Capitalized R&D in 3-Statement Models, Valuations, and Big Beautiful Bills

How to Make a Mountain Out of a Correctional Mole Hill

Capitalized R&D: Much Ado About… Something?

We recommend **against** adjusting companies' financial statements to "capitalize" R&D in models and valuations.

If the company is *already* capitalizing some/all of its Research & Development (very common for int'l companies under IFRS), you can continue with that.

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Yes, some sources, like Prof. Damodaran at NYU, recommend adjusting for **theoretically sound** reasons…

…but it creates **practical issues** with the forecasts, valuation multiples, and comparability, and the ongoing AI hype wave and spending make it even trickier.

Capitalized R&D: Much Ado About… Something?

If you want this tutorial in writing, along with screenshots, PDFs, and the Excel model, go to this URL (**pinned in the comments**):

https://breakingintowallstreet.com/kb/financial-statement-analysis/capitalized-rd/

Why to Avoid Capitalized R&D: Outline

Part 1: The Short Answer…

- **Basics:** Shown in the Twitter / X Model excerpt – at the time of this deal, U.S.-based firms had to capitalize and amortize their domestic R&D spending for tax purposes

- **So:** Take the normal R&D spending on the IS and instead of deducting it right away, distribute it over ~5 years, and deduct that amortization

- **One Step Further:** This is just for the Tax calculation; to "capitalize" it fully, we would list the R&D on the Cash Flow Statement under CapEx and then list the R&D Amortization directly on the IS

Part 1: The Short Answer…

- **U.S. GAAP:** This treatment was only a requirement for a few years; ended when the "One Big Beautiful Bill" passed in 2025, allowing companies to fully deduct R&D once again

- **Practical Issues:** How do you estimate the "useful life" of R&D spending or split it into different projects/tasks? Rely on and trust the company? What if they don't disclose anything? What to do about massive spending on AI tokens?

- **Valuation:** Means that **EBITDA** now differs for companies that capitalize vs. expense R&D and requires adjustments; distorts operational metrics like ROIC, also requiring adjustments

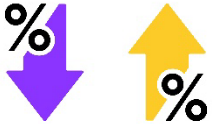
Part 2: Companies Already Capitalizing R&D

- **Xero:** Accounting/finance software for small businesses; based in New Zealand

- **Accounting:** By default, it **capitalizes** part of its R&D spending and **expenses** the rest (IFRS allows expensing for the experimental/trial stage of development)

- **DCF Treatment:** Deduct both portions and reflect much higher D&A due to the R&D Amortization

- **Proper Benchmarks:** D&A / Revenue vs. (CapEx + Capitalized R&D) / Revenue rather than just CapEx



Part 3: Comparability Issues

- **Advocates:** Often argue that capitalizing R&D "more accurately" represents companies' margins in a DCF…

- **And:** Maybe, but these differences even out over time, and capitalizing R&D creates issues with other methodologies
- **Company A:** Expenses 100% of its R&D spending
- **Company B:** Capitalizes 100% of its R&D spending

- **Company A:** Lower EBITDA and much higher EBITDA multiple

Part 3: Comparability Issues

- **But:** This is quite deceptive because both companies spend the same amount in a year; just record it differently

- **Solution:** Deduct *all* R&D spending within EBITDA, including Capitalized R&D, to get a better comparison

- **Other Metrics:** Similar issues with metrics like ROIC because the Equity and Cash levels and NOPAT also differ

- **So:** Why bother? By making one "adjustment," you end up having to make many others in sets of comparable companies

Recap and Summary

- **Part 1:** The Short Answer

- **Part 2:** What to Do for a Company Already Capitalizing R&D

- **Part 3:** Comparability Issues and Valuation Multiples