Study examines how financial disclosure policy affects firms' innovation strategy

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If companies in sectors like pharmaceuticals or technology could keep early failures private, would that encourage more innovation and long-term success?

Researchers at the University of Zürich and Carnegie Mellon University have explored that question and found that how companies share financial information can significantly impact their willingness to innovate. Within a commonly-used bandit problem designed to model innovation choices, they discovered that when firms can keep early failures private, they are encouraged to experiment more, leading to greater long-term success.

The study was published in the *Journal of Accounting Research*.

"Our findings suggest that companies are more likely to innovate when they can manage the timing of their disclosures," said Pierre Jinghong Liang, study co-author and professor of accounting at the Tepper School of Business at Carnegie Mellon. "This insight is crucial for both managers and policymakers aiming to foster a more innovative business environment."

Companies face a strategic choice between using existing technologies, which are reliable, and exploring new methods, which are riskier but could yield greater rewards in the long run. Understanding how disclosure policies influence these choices can help create better regulations and business practices that encourage innovation.

The researchers focused on companies facing an innovation choice in an early trial stage followed by a later full-scale product launch for this study. They analyzed how managers' decisions to innovate were affected based on when they had to disclose financial results. The results showed that firms operating in an environment with voluntary early-stage disclosure and mandatory later-stage disclosure were more likely to experiment with new methods, leading to higher long-term success.

For example, imagine a company has two ways to make a product: one method they've used before and know works well; and a new, untested method that might be better but could also fail. In the first period, the company tries the new method on a small scale. If it works, they use it for a bigger launch in the second period; if it fails, they return to the old method. This way, the company learns and decides whether to stick with the safe option or take a risk for potentially better results.

"Our research highlights that early mandatory disclosure can actually hinder innovation by pushing managers to avoid risky, but potentially rewarding, new methods," said Evgeny Petrov, a co-author of the study and a professor of accounting from the University of Zürich.

"This was a surprising finding that challenged traditional views on transparency," added Professor Hui Chen, another co-author also from the University of Zürich.

The study authors offer the following theoretical predictions: Private startups planning to go public (like through an IPO) are more likely to innovate compared to those that remain private. On the other hand, public companies planning to go private are less likely to innovate than those that stay public. This is important because it shows how different rules for sharing financial information can influence a company's willingness to try new things and be creative.

Understanding the timing of financial disclosures can help investors, regulators, and business leaders make better decisions to support innovation.

More information: Hui Chen et al, Innovation and Financial Disclosure, *Journal of Accounting Research* (2024). DOI: 10.1111/1475-679X.12546

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