

INSTITUTIONAL SHAREHOLDERS' COMMITTEE

Suggested Disclosure of Research and Development Expenditure

1 INTRODUCTION

- 1.1 Institutional investors are from time to time accused of not making sufficient allowance for a company's long term growth potential. Sometimes the answer is that companies are too secretive about their long term plans for investors to be able to assess that potential.
- 1.2 These arguments come into focus over Research and Development. Of all classes of 'discretionary expenditure', R&D is the one most closely linked with long-term development. Yet most companies do no more than comply with the very limited disclosure requirements of SSAP 13 and some do not even do that. How then can shareholders hope to make judgements about long-term prospects?

This paper attempts to break the impasse by setting out those facts about R&D that it would be useful for institutional investors to know, whether through the accounts or through other channels. The onus is now with companies to provide that information.

2 WHY DISCLOSURE OF R&D COSTS WOULD BE HELPFUL

- 2.1 A company's commitment to R&D is an important indication of its future prospects and investors are keen to learn as much as they can about this topic, including the record in recent years, since any information on successful innovation in the past is indicative of the likely success of current and future expenditure.
- 2.2 Investors would particularly like to know, of course, about future plans, and here they come up against a company's understandable need to keep secrets from competitors. Often, however, secrecy is maintained as a matter of routine, without regard to its necessity. Where details cannot be disclosed without giving away too much to competitors, a lot can be done to strengthen the confidence of investors by speaking in general terms of major projected launches. *The rule should be to be positive and to reveal as much about research and innovation as is consistent with competitive prudence.*

3 COMPARABILITY AND DEFINITIONS OF R&D

- 3.1 Institutions are interested in how much is spent on R&D by any one company in comparison with its competitors in the same sector.
- 3.2 Our recommendation is that within any one sector, the definition of R&D used should be spelt out in detail, in a way that is relevant to patterns of research and development in that sector. *All companies within each sector*

should be encouraged to use the same industry-specific definition. If this could be achieved, comparisons within each industry could legitimately be made, as could analyses of year on year changes. Comparisons between industries could still be difficult, but the ISC recognises that appropriate levels of R&D investment vary greatly from one industry to another, and consequently considers that comparisons within an industry are more meaningful.

- 3.3 To achieve the above recommendation, a high level of cooperation within each industry would be required, firstly to establish a standard industry-specific definition of R&D and secondly, to secure a sufficiently wide commitment to using that definition when disclosing the level of R&D. Here the Trade Associations of each industry would have a key role to play.
- 3.4 It will be seen from the above that the precise definition of R&D used in any one sector is of less importance than that all companies in that sector should use the same one. The ISC will not, therefore, attempt to suggest its own definition, on top of those already put forward by others. However, with regard to the three categories of R&D identified in SSAP 13 (pure research, applied research and *development*) the ISC suggests that figures for all three should be given, but that the third category should be interpreted in its broadest sense. *All costs relating to the development and improvement of existing products and processes should be included as well as all costs relating to new products and processes.*

4 R&D DATA USEFUL TO INSTITUTIONAL SHAREHOLDERS

Latest Financial Year

- (a) Total R&D spend (unless insignificant by relevant industry standard).
- (b) Split (a) above between pure research/applied research/product or process development.
(Helpful as time horizons and risk and potential returns on each R&D category differ.)
- (c) Disaggregation of "in-house" R&D from that paid by or undertaken for third parties.
- (d) Allocation of "in-house" total to different company divisions.
- (e) Any data on specialist staff, buildings and equipment set aside for R&D. Any major R&D projects that have occurred during the year.

Earlier Years

- (a) Total spend in previous year.
- (b) Split (a) above between pure research/applied research/product or process development.
- (c) Allocation of "in-house" total to different company divisions.
- (d) Proportion of current sales attributable to products introduced in last 3-5 years.

- (e) Case histories of any R&D led successes in recent years.

Current Plans and the Future

- (a) The total budgeted for R&D in the current year and in the next two to three years. The company's overall strategy on R&D, now and in the years ahead.
- (b) Where there are not adequate reasons for maintaining secrecy, plans for specific new products or services. Marketing thinking behind projected launches. Basis of marketing research. Key factors that will determine success.

5 NOTES

The information requested in this paper could be provided in many ways: through press releases, at presentations to analysts, during the company's Annual General Meeting, in the narrative section of the annual report, or in the audited financial statements. To the extent that it is in the financial statements, the R&D figures must relate to activities within the SSAP 13 definitions.

SSAP 13

SSAP 13 (revised) provides the framework within which all UK companies are required to disclose R&D expenditure. However, it only sets out *minimum* disclosure levels. The ISC hopes that companies will at least comply fully with the SSAP. Further, it is hoped that more aspects of R&D will be disclosed than the SSAP requires.

SSAP 13 splits R&D into the following broad categories:

- (a) Pure (or basic) research: experimental or theoretical work undertaken primarily to acquire new scientific or technical knowledge for its own sake rather than directed towards any specific aim or application;
- (b) Applied research: original or critical investigation undertaken in order to gain new scientific or technical knowledge and directed towards a specific practical aim or objective;
- (c) Development: use of scientific or technical knowledge in order to produce new or substantially improved materials, devices, products or services, to install new processes or systems prior to the commencement of commercial production or commercial applications, or to improving substantially those already produced or installed.

Frascati

Innovation is defined in the OECD Frascati Manual as follows:

'Scientific and technological innovation may be considered as the transformation of an idea into a new or improved saleable product or operational process in industry and commerce or into a new approach to a

social service. It thus consists of all those scientific, technological, commercial and financial steps necessary for the successful development and marketing of new or improved manufactured products, the commercial use of new or improved processes and equipment or the introduction of a new approach to a social service'.

Other Initiatives

The CBI's Innovation Trends Survey and the DTI's "Scoreboard" may prove helpful in any attempt to compare R&D expenditures within an industry sector.

Overseas Considerations

In arriving at the recommended items of disclosure, the ISC has noted disclosure levels of overseas companies particularly those in the USA and amongst Scandinavian countries, both as a benchmark for what can be revealed and because those companies are often the competitors of the UK companies and, as such, can represent alternative investment opportunities.

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