Accounting transparency effort tied to decreased funding for innovation

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Two new studies find that regulations aimed at improving the transparency of corporate accounting practices may have had unintended consequences. Specifically, the researchers found that corporate financial reporting requirements implemented in 2007 were associated with decreases in the amount of money companies spent on innovation, capital improvements, and mergers and acquisitions.

The first paper, "IRS Scrutiny and Corporate Innovation," is published in the journal *Contemporary Accounting Research*. The second paper, "Did FASB Interpretation Number 48 (FIN 48) Affect Noninnovative Corporate Investment?", was published in the *Journal of the American Taxation Association*.

"Accounting transparency is important, particularly for publicly traded companies," says Nathan Goldman, corresponding author of the two papers. "That being said, our findings suggest there can be unexpected knock-on effects of some transparency efforts, such as a decline in corporate innovation." Goldman is an associate professor of accounting in North Carolina State University's Poole College of Management.

The studies' findings are particularly relevant given new rules passed on Aug. 30 that require companies to provide enhanced tax disclosures beginning in 2025.

The two studies focus on something called Financial Interpretation Number 48 (FIN 48).

The Financial Accounting Standards Board is responsible for regulating accounting practices in the United States. In 2007 the FASB issued FIN 48, a document that addressed two issues related to corporate income tax.

First, FIN 48 adopted a "more likely than not" standard for unrecognized tax benefits (UTBs)—which are tax positions that save a company money, but which may be overturned by an IRS audit. The new standard meant that companies could claim a given tax benefit, but had to make clear to auditors and stakeholders that they have to pay the relevant tax if they deemed it more likely than not that an audit would overturn the tax claim.

Second, FIN 48 required publicly traded companies to incorporate more detailed descriptions of any UTBs in their financial disclosures—which are used by shareholders and others to assess the financial health of companies.

"Companies are reluctant to highlight uncertainty regarding their tax burden in public-facing financial statements," Goldman says. "That's because companies feel that statements of uncertainty may raise concerns among shareholders and—perhaps more importantly—invite additional scrutiny from the IRS.

"Given this resistance to reporting uncertainty, my collaborators and I were curious about the extent to which FIN 48 may have influenced corporate investment decisions. For example, research and experimentation (R&E) tax credits are a legitimate tool for subsidizing innovation costs. But the regulatory language governing R&E tax credits leaves substantial room for interpretation, and that means that claiming R&E tax credits will often qualify as a UTB that companies would need to report in their financial statements."

To determine how FIN 48 may have influenced corporate decisions, researchers conducted two studies.

For one study, Goldman and colleagues focused on determining the extent to which FIN 48 was associated with changes in corporate spending on "innovation." Specifically, the researchers used patent applications as proxies for corporate innovation and looked at data on the number of patents filed by both publicly traded and private companies in the four years leading up to FIN 48 and the four years following the issuance of FIN 48. Because privately held companies are not required to publicly disclose their UTBs, any differences between public and private companies in the number of patents filed after FIN 48 likely reflects the impact FIN 48 had on how companies chose to invest their resources.

"We found that the number of non-radical corporate innovations declined due to enhanced IRS scrutiny following the implementation of FIN 48. However, radical patent applications—meaning new patents that hinge on new discoveries and don't cite other patents—incurred no change," Goldman says.

"These findings tell us that public companies were shying away from investing in areas where claiming R&E tax credits would trigger new UTB reporting requirements under FIN 48. To put that in context, there was no change in patents filed by private companies, suggesting that FIN 48 was responsible for the difference in innovation investments between public and private companies."

This finding raised the question of whether companies that reduced innovation were instead using those resources to invest in other aspects of their business.

To explore this question, Goldman looked at data from publicly held companies based in the U.S. as well as comparable companies based outside of the U.S. The data covered the three years prior to FIN 48 and the three years following the issuance of FIN 48.

"Because companies based outside the U.S. are not subject to FIN 48, but are otherwise competing in the same sectors in the same global marketplace, this second study is able to determine the extent to which FIN 48 is associated with changes in investment strategy by U.S. based public firms," Goldman says.

In the second study, Goldman found that public companies had reduced their investments in capital expenditures—such as buying real estate or equipment—and investments in acquiring other companies. In other words, the same companies that were decreasing investments in innovation were not shifting those resources into other areas that would help them improve their market share.

"In the context of UTBs and IRS oversight, investments in capital expenditures and acquisitions are less uncertain than investing in innovation, but they do still carry some uncertainty," Goldman says.

"Taken together, the findings from these two studies suggest that this uncertainty, and FIN 48's UTB reporting requirements, were sufficient to put a damper on all three investment areas: innovation, capital expenditures and acquisitions. Instead, the companies could choose to simply increase their cash reserves, increase dividends to shareholders or increase spending on employees.

"Accounting standards are constantly evolving to improve corporate transparency, which is laudable," Goldman says. "However, it's important to understand the full scope of impacts associated with these transparency efforts. Our research here suggests that companies are wary of highlighting any uncertainty related to their investments, and that transparency efforts have inadvertently led to companies backing away from investments in research and other areas. It underscores that regulatory bodies need to consider the myriad ways new standards can influence corporate decision-making."

Goldman says, "The results of our research on FIN 48 suggest that the disclosure requirements passed by the FASB on Aug. 30 may have unintended effects."

More information: Nathan Goldman et al, IRS scrutiny and corporate

innovation, *Contemporary Accounting Research* (2023). DOI: 10.1111/1911-3846.12905

Nathan C. Goldman, Did FASB Interpretation Number 48 (FIN 48) Affect Noninnovative Corporate Investment?, *The Journal of the American Taxation Association* (2023). DOI: 10.2308/JATA-2021-034

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