FINANCIAL REPORTING REGULATION AND SMALL RESEARCH-INTENSIVE FIRMS

by Bertrand Horwitz and Richard Kolodny

Within the past several years we have witnessed an increasing concern by Congress, particularly Senator Gaylord Nelson's Select Committee on Small Business, about the retardation of small business capital formation. Various task forces have been established to suggest ways to stimulate capital formation by small business, e.g., the Advisory Committee on Federal Policy on Industrial Innovation. The recommendation of these groups have tended to follow a similar pattern. Most frequently suggested has been a revision of the tax laws, such as raising the surtax exemption or permitting investors to defer capital gains taxes on reinvestment in small business. Also mentioned are revisions in the laws applying to Small Business Investment companies, revisions of ERISA with a view toward amending the "prudent man" rule to permit pension funds to make greater investments in small business, and revisions of state and federal regulation in general. Certainly, the need to stimulate small business investment is widely recognized.

This article will focus on the effect of reporting rules required by the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) on small business capital formation. Although the Commission has historically recognized that its essential function is "investor protection," it has recently, and of its own volition, been concerned with impediments to capital formation which arise from the high cost of compliance with its rules. Formally, a June 4, 1975 amendment to the SEC Act of 1934 has, in effect, required the Commission to undertake an economic study of its own rules:

> The Commission, in making rules and regulations pursuant to any provisions of this chapter, shall consider among other matters the impact any such rule or regulation would have on competition. The Commission shall not adopt any such rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of this chapter.[1]

In the spirit of this amendment, the SEC recently amended several rules which were judged to be unfairly burdensome to small business. A major step was taken when the Commission allowed small companies offering securities in amounts between $1.5 and $5 million to use a simplified form of registration, Form S-18, which significantly reduces their legal and accounting costs. Previously, all companies were required to file on Form S-1, the Commission's most elaborate and most costly registration form.

Many respondents at the SEC public hearings on problems of small business

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This article is an outgrowth of a larger study on the economic consequences of R&D reporting, which was partially supported by the National Science Foundation, Grant PRA 78-21782.

[1] Securities and Exchange Act, 15USC, Par. 78 w(a)(2), June 4, 1975.

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had complained about costly registration and reporting rules. Data collected in an earlier study by the Advisory Committee on Corporate Disclosure supported their contention.[2] In that study it had been found that the average cost per $100,000 of sales for submitting Form S-1 alone, i.e., excluding costs of Forms 10-K, S-7, and 10-Q, was $1,849.91 for a small company with assets less than $100 million, compared to $27.30 for a medium-sized firm with assets between $100 million and $1 billion. (No data were given for companies over $1 billion, but a reasonable approximation would be $5.00 per $100,000 of sales.) The new Form S-18, and amendments to form 10-K for annual reports, considerably reduce disclosure costs for small firms.

Another sign that consideration is being given to the impact of disclosure requirements on small business is the recent establishment of the Office of Small Business Policy within the SEC:

> The great concern which the government has today for the well-being of small business stems from the vital role it plays in the general economy. The contribution of small businesses in supplying jobs, technical innovation, and generally in keeping our system competitive requires that unnecessary obstacles to their formation and growth be removed. . . . The [new] Office of Small Business Policy [of the SEC] will have primary responsibility for developing and assisting in the development of rules and regulations designed to assist and ease capital formation.[3]

Financial disclosure rules, such as in registration statements or annual reports, constitute only one of two general responsibilities of the SEC. The other responsibility is the establishment of the particular measurement rules (accounting principles) to be used in reporting the relevant information. In other words, two of the SEC's responsibilities can be viewed as (1) the determination of the level of disclosure, and (2) the determination of the manner (i.e., measurement rules) by which that disclosure is presented. Until recently, the latter responsibility had received comparatively little consideration by the SEC. Beyond that, almost no attention, again until recently, had been devoted to the specific question of how mandated measurement rules impact on capital formation of small business. Let us turn to this question.

Recognition of Possible Effects of Measurement Rules on Business Decisions

The SEC has the sole authority and responsibility for establishing ". . . the methods to be followed in the preparation of accounts and the form and content of financial statements to be filed under the Acts. . . ." In fulfilling this responsibility, the Commission has relied on a private standard-setting body, the Financial Accounting Standards Board, to "provide leadership in establishing and improving accounting principles."

A cardinal objective of the FASB and its predecessor, the Accounting Principles Board, in fulfilling the responsibility delegated to them by the SEC, has been to eliminate "wrong" methods of reporting in its attempt to achieve uniformity. Uniformity, sometimes referred to by its opponents as "rigidity," is viewed by the FASB as a means of eliminating any abuses by management of previously existing alternatives, and as a necessary ingredient of providing improved comparability of financial statements to investors.

The debate over whether to impose uniform measurement rules has centered on potential consequences for investors. The effects of such rules on

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[2] U.S. Congress, House Committee on Interstate and Foreign Commerce, *Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission*, 95th Congress, 1st Session, 1977, Chapter 27, "The Small Business Problem."

[3] R. Karmel, "Regulatory Reform to Assist Small Business," remarks to the Hennepin County Bar Association, Securities Law Section, Minneapolis, Minnesota, April 26, 1979.

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the investment decisions of firms, particularly smaller firms, generally have been neglected. There have been two important exceptions, however. First, during the Kennedy and Nixon years a controversy arose about the single, most appropriate method to use for measuring the effects of the tax savings arising from the investment credit. The Senate Finance Committee later wrote into the 1974 tax act a clause that companies should have a free choice between two alternatives. The provision to permit alternative methods was strongly supported by the Treasury Department on the grounds that, otherwise, the mandated method might diminish the job-creating effect of the credit.

A second instance arose in 1976 when the FASB deliberated the appropriate measurement rule for the accounting of unsuccessful drilling and exploration costs in the oil and gas industry. At that time, the practice was either to expense or defer those expenditures.

After extensive hearings, the Board issued an Exposure Draft which banned the deferral option. Small companies were most affected by the rule, since a significantly higher percentage of such companies had relied on the deferral method. The SEC was immediately appealed to and reminded that the 1975 Amendment required it to hold hearings evaluating the economic impact of the FASB recommendation.

Testimony before the SEC by the managements of smaller firms revealed a strong concern that, because the mandated switch would reduce profits or increase losses, the cost of capital of affected firms would rise. This, they claimed, would result in a reduction in exploration activity. Also, it was alleged that firms would decrease exploration activity in an attempt to offset or eliminate the reduction of profits or increase in losses that would otherwise follow.

Many other groups, organizations and agencies, including the Justice Department, the Department of Energy and the Federal Trade Commission, expressed reservations about the ruling, contending that negative economic consequences might ensure. For example, at the hearings before the SEC, the FTC testified that "[a] firm delaying certain activities, will be able to alter its accounting earnings, and meet a perceived need to maintain high net income. Thus, an accounting change *could* lead to altered spending activity in a way that otherwise does not make good business or economic sense."[4] (Emphasis added.) Finally some persuasive evidence was also provided on this issue by scholarly research that concluded that the security returns of the firms affected by the mandated switch were reduced relative to the unaffected firms.

After considering the testimony presented at the hearings, the SEC decided that neither deferral nor expensing was appropriate, that research should begin on a form of current value accounting, and that both methods which had been used would remain acceptable for the time being. The FASB then suspended the statement containing its expensing rule.

R & D Accounting and Small Companies

An issue regarding the appropriate uniform method to account for research and development was raised in the early 1970s. As in the case of the oil and gas controversy, two methods had been used to account for R & D: the deferral method, by which R & D could be treated as an investment and written off over time, and the expense method which allows

[4] Federal Trade Commission, Bureau of Competition, *Comments before the SEC Concerning Accounting Practices of Oil and Gas Producers*, File S7-315, May, 1978, p. 27.

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R & D to be written off against income in the year of incurrence. Also, as in the oil and gas industry, the most significant users of the deferral method were small companies.

In 1974 the Board held hearings and unanimously voted to require expensing of R & D outlays by all companies. The rule—Statement No. 2, *Accounting for R & D Costs*—became effective January 1, 1975, and was formally accepted by the SEC in October 1975 as ASR 178. This was four months after the aforementioned amendment to the Exchange Act requiring that rules and regulations not be anti-competitive.

Although respondents at the hearings generally agreed on the need for disclosing the amounts of R & D outlays, there was disagreement on the method of measurement, the smaller, deferring companies raising the greatest objections to mandated expensing. These companies claimed that imposing the expensing method would raise their cost of capital, causing them to cut back on their R & D expenditures.

There was no research related to the economic effects of mandating the expense-only rule prior to its adoption. The only research on this issue cited by the FASB came in its Statement No. 7, *Accounting and Reporting by Development Stage Companies,* which was issued in June, 1975. There the Board referred to a Department of Commerce study which concluded that "FASB's Statement Two should not have a significant impact on those firms who have heretofore capitalized R & D."[5]

The study cited was based entirely on interviews with forty lenders and investors, managers of eleven small, high-technology firms (only four of which had used the deferral method), eleven accountants, and several government agencies. The motivation for the study resulted from the Department's concern with "a recent drop in R & D investment and the need for incentives to assist technological innovation."[6]

The study revealed that, although all of the sophisticated investors queried replied that they would not limit their investments in developing R & D companies as a result of the rule, 25 percent thought that *other* sophisticated investors might limit their investments. More importantly, over 40 percent of the sophisticated investors (venture capitalists, investment bankers, etc.) thought that the average investor would limit his or her investment in these companies as a consequence of the expense-only rule. A recent study of the sources of total capital of small, high-technology firms reveals that a significant proportion of the total is supplied by the "average investor," perhaps about 30 percent.[7]

The eleven accountants interviewed felt that the mandated change would not affect R & D investments by companies. However, the reasons for such a belief were not indicated; conceivably the responses might have been related to the perceived need to reduce auditors' risk, as it is easier to verify expensed than capitalized R & D.[8] Most importantly, three of the eleven managers of the high technology firms said that they would reduce planned R & D expenditures as a consequence of the mandatory change, and four of

[5] Statement of Financial Accounting Standards No. 7, *Accounting and Reporting by Development Stage Enterprises*, FASB, Commerce Clearing House, Inc., 1979, par. 50.

[6] U.S. Department of Commerce, "Impact of FASB's Ruie Two Accounting for Research and Development Costs on Small/Developing Stage Firms" (Washington, D.C.: U.S. Department of Commerce, January 20, 1975).

[7] *An Analysis of Venture Capital Market Imperfections*, National Bureau of Standards, 1976, p. 11.

[8] Perhaps the Board had this in mind when it stated that ". . . a standard-setting authority must concern itself with the costs and benefits of the standards it sets—costs and benefits to both users and preparers of such information, and to others like auditors who are also concerned with it." Financial Accounting Standards Board, Exposure Draft, *Qualitative Characteristics: Criteria for Selecting and Evaluating Financial Accounting and Reporting Policies*, August, 1979, par. 117.

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the eleven replied that they anticipated difficulty in raising capital because of the ruling. Since, as noted above, only four of the companies interviewed used the deferral method, we can conclude that 75 percent of the affected firms stated they would cut back R & D and 100 percent stated they would have more difficulty raising capital as a consequence of the ruling. This conclusion rests on the assumption that none of the seven expensing firms interviewed would change their business, since they would be unaffected by the rule.

The Impact of R & D Rule: Empirical Results

Because of feared economic consequences, the proposed uniform rules for reporting the investment tax credit and for reporting exploration and development costs never became effective. Thus, one can only conjecture about consequences had they been enacted. Because Statement No. 2 became effective in January 1975, however, it is possible to test empirically the hypothesis that the expense-only rule had no effect. We have completed a series of such tests.

Companies were selected from the SEC *Disclosure Journal* which (1) had deferred R & D before the rule, (2) had an auditor's qualification signifying a material effect on income or assets resulting from the required switch from deferral to expensing, and (3) had information on R & D outlays in their SEC Forms 10-K for 1970-1977, inclusive. A sample was selected of forty-three small companies which satisfied the three conditions listed above. Each of these firms did not have more than $100 million of sales and was traded over-the-counter. Also selected was a control sample of companies matched with the first set of firms by industry, sales volume and the relation of R & D to sales before the ruling.

An analysis was conducted, using a series of Wilcoxon Signed-Ranked Matched-Pairs tests. Three measures of the importance of R & D were considered: average yearly percentage change of R & D, average ratio of R & D to sales, and average value of R & D for an affected firm, relative to its match firm. Average values of these three variables were taken for each firm before and after the date of the rule. The results of the statistical tests showed a significant decline in all three R & D measures for the affected group of firms compared to the control group (firms always expensing). The results were sufficiently strong to justify the statement that the probability of their occurrence by chance was either 1 in 100 or 1 in 1,000. Thus, it may be concluded that there is an association between the decline of R & D outlays for the affected frims and the effective date of FASB No. 2.

Conclusion

Just as the level of financial disclosure is now being subjected to a cost-benefit analysis, we need to determine whether or not required measurement rules (particularly single, uniform methods that reduce reported profit and increase its variability), impact on firms differently. We need to be particularly concerned about small firms which, as former President Carter has said, are "the essence of our free enterprise economy."

In this article it has been shown how a single measurement rule was relaxed in the oil and gas industry, apparently because of adverse economic consequences. Previously, the FASB had softened considerably its final ruling on troubled debt restructuring, after members of the banking industry had testified that extremely adverse economic consequences would result if the procedures specified in an exposure draft were adopted.

Research and development, however, is not confined to a single industry, and, as we have seen, the af-

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fected firms are quite small. As a small company president said during the public hearings on R & D, "Innovators are a diverse, scattered, small-company type of group. They will not mobilize as a group for any purpose, much less to oppose accounting or legal rule changes, however consequential. . . ."[9] Therefore, rather than waiting for political opposition to initiate a review, a re-examination of FASB 2 probably should be considered now because, as David Solomons has said, the rule was ". . .bad cartography. . .however expedient the treatment may be."[10]

The research briefly reported here suggests that the imposition of a single measurement rule for R & D outlays may have adversely affected some small firms, particularly small, high technology firms. Because investment in R & D is so vital to future productivity, and because the small firm has a significant role in innovative research, the rule should be reviewed.

[9] Public Record, FASB No. 2, *Accounting for Research and Development Costs, Volume* XI, Financial Accounting Standards Board, 1974.

[10] David Solomons, "The Politicization of Accounting," *Journal of Accountancy*, November 1978, p. 72.

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