whether to create, enhance or sustain products, services, and processes, then how will the organisation exist for the long term in our fast-changing world? Therefore, have these organisations invested in the all-important R&D that underpins innovation but not separately reported the expenditure?

If true, then stakeholders, including investors, lenders and employees, will not understand the significance of R&D to the organisation, and potentially its future prospects.

To answer the above questions, our research analysed a significant proportion of apparently R&D-inactive organisations across 40 countries/locations to:

- identify their unique characteristics
- analyse the volume and location of R&D disclosures in their annual reports
- consider the reasons for a lack of disclosure and, importantly,
- make recommendations for continual improvement in reporting.



Some headline findings:

- Some organisations might not be genuinely R&D inactive, in spite of the lack of disclosure of R&D assets or expenses in their financial statements: 170 samples of annual reports have reported more than 100 R&D-related terms, while another 496 samples have reported between 50 and 100 R&D-related terms.
- R&D-inactive organisations tend to be located in countries/locations where the country-level R&D expenditure is below 3% of GDP.⁴ This indicates a less conducive environment for R&D investment.
- Organisations that report low levels of other intangible assets and high levels of tangible assets tend to be R&D inactive.
- Switching from one category to another (ie from R&D inactive to R&D active, or vice versa) seldom happens. During the five years under review:
 - nearly half (49%) of all sampled organisations had never been R&D active
 - only 9% of all sampled organisations had switched from one category to the other
 - a small proportion (2%) had switched from being R&D inactive to R&D active
 - merely 1% of all sampled organisations had switched from being R&D active to R&D inactive.
- The mean frequency of R&D-related terms detected in annual reports is 15. The mean frequency in the narratives and the financial statements is 12 and 6 respectively.
- Nearly one in five (17%) annual reports sampled contain a high volume of R&D-related terms in both the narratives and the financial statements. That is 2,013 samples. For these samples, the mean frequency of R&D-related terms in the annual report as a whole, the narratives and the financial statements is 34, 27, and 11 respectively.
- Frequently used R&D-related terms in the annual reports of R&D-inactive organisations are similar to those used by their R&D-active peers. In fact, 12 out of the 30 most frequent R&D-related terms analysed in this research correspond to the top 15 most frequent terms in the reports of R&D-active organisations.

⁴ Table A1.1 in the research report sets out the country-level mean R&D expenditure in the economy as a whole as a percentage of the country's GDP, for the sample period.

This research reveals a disconnection between disclosures in the narrative sections of annual reports and the financial statements. Annual reports that indicate investments in R&D through a high volume of narrative references to R&D have left users wanting, as they are unable to discern the amounts involved. The mixed signals are confusing users about the significance of R&D to the organisation.

Probable reasons for this, identified through a series of roundtable discussions with preparers of financial statements, auditors, standard setters and policymakers include:

- ambiguity over what constitutes R&D in the contemporary economy
- difficulty in applying materiality by nature in disclosures
- an absence of explicit requirements for disclosing qualitative information about R&D
- lack of incentives for separately recording and reporting of R&D expenditure, for instance tax reliefs or R&D grants
- a corporate culture that reduces the openness and extent of R&D reporting, and
- the organisation's funding requirements raising concern over reporting.

The findings in this research point towards some fundamental problems in the reporting of R&D.

- First, if an R&D activity is not considered R&D according to IAS 38, the expenditure is recognised and reported according to its underlying nature. Hence, no R&D expenditure is reported despite a high volume of R&D-related terms used in the narratives.
- Second, R&D expenditure may have been recognised, but the amount was not reported separately.
- Third, ambiguous disclosures that indicate investment in R&D without reporting the amounts involved are not decision useful and are confusing.

Remedying the current situation requires the collective effort from all parties that have a stake in corporate reporting.



Key recommendations for professional accountants:

1. *Review and identify activities that should be classified, and accounted for, as R&D.*
2. *Connect non-financial information in the narratives with financial information in the financial statements.*
3. *Encourage a change of mindset for R&D reporting across departments.*
4. *Provide further information that explains the significance of R&D to the organisation's business model.*
5. *Avoid boilerplate disclosures.*
6. *Collate information about activities that are perceived to be R&D, to inform standard setters.*
7. *Seize opportunities to highlight application challenges and discuss practical solutions with standard setters and/or policymakers.*

Other recommendations for those charged with governance, the auditors, standard setters and policymakers, and users of annual reports are set out in the 'Recommendations' section of this report.

Introduction

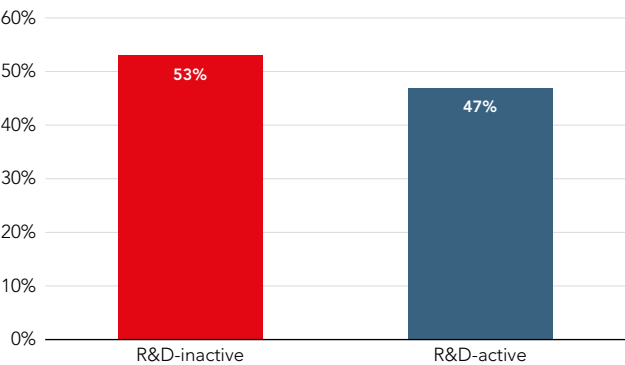


‘Did the organisation engage in R&D or not?’

That question will probably come to mind after reading over 100 R&D-related terms in an annual report that does not report any R&D expenditure in the financial statements – whether as an expense or capitalised as an intangible asset.

Not every organisation will engage in R&D year after year. In fact, over half (53%) of all sampled organisations in our research are R&D inactive (Figure 1). For the purpose of this research, the term an ‘R&D-active organisation’ refers to an organisation that reports either an R&D asset and/or an R&D expense separately, whereas an organisation that has not reported any R&D asset and/or R&D expense separately is regarded as ‘R&D inactive’.

FIGURE 1: Proportion of samples that are R&D inactive vs R&D active

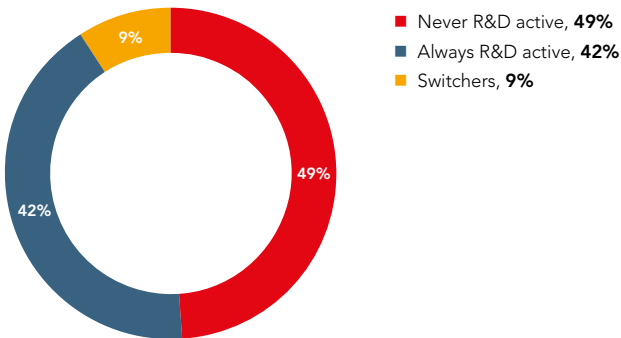


This research gathered 71,787 samples of financial data from listed organisations in 40 countries. The samples span 10 industries. Nearly half (49%) of them were never R&D active throughout the five years under review, ie from 2017 to 2021.

Switching from one category to another (ie from R&D inactive to R&D active, or vice versa) seldom happens (Figure 2). During the five years under review, only 9% of all sampled organisations switched from one category

to the other. A small proportion (2%) of all samples have switched from being R&D inactive to R&D active. Merely 1% have switched from being R&D active to R&D inactive.

FIGURE 2: Proportion of samples across categories that indicate R&D activity

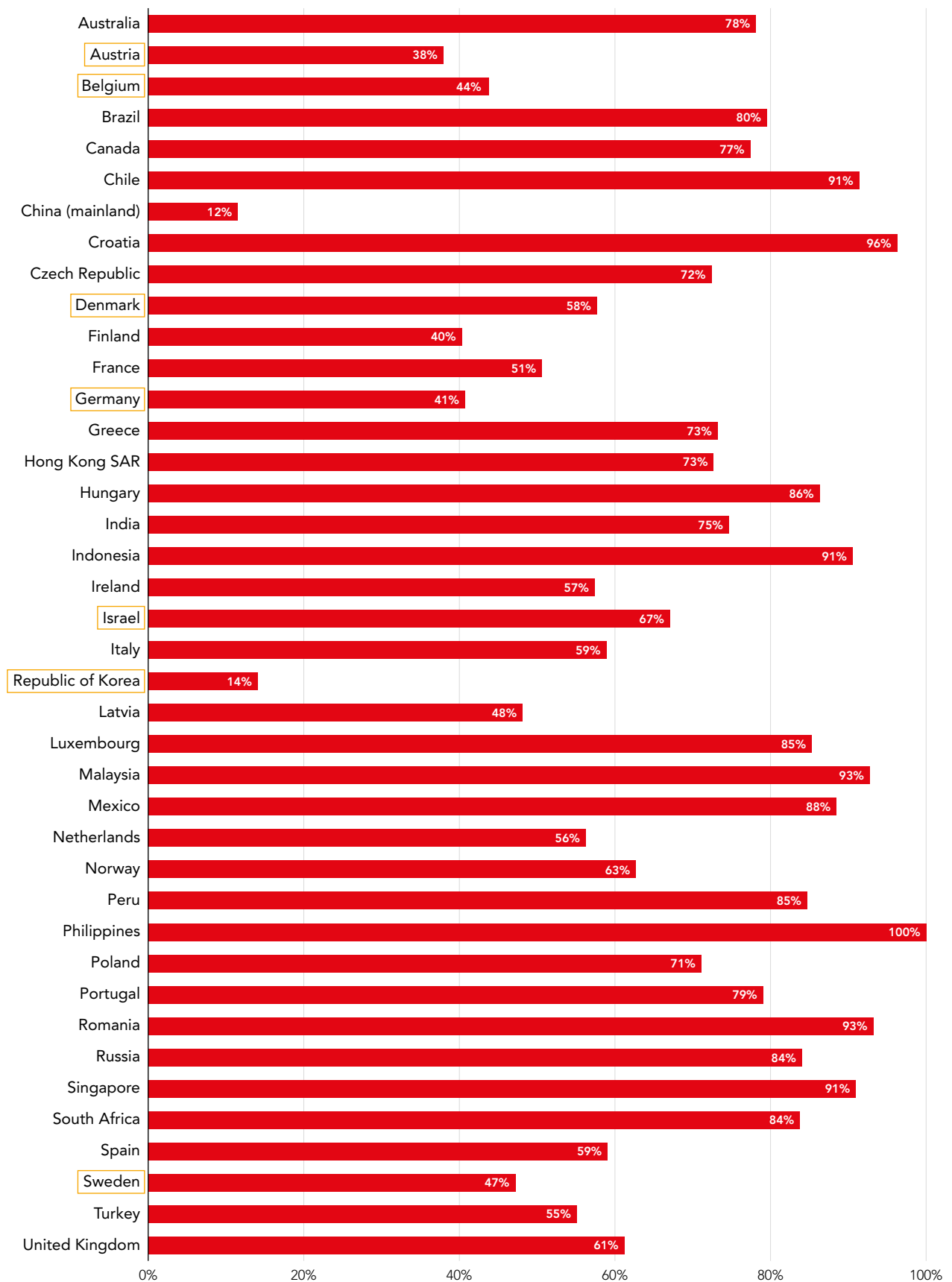


Some countries/locations have more R&D-inactive organisations than others. Over 80% of the samples of organisations' financial data from 13 countries/locations are R&D inactive. These countries include Chile, Croatia, Hungary, Indonesia, Luxembourg, Malaysia, Mexico, Peru, Philippines, Romania, Russia, Singapore and South Africa.⁵

On the other hand, only 11.5% and 14.1% of samples from mainland China and the Republic of Korea are R&D inactive. This means that over 85% of samples from these countries/locations are R&D active (Figure 3).

R&D-inactive organisations tend to be located in countries/locations where the country-level R&D expenditure is below 3% of GDP. This indicates a less conducive environment for R&D investment.

⁵ See Figure 3. Figure 2.2 in the research report also show the percentage of R&D-inactive organisations by country/location.

FIGURE 3: Proportion of R&D-inactive organisations – by country/location

Indicates a country with very large country-level investments in R&D as a proportion to GDP ($\geq 3\%$).

R&D reporting impacts perceived value

We wondered if such a high proportion of organisations really do not pursue innovation or engage in R&D to create new products, or new services, or new processes that will give them an edge over competitors. What if investors, lenders, employees or even customers start asking similar questions?

Several other questions began to develop. Will it be difficult for an R&D-inactive organisation to raise new financial capital? Can it attract and retain talent?

This research found that R&D-inactive organisations tend to have a higher book-to-market ratio (BM) than their R&D-active counterparts.⁶ A higher BM means the organisation's shares are valued closer to its book value than would be the case if the BM were lower. That indicates investors' perception of lower growth opportunities for the organisation. Even so, it appears that investors do pay attention to the narratives. R&D-inactive organisations that used more R&D-related terms in the narratives than the mean count are labelled as 'above-average disclosers' in this research. Above-average disclosers tend to have

lower BM⁷ than below-average disclosers, though not as low as R&D-active organisations. Perhaps the absence of R&D expenditure does not instil much confidence in the organisation's commitment to R&D.

On the talent front, a 2023 survey by ACCA has found that 'career development / learn and grow opportunities' is the top factor attracting talent to employers, particularly among the Gen Z (ACCA 2023). Therefore, the perception of such opportunities is very important for attracting and retaining talent.

An organisation has to consider carefully what to say or not say about R&D, as the narrative will affect stakeholders' perception of its future prospects.

Ambiguous disclosure about R&D

Speaking of disclosure, we detected a higher frequency of R&D-related terms in the narratives ('front-end') of annual reports than in the financial statements ('back-end'). The mean and maximum number of R&D-related terms detected in our samples of annual reports are presented in Table 1 below. For comparison, we contrast this finding with the mean number of R&D-related terms detected in R&D-active organisations in earlier research (Mazzi et al. 2019). This finding indicates that the volume of R&D disclosures for some R&D-inactive organisations is as high as that of their R&D-active counterparts.

R&D-inactive organisations in some countries/locations and industries tend to use more R&D-related terms than others

Annual reports from organisations in Finland, France, Italy, the Netherlands, Norway, Spain, Sweden and Turkey tend to have a higher frequency of R&D-related terms. The mean frequency in these annual reports is above 25, even though some of these countries have a relatively high proportion of R&D-inactive organisations. In contrast, organisations from Australia, Brazil, Canada, Denmark, Greece, Hong Kong, India, Indonesia, and Singapore tend to disclose the least frequently. The mean frequency in these annual reports is below 15.⁹

R&D disclosures appear to be motivated by the level of R&D investment in the country/location where an organisation is domiciled. More than half of sampled annual reports from Finland, France, Germany, the Netherlands, and Sweden have a high level of disclosures.¹⁰ The mean frequency for these samples exceeds 33.¹¹ Country-level R&D expenditure exceeds 3% of GDP in Germany and Sweden, while ranging between

TABLE 1: Number of R&D-related terms detected

	R&D-INACTIVE		R&D-ACTIVE ⁸
	Mean	Max	Mean
Financial statements	6	143	9
Narratives	12	598	15
Annual report	15	606	25

⁶ Table 2.3 in the research report compares the characteristics of R&D-inactive and active organisations, including the book-to-market ratio (BM).

⁷ Table 3.7 in the research report compares the characteristics of R&D-inactive organisations classified as above and below average disclosers.

⁸ Mazzi et al. (2019)

⁹ Table A5.1 in the research report sets out the frequency of R&D disclosure by country/location.

¹⁰ Table 3.4 in the research report shows the number of samples in each country/location by disclosure group (Minimal, Low and High disclosers) based on the frequency of R&D-related terms in the annual reports as a whole, the narratives and the financial statements.

¹¹ Figure 3.1 in the research report shows the mean number of R&D-related terms by country/location for high disclosers.

2% and 3% for the other countries.¹² Earlier research also suggested that R&D-active organisations in these countries tend to be high disclosers (Mazzi et al. 2019).

Organisations in the Healthcare, Utilities, Telecommunications, and Technology industries exhibit some of the highest frequency of use of R&D-related terms. The mean frequency in the annual reports from these industries is above 24. Given the perception that these industries' activities tend to be R&D intensive, this finding should come as no surprise. One roundtable participant put it aptly:

“Technology is shaping the business landscape and one would expect to see more disclosure in the information technology sector – on what research and development a company in this sector is doing. Technology is moving very fast and that cannot happen if there is no R&D”.

On the other hand, organisations in the Basic Materials, Financials and Consumer Discretionary industries tend to provide the fewest R&D disclosures. The mean frequency in these annual reports is below 12.¹³

Familiarity with reporting of other intangible assets increases disclosure of R&D-related terms

Interestingly, R&D-inactive organisations that report software development assets or other intangibles tend to use more R&D-related terms than peers that don't report these assets.¹⁴ Some R&D-related terms may have been used in describing the software development assets or other intangibles.

This correlates with another finding. Some of the most frequently used R&D-related terms are those mentioned frequently in IAS 38. Most of them relate to the criteria for the capitalisation of development costs. In fact, 12 out of the 30 most frequently used R&D-related terms identified in the annual reports of R&D-inactive organisations correspond with the top 15 most frequently used R&D-related terms in the annual reports of R&D-active organisations (Mazzi et al. 2019). They are 'research and development'; 'R&D'; 'product development'; 'new technology'; 'ability to use'; 'internally generated'; 'software development'; 'technical feasibility'; 'clinical trial'; 'technology development'; 'development phase'; and 'research development'. Other frequently used terms are 'innovation'; 'patent'; and 'new project'.

We do not rule out the possibility of boilerplate disclosure. What is perplexing, however, are the examples of boilerplate disclosures relating to accounting policies for

R&D in reports where no expenditure is disclosed and there is often very little R&D-related disclosure in the narratives.¹⁵ Accounting policies should be relevant to the understanding of the financial statements. Unfortunately, irrelevant or ill-thought-through boilerplate disclosure does not meet this objective.

Are these organisations genuinely R&D inactive?

One unnerving finding is that a large number of R&D-inactive organisations used high volumes of R&D-related terms. Nearly one in five (17%) samples of annual reports contain a high volume of R&D-related terms in both the narratives and the financial statements despite not reporting any R&D expenditure.

That is 2,013 samples (Table 2). For these samples, the mean frequency in the annual report, narratives and financial statements are 34, 27, and 11 respectively. These annual reports are sending mixed signals to users about the significance of R&D to the organisation.

TABLE 2: Number of samples in each disclosure group (ie Minimal, Low and High), across Narratives and Financial Statements

	FINANCIAL STATEMENTS			
Narratives	Minimal	Low	High	Total
Minimal	2,193	831	844	3,868
Low	2,123	850	1,250	4,223
High	1,165	760	2,013	3,938
Total	5,481	2,441	4,107	12,029

In fact, 170 samples of annual reports included more than 100 R&D-related terms, while another 496 samples included between 50 and 100 R&D-related terms without reporting any R&D expenditure. It is difficult to comprehend the motive behind putting so much effort into narrative reporting if there is no investment in R&D, or if the R&D is not material.

IAS 38 requires the aggregate amount of R&D expenditure recognised as an expense during the period to be disclosed (IAS 38: paragraph 126). Further, if the organisation has capitalised development costs as an asset, IAS 38 requires disclosure of, among other information, the gross carrying amount and any accumulated amortisation at the beginning and end of the period (IAS 38: paragraph 118).

Is this a simple case of non-compliance with the IFRS Accounting Standards?

¹² Table A1.1 in the research report sets out the country-level mean R&D expenditure in the economy as a whole as a percentage of the country's GDP, for the sample period.

¹³ Table A5.2 in the research report shows the frequency of R&D-related terms used in the annual reports as a whole, narratives and financial statements by industry.

¹⁴ Table 3.1 in the research report shows the frequency of R&D-related terms disclosed by organisations that capitalised software development cost (Panel B) and other intangibles (Panel C).

¹⁵ Chapter 3, section 3.5 (Type 2 examples) in the research report sets out extracts from annual reports that depict boilerplate disclosures within accounting policies note.

Reasons inhibiting separate disclosure of R&D expenditure

We identified several plausible reasons for this phenomenon through conversations with preparers, auditors and users, as well as standard setters and policymakers, in three roundtables that we hosted in November 2022. The problem is not as straightforward as it appears.

We believe the following reasons will resonate.

The definition of R&D is not clear. The preparer of financial statements may not identify the organisation's activity as R&D, given the definitions in IAS 38. The perception of what constitutes R&D may differ from one industry to another. Activities relating to building relationships, human resources and customer acquisition, for example, are not typically associated with the definition of R&D in the standard. In essence, if an organisation does not regard its activity as R&D as defined in IAS 38, the associated costs would not be classified as R&D expenditure. Hence, there would be no R&D expenditure to be recognised and disclosed separately.

Qualitative aspects of materiality might have been omitted. Some organisations might have assessed the quantitative aspect of materiality only when considering disclosure but neglected the 'materiality by nature' aspect.¹⁶ Thus, the R&D expenditure may have been omitted because the amount is small relative to other elements in the financial statements. Even so, an R&D activity may influence the economic decisions that users make on the basis of the financial statements. The magnitude or nature of an R&D activity, or a combination of both, could be the determining factor when assessing materiality. This important task of ensuring the right assessment of materiality rests with management and those charged with governance, and is subject to review by the auditors. This observation therefore highlights the importance of having, among those charged with governance, a professional accountant who understands the business and is proficient in corporate reporting.

No explicit requirement to disclose information about R&D. In the meantime, there is no explicit requirement in IAS 38 to disclose information about R&D activity other than the associated amount. Leaving it to the discretion of preparers of financial statements to determine the nature and extent of information about R&D to be disclosed may have resulted in the disproportionate volume of disclosures outside the financial statements, ie in the narratives.

While the factors above are technical in nature, the following factors are operational and financial-related.

Lack of incentives to reallocate costs to R&D for separate disclosure. R&D costs may not be distinct from other operating costs in an organisation. For example, salaries, rent, electricity and raw materials could have

been recognised as expenses in the statement of profit or loss in accordance with the relevant IFRS Accounting Standards. Reallocating these costs into a separate R&D category will require creating additional processes and internal controls, which also incur incremental costs.

As one roundtable participant put it:

'If regulators require [a] certain amount or percentage of R&D to qualify for licence/access/eligibility for whatever, companies may disclose R&D [costs] separately and disclose more information [sic]'.

Organisations would typically want to balance the cost with the benefits from providing the disclosures. Therefore, if an organisation does not see the benefit or incentive for disclosing R&D expenditure separately (such as obtaining R&D grants or tax reliefs), it is unlikely to do so.

Culture. The extent of disclosure is possibly influenced by an organisation's cultural attitude to corporate reporting and openness to discussing future or current innovation. Organisations with a culture that is compliance-centric may disclose to the extent required by the IFRS Accounting Standards. On the other hand, organisations that worry about commercial sensitivity may attempt to disclose the minimum to avoid competitors learning about the organisation's R&D. Nevertheless, a culture of secrecy within a given jurisdiction does not seem to stop organisations from becoming above-average disclosers.¹⁷ This indicates that other factors are likely to be at play. Ultimately, the objective should be to promote a corporate culture that promotes transparency so that the organisation will provide reliable and decision-useful information to users of financial statements.

Funding requirements. On the other hand, an organisation that requires funding may be tempted to disclose more information about where it is spending money, eg on R&D. The disclosure may help investors or lenders to understand and appreciate where the organisation is building value. R&D-inactive organisations tend to have a higher proportion of debt over equity in their capital structure than do R&D-active organisations. Ownership of R&D-inactive organisations tends to be closely held by a small group of owners.¹⁸ This indicates more reliance on debt for funding and the type of funding appears to influence the nature and extent of R&D disclosure.

¹⁶ According to paragraph 7 of IAS 1 Presentation of Financial Statements, information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general-purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. Materiality depends on the nature or magnitude of information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole.

¹⁷ Table 3.7 in the research report shows the mean secrecy index in jurisdictions where above-average and below average disclosers are located.

¹⁸ Table 2.3 in the research report compares the characteristics of R&D-inactive and active organisations, including their leverage and percentage of closely held ownership.

Fundamental problems in the reporting of R&D

The observations in this research point towards some fundamental problems in the reporting of R&D.

- First, if the R&D activity is not considered as R&D within IAS 38, the associated costs are reported according to the underlying nature of those costs.
- Second, R&D expenditure may be recognised either as an expense or an asset, but the amount is not reported separately.
- Third, disclosures that indicate investment in R&D but inhibit users from discerning the amounts involved are not decision useful and are confusing.

Unless these problems are addressed in the IFRS Accounting Standards, they will persist, and organisations are likely to continue disclosing information about R&D only in the narratives, where disclosures are currently voluntary.

These problems may produce consequences that extend beyond the organisation. For example, government agencies and analysts often compile data about organisations and their activities through organisations' general-purpose financial reports. If organisations that are undertaking R&D do not disclose the amounts separately, either capitalised or expensed, their R&D expenditure will be reported as 'nil' in these analyses. This risks presenting a misleading picture to people who subsequently search for information using these analyses. As organisation-level data is aggregated into statistics, better reporting by every organisation will produce better-quality data at industry and national level.



Recommendations – Better R&D reporting goes beyond the organisation

The findings from this research indicate there is substantial room for improvement in the quality and reliability of corporate reporting in this area, particularly for a sizeable number of organisations that may not be genuinely R&D inactive.

We have included recommendations that are targeted at each stakeholder group, including organisations undertaking R&D, the professional accountants servicing them, standard setters, policymakers and the users of annual reports. Proactive actions by all stakeholders will support the production of more reliable and decision-useful information about R&D around the world.

Professional accountants and organisations undertaking R&D

Reporting R&D expenditure separately and providing further information about R&D may improve an organisation's attractiveness to investors and talent, as mentioned above. In the absence of guidance on the nature and extent of information that users want, organisations and professional accountants have resorted to disclosing information at their own discretion. Standard setters and policymakers will need to remedy this situation.

In the meantime, we recommend that professional accountants should take the following steps.

1. Engage with other functions in the organisation to **review and identify activities that should be classified, and accounted for, as R&D**. This is particularly relevant for organisations that currently employ a high volume of R&D-related terms in the narratives but give no matching R&D expense or asset in the financial statements. This phenomenon demonstrates a potential disconnection between the work of professional accountants, as preparers of financial statements, and other functions or departments in the organisation.
2. Work collaboratively with those responsible for the production of the narrative element of the annual report to **connect non-financial information in the narratives with financial information in the financial statements** (ie connecting the front and back ends of annual reports) to ensure information provided by different parts of the organisation is reliable and consistent.
3. **Encourage a change of mindset for R&D reporting across departments**.¹⁹ A shift in mindset will be necessary to enable the finance and other functions to connect the interrelations of several capitals at work and, therefore, to support better R&D reporting by collectively:

- a) identifying R&D, even if the activity happens in different parts of an organisation
- b) setting up processes and controls for separate tracking of R&D-related costs, or
- c) increasing openness to reporting R&D and the associated costs.

4. Provide further information that explains the significance of R&D to the organisation's business model. Such information should include:

- a) a general description of the R&D activity
- b) the part (or segment) of the organisation that is conducting R&D, or which part (or segment) of the organisation that R&D is conducted for
- c) the stage that the R&D activity has reached
- d) the cumulative expenditure
- e) the estimated future costs for completing it
- f) a link to financial impact – such as impact on its financial performance, financial position and/or cashflows, and
- g) a link to environmental or social impact, where relevant.

While the link between current R&D expenditure and future value may seem tenuous, insights into the nature of R&D activity will help users understand what the organisation is doing and that a proportion of the organisation's value will be derived from intangibles, or something new.

For example, in future more organisations than at present will probably invest in R&D to address sustainability matters, such as reducing greenhouse gases (GHG) emissions in their business models. If that is the case, users will want to know how much the organisation is spending on R&D and what would be the potential environmental as well as financial impacts.

5. **Avoid boilerplate disclosure**. Many users rely on general purpose financial statements for much of the financial information they need. Thus, the financial statements should explain the significance of material events and transactions and the disclosure of accounting policies should be relevant to an understanding of the financial statements.

¹⁹ A new [ACCA professional insights](#) report will present the importance of integrative thinking in managing multi-dimensional problems. It will explore the qualities of integrative thinking and will inform CFOs and aspiring CFOs about the key development approaches that will benefit them and their colleagues. The report will be published in August 2023.

6. Collate information about activities that are perceived to be R&D to inform standard setters.

Information about activities that are perceived to be R&D but do not fit into the current definition in IAS 38 will inform standard setters in updating the definition for intangibles, research, and development, as well as updating the accounting requirements. For example, this will help in informing the IASB on its Intangible Assets research project, which has been added to its workplan for 2022 to 2026.

7. Seize opportunities to highlight application challenges and discuss practical solutions with standard setters and/or policymakers. Real-life information from organisations undertaking R&D will greatly inform and influence the standard-setting process, and the creation of application guidance and illustrative examples to assist with accounting and reporting of R&D expenditure. Therefore, professional accountants should participate in outreach events and respond to consultations from standard setters and/or policymakers.

Those charged with governance (TCWG)

TCWG have the responsibility for ensuring that the organisation under their charge prepares financial statements that are true and fair. There should be greater scrutiny by TCWG when a high volume of R&D disclosure in the narratives of an annual report is not accompanied by separate disclosure of R&D expenditure in the financial statements. Therefore, we recommend TCWG take the following steps when discharging their responsibility.

- 1. Critically assess the application of materiality by management** to ensure that both the qualitative and quantitative aspects of materiality have been considered when no R&D expenditure is separately disclosed to accompany a high volume of R&D disclosure in the narratives (IAS 1: paragraph 7). In this regard, the absence of an R&D expenditure in the financial statements should not be an omission or material misstatement. Besides omission, it is worth noting that IAS 1 considers material information is obscured if the information about a material item, transaction or other event is scattered throughout the financial statements.
- 2. Review the relevance and connectivity of information in the narratives and financial statements** of annual reports to ensure that the financial and non-financial information reported in different parts of the annual report is consistent and reliable. Remind management to avoid boilerplate disclosures, particularly disclosures that are not relevant to a user's understanding of the financial statements.
- 3. Review the composition and competency of TCWG.** TCWG (often, this will be the board of directors) have the power to influence and constructively challenge management's reporting of R&D. Therefore, TCWG should have the appropriate expertise to

discharge their stewardship responsibilities, including supervising management in producing high-quality general-purpose financial reports. The findings in this research highlight the importance of having, among TCWG, a professional accountant who understands the organisation's business, is proficient in corporate reporting and can discharge that responsibility.

Auditors

The purpose of an audit is to enhance the degree of confidence in the financial statements. As part of an audit, in accordance with the International Standards on Auditing (ISA), auditors are required to obtain an understanding of the organisation and its environment (ISA 315: paragraphs 7, 19 and 20).

Though the auditor's opinion does not cover the other information that accompanies the financial statements (ISA 720: paragraph 2), the auditor is required to read and consider whether there is a material inconsistency between the other information and the financial statements, or the auditor's knowledge about the organisation and its environment (ISA 720: paragraphs 3 and 11). An auditor who identifies a material inconsistency is required to discuss the matter with management and, if necessary, perform further procedures to conclude whether there is a material misstatement (ISA 720: paragraph 16).

Our recommendations (1) and (2) for TCWG, as set out above, are similarly applicable to auditors. In addition, auditors should **assess the discovery of any activity that should be classified and accounted for as R&D, for risk of material misstatement**. Auditors should also **assess whether the discovery is a significant finding to be reported to TCWG** (ISA 260: paragraph 16).

Standard setters and policymakers

The IAS 38 was issued in 1998 in an era where intangible assets, and R&D specifically, were not as significant as now for contemporary economies. At this point, it is our view that there is a need to fundamentally rethink what constitutes research and what constitutes development, and to use terminology that is as precise as possible. This should drive organisations to more consistent and reliable consideration of whether they are doing R&D, or not doing R&D, and then classifying the expenditure accordingly. This exercise should include intangibles and how to account for them.

In fact, most respondents to the IASB's Request for Information for Third Agenda Consultation commented on and rated a project on intangible assets as a high priority (IASB 2022). Feedback also indicates that intangible assets have become increasingly important in creating value. In its Feedback Statement, the IASB has added Intangible Assets to its research project pipeline for 2022 to 2026 and this is an area that requires the IASB and International Sustainability Standards Board (ISSB) to work together to develop consistent terminology and compatible requirements.

On that note, we recommend standard setters and policymakers should take the following steps.

1. **Critically review and update the definitions, taxonomy and terminology** of intangibles and R&D in IAS 38 – bringing them up to date and ensuring maximum alignment among national, regional and international standard setters.
2. **Review the requirements for recognition and measurement** of intangibles, and R&D. The difficulty in distinguishing the research and development phase owing to the iterative and continuous process of R&D is an area that requires reviewing. In addition, the difficulty in meeting, and the ambiguity of, the six criteria outlined in paragraph 57 of IAS 38 has been cited as a barrier to capitalising development costs in earlier research (Mazzi et al. 2019). This is another area that should be reviewed.
3. **Enhance the disclosure requirements** for intangibles and R&D. Information about R&D will be more useful if it assists users to understand the significance of such activities to the organisation's business model and the potential financial impact. This should be extended to environmental and social impact, where relevant. Disclosure requirements for both financial and non-financial information should be clear and explicit. As one roundtable participant said:

‘These disclosures should not stand alone. They should be related. You should make a link to financial performance’.
4. **Provide guidance** for applying the definition and the recognition and measurement requirements. For example, explaining the thought process in applying the definition and the recognition and measurement requirements will be helpful for preparers, auditors and supervisory bodies.
5. **Update the examples** of what may constitute research or development activities.
6. **Provide illustrative disclosures** showcasing the decision-useful information that users need.

The additional guidance in recommendations (4), (5), and (6), taken together, should help remove barriers to reporting and accounting appropriately for R&D. They should facilitate a change of reporting behaviour among preparers and enhance comparability of reporting across organisations.

We suggest undertaking the above exercise, steps (1)–(6), in collaboration with organisations undertaking R&D and working together with national and regional standard setters to gather live data, field-test solutions and maximise alignment of definitions and accounting requirements.

In relation to recommendation (3), we are keenly aware of the IASB's improved approach to developing disclosure requirements in guidance that was published on 8 March 2023 (IASB 2023). The disclosure requirements of an accounting standard that will be drafted in accordance with this guidance will typically comprise three main components:

- a) an overall disclosure objective that describes the overall information needs of users of financial statements
- b) specific disclosure objectives that describe the detailed information needs of users, and
- c) a description of the items of information that satisfy the specific disclosure objectives.

In relation to (b), further information about R&D that will be useful to users is set out in our recommendation (4) for professional accountants.

Users

Improving the reporting of R&D requires a multitude of solutions. Users can become part of the process of producing decision-useful information that meets their needs.

Therefore, we recommend that users should take the following steps.

1. **Participate in outreach and/or consultations by standard setters and/or policymakers.** Real-life information from users about the nature and extent of the information that drives their decisions will greatly inform the creation of application guidance and illustrative examples by standard setters. The guidance will in turn assist organisations in preparing the required information in a consistent and comparable manner. In addition, certain users may influence policymakers to promote the reporting of R&D and the associated expenditure. These users may rely on the general-purpose financial reports for assessing eligibility for licences, grants, R&D-related financing, or tax incentives.
2. **Take a closer interest in an organisation's activities.** This is particularly relevant for investors who should be using available channels, such as the investor relations department, to convey enquiries or challenge conflicting disclosures by management. Investors may also suggest improvements to reporting in the annual reports.

Conclusion and the way forward

Better reporting of R&D should help users to understand the significance of R&D to the organisation's business model and connect it to any material financial, social and/or environmental impact that is relevant to the organisation. Better reporting of R&D by organisations will also have a profound impact on the quality of data in industry- or national- level statistics.

Therefore, the information gap between information reported within and outside the financial statements needs to be closed. Annual reports should not be sending mixed signals to users about the significance of R&D to the organisation.

Proactive actions by all stakeholder groups collectively will be necessary to produce reliable and decision-useful information and improve the overall quality of corporate reporting by organisations undertaking R&D.

We emphasise the following key recommendations for relevant stakeholder groups.

Professional accountants should:

1. **review and identify activities that should be classified, and accounted for, as R&D**
2. **connect non-financial information in the narratives with financial information in the financial statements** to ensure information provided by different parts of the organisation is reliable and consistent
3. **encourage a change of mindset for R&D reporting across departments**
4. **provide further information that explains the significance of R&D to the organisation's business model**
5. **avoid boilerplate disclosures**
6. **collate information about activities that are perceived to be R&D, to inform standard setters**
7. **seize opportunities to highlight application challenges and discuss practical solutions with standard setters and/or policymakers.**

Recommendations (6) and (7) will greatly inform standard setters in their efforts to review and update IAS 38 as well as related IFRS Accounting Standards and guidance.

Those charged with governance (TCWG) should:

1. **critically assess the application of materiality by management** to ensure that both the qualitative and quantitative aspects of materiality have been considered when preparing disclosures in the financial statements
2. **review the relevance and connectivity of information in the narratives and financial statements in annual reports**
3. **review the composition and competency of TCWG** for their effectiveness in supervising the organisation's quality of corporate reporting.

Auditors should:

1. **assess the discovery of any activity that should be classified, and accounted for as R&D, for risk of material misstatement**, and report the discovery to TCWG if it is a significant finding
2. **take note of our recommendations (1) and (2) for TCWG, above, which are similarly applicable to auditors.**

Standard setters and policymakers should:

1. **critically review and update the definitions, taxonomy, and terminology** of intangibles and R&D in IAS 38
2. **review the requirements for recognition and measurement** of intangibles and R&D
3. **enhance the disclosure requirements** for intangibles and R&D
4. **provide guidance** for applying the definition and the recognition and measurement requirements
5. **update the examples** of what may constitute R&D activities
6. **provide illustrative disclosures.**

We suggest undertaking the above exercise, (1) – (6), in collaboration with organisations undertaking R&D and working together with national and regional standard setters.

Users should:

1. **participate in outreach and/or consultations** to inform standard setters and/or policymakers about the nature and extent of the information they need to drive their decisions
2. **take a closer interest in an organisation's activities** and convey enquiries or challenge conflicting disclosures by management through available channels, such as the investor relations department.

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Appendix A: Glossary

TERM	DESCRIPTION
back-end of annual report	See 'financial statements' q.v.
CFO	Chief financial officer
Conceptual Framework	The revised Conceptual Framework for Financial Reporting issued by the IASB in March 2018
financial statements	This refers to the back-end of an annual report, which comprises the complete set of financial statements and the auditors' report. A complete set of financial statements is defined in paragraph 10 of IAS 1 Presentation of Financial Statements.
front-end of annual report	See 'narratives' q.v.
IASB	The International Accounting Standards Board
IAS 1	IAS 1 Presentation of Financial Statements
IAS 38	IAS 38 Intangible Assets
ISA	International Standard on Auditing
ISA 260	ISA 260 (Revised) Communication with Those Charged with Governance
ISA 315	ISA 315 (Revised 2019) Identifying and Assessing the Risks of Material Misstatement
ISA 720	ISA 720 (Revised) The Auditor's Responsibilities Relating to Other Information
narratives	This refers to the front-end of an annual report up to but excluding the financial statements.
R&D-active	An organisation that reports either an R&D asset and/or an R&D expense separately in its financial statements
R&D-inactive	An organisation that has not reported any R&D asset and/or R&D expense separately in its financial statements
recognition of R&D	According to paragraph 18 of IAS 38, the recognition of an item as an intangible asset requires an organisation to demonstrate that the item meets the definition of an intangible asset, and the recognition criteria. As per paragraph 21 of IAS 38, an intangible asset shall be recognised if, and only if: (a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the organisation; and (b) the cost of the asset can be measured reliably. An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an organisation can demonstrate all six criteria set out in paragraph 57 of IAS 38. However, no intangible asset arising from research (or from the research phase of an internal project) is to be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred, as per the requirement in paragraph 54 of IAS 38.
report/reporting	The communication of information about an organisation. This can be done through numerous media, including the annual report, comprising the narratives and financial statements. Effective communication of information in financial statements makes that information more relevant and contributes to a faithful representation of an entity's assets, liabilities, equity, income and expenses. It also enhances the understandability and comparability of information in financial statements, according to paragraph 7.2 of the Conceptual Framework.
significant findings from audit	These are matters that auditors shall communicate with TCWG, as required in paragraph 16 of ISA 260.
switchers	Organisations that have switched from one category to another (ie from R&D inactive to R&D active, or vice versa).
TCWG	Those charged with governance
users	This term typically refers to existing and potential investors, lenders and other creditors. Existing and potential employees, suppliers or customers may also use the annual report when seeking information about the organisation.

Appendix B: Location of key information and data analysis employed in this research

This table aims to help you find key information and data analysis employed in this research that are presented in the research report, *Reporting of R&D: Disclosure without Recognition?* All references to page numbers for corresponding tables or figures refer to their location in the research report.

KEY INFORMATION	FIGURE/TABLE	PAGE
Sample selection process	Table 2.1	11
Sample composition of R&D-active, R&D-inactive and switchers	Figure 2.1/Table 2.2	12
Definition of variables used in univariate and multivariate analysis	Table A2.1	46
List of R&D-related terms used in this research	Table A4.1	50
DATA ANALYSIS BY COUNTRY/LOCATION		
Percentage of R&D-inactive samples by country/location	Figure 2.2	14
Proportion of R&D-active and R&D-inactive samples by country/location	Table A1.1	44
Percentage of country-level mean R&D expenditure in the economy as a proportion of the country's GDP, for the sample period	Table A1.1	44
Comparison of characteristics of R&D-inactive and R&D-active organisations (excluding mainland China)	Table 2.3	17
Comparison of characteristics of R&D-inactive and R&D-active organisations (mainland China only)	Table A3.1	48
Multivariate analysis examining the likelihood of being classified as an R&D-inactive organisation (excluding mainland China)	Table 2.4	18
Multivariate analysis examining the likelihood of being classified as an R&D-inactive organisation (mainland China only)	Table A3.2	49
Number of samples in each country/location by minimal, low and high disclosure group across annual reports, narratives and financial statements	Table 3.4	25
Frequency of R&D-related terms in annual reports, narratives and financial statements of High disclosers by country/location	Figure 3.1	26
Frequency of R&D-related terms in all sampled annual reports, narratives and financial statements by country/location	Table A5.1	51
DATA ANALYSIS BY INDUSTRY		
Percentage of R&D-inactive samples by industry (excluding mainland China)	Figure 2.3	15
Proportion of R&D-active and R&D-inactive samples by industry (all samples)	Table A1.2 (Panel A)	45
Proportion of R&D-active and R&D-inactive samples by industry (mainland China only)	Table A1.2 (Panel B)	45
Percentage of R&D-inactive samples by industry (mainland China only)	Figure A3.1	48
Number of samples in each industry by minimal, low and high disclosure group across annual reports, narratives and financial statements	Table 3.5	27
Frequency of R&D-related terms in annual reports, narratives and financial statements of High disclosers by industry	Figure 3.2	28
Frequency of R&D-related terms in annual reports, narratives and financial statements by industry	Table A5.2	52

KEY INFORMATION	FIGURE/TABLE	PAGE
DATA ANALYSIS BY TYPE OF DOCUMENT		
Frequency of R&D-related terms in annual reports, narratives and financial statements (all samples)	Table 3.1 (Panel A)	22
Frequency of R&D-related terms in annual reports, narratives and financial statements (across samples that did and did not capitalise software development cost in the year)	Table 3.1 (Panel B)	22
Frequency of R&D-related terms in annual reports, narratives and financial statements (across samples that did and did not report other intangibles)	Table 3.1 (Panel C)	22
Frequency of R&D-related terms in annual reports, narratives and financial statements across minimal, low and high disclosers	Table 3.2	23
Number of samples in each disclosure group (ie, minimal, low and high) across narratives and financial statements.	Table 3.3	24
Characteristics of organisations classified as above and below average disclosers (based on frequency of R&D-related terms in narratives)	Table 3.7	30
Determinants of the likelihood of an organisation being an above average discloser in annual reports, narratives and financial statements	Table 3.8	31
Most and least popular R&D-related terms identified in annual reports of R&D-inactive high disclosers	Table 3.6	29
Most and least popular R&D-related terms identified in all sampled narratives and/or financial statements of R&D-inactive organisations	Table A6.1	53

