

# Why do Clawback Provisions Affect Financial Reporting Quality? - An Analysis of Trigger Effects

Yu-Chun Lin

**Abstract**—We identify clawback triggers from firms' proxy statements (Form DEF 14A) and use the likelihood of restatements to proxy for financial reporting quality. Based on a sample of 578 U.S. firms that voluntarily adopt clawback provisions during 2003-2009, when restatement-based triggers could be decomposed into two types: fraud and unintentional error, and we do observe the evidence that using fraud triggers is associated with high financial reporting quality. The findings support that fraud triggers can enhance deterrent effect of clawback provision by establishing a viable disincentive against fraud, misconduct, and otherwise harmful acts. These results are robust to controlling for the compensation components, to different sample specifications and to a number of sensitivity.

**Keywords**—Accruals quality, Clawback provisions, Compensation, Restatements.

## I. INTRODUCTION

THE clawback provision has received increased attention from regulators, academics, and practitioners in recent years. Section 304 of Sarbanes-Oxley Act (hereafter, called SOX) stipulates that certain bonuses previously paid to the executives could be recouped when restatements occur due to material noncompliance or misconduct.<sup>1</sup> Section 954 of the 2010 Dodd-Frank Act rules all listed firms to implement a policy to recover compensation after restatements that occur due to material noncompliance (U.S. Congress, 2010).<sup>2</sup> We believe an analysis of trigger effects in clawback provision is warranted, as clawback provisions tie executive compensation to financial reporting quality.

The design and implementation of firms' clawback policy can dramatically affect how it is perceived, its efficacy as a

deterrent against misconduct or harmful acts, and the extent to which it may be enforced. Prior research uses the dummy variable (i.e., which presents whether firms adopt clawback provisions) to shows the benefits of clawback provisions adoption [4], [6], [7] but do not discuss the differential effects of the clawback trigger types.

Using all clawback adopters, we find that fewer restatements and improved accruals quality are more likely when firms adopt clawback provisions. Particularly, comparing fraud trigger with unintentional error trigger, we find that fraud trigger has stronger deterrent than unintentional error trigger against financial misstatements. This study contributes to the literature in many other ways. The findings are relevant to regulators and managers concerned with corporate governance. Prior literature provides evidence to indicate the benefits of adopting clawback provisions [4], [6], to the best of our knowledge, no other published study has reported a finding indicating that when firms explicitly specify misconduct as the trigger, the clawback provisions are more effective. Our empirical results are expected to have useful implications for the mandatory clawbacks under Section 954 of the Dodd-Frank Act, which is based on erroneous financial statements. We find no significant association between unintentional error trigger and financial reporting quality.<sup>3</sup>

The remainder of this dissertation is organized as follows. Section II discusses the background, literature and hypothesis development. Section III describes the sample and research design. Section IV reports the descriptive statistics and empirical results. Section V contains summary and conclusion.

## II. LITERATURE AND HYPOTHESIS DEVELOPMENT

### A. Institutional Background

Although some firms utilize clawbacks prior to 2002, Section 304 of SOX is the first federal statute to introduce that certain bonuses previously paid to the executives could be forfeited to the issuer. SOX authorizes the Securities and Exchange Commission (SEC) to recoup these bonuses under Section 304 but the SEC rarely enforces this provision due to its limited recourses and difficulty in proving managerial

Yu-Chun Lin is a PhD in accounting with the National Chengchi University, Taipei, TAIWAN (phone: +886-911-831772; e-mail: 95353503@nccu.edu.tw).

<sup>1</sup>Because SOX authorizes the Securities and Exchange Commission (SEC) to recoup these bonuses under Section 304, the SEC rarely enforces this provision due to the difficulty in assessing and proving managerial misconduct (Chan et al. 2012b; Fried and Shilon 2011)

<sup>2</sup>The SEC must direct national stock exchanges to require each listed firm to adopt a policy to require the clawback of incentive compensation erroneously awarded to current and former executive officers during the three-year period preceding the date on which a firm is required to prepare an accounting restatement. The implementation of Section 954 is postponed to Final 2013. A notable trend in the development of the clawback provisions is that many U.S. listed firms voluntarily adopted their own provisions to recover bonuses before the Dodd-Frank Act.

<sup>3</sup>By comparison, SOX indicates fraud/misconduct as the trigger of the recoupment but the Dodd Frank Act operates as a "no-fault" provision.

misconduct [5].<sup>4</sup> Afterward, under the Emergency Economic Stabilization Act (EESA) of 2008 and the American Recovery and Reinvestment Act (ARRA) of 2009, the federal bail-out program re-introduced the concept of executive repayment related to inaccuracies of financial statements.<sup>5</sup>

Only financial restatements arising from misconduct gives rise to the SOX clawback, which may be enforced solely by and at the discretion of the SEC, in contrast, Section 954 of the Dodd-Frank Act in 2010 requires all listed firms adopt and implement a policy on the recovery of incentive compensation based on erroneous financial statements that are later restated due to material noncompliance with financial reporting requirements. Since the clawback provisions are mandatory under the Dodd-Frank Act, and enforced by the boards, directors will become increasingly concerned with the compliance with Dodd-Frank Act. In light of the importance of the clawback provisions to firms' compensation strategy, shareholder groups, legislators, and compensation reform advocates are endorsing clawbacks as an effective tool to prevent undeserved windfalls by mitigating compensation-related risk.

### B. Evidence of Clawback Provisions

There are four research lines for clawback provisions adoption. First, some studies discuss the economic determinants of firms' voluntarily adopting clawback provisions. Prior studies find that firms with more independent governance [1], larger firm size [3], and previous financial restatements [7] are more likely to voluntarily adopt clawback provisions. In addition, influential CEOs reduce the likelihood that a firm will adopt a clawback provision [1], [3].

Second, some research suggests that clawbacks are effective governance mechanisms that improve financial reporting quality and affect auditor behavior. For example: Chan et al. [4] shows that voluntary clawback adoptions lead to a reduction in financial misstatements. Also, market reacts favorably to such voluntary adoption by higher earnings response coefficients. Notably audit fees are lower after clawback provisions are adopted because auditors may perceive clawback adopters as associated with lower control risk, leading to lower audit risk. In another study, Chan et al. [5] finds that, while clawback-adopting firms reduce accruals management, they increase real transactions management (e.g., reduce R&D

expenditures), especially when firms have pressure to meet or beat earnings benchmarks.

The third research issue is to test market reaction to clawback provision adoption. By adopting clawback policies, firms may signal their governance quality is that they can access to more capital with lower costs [3]. Gao et al. [7] finds a significantly positive market reaction to the announcement of clawback adoption, as well as a reduction in bid-ask spreads following clawback adoption, particularly in firms with previous restatements. Finally, some studies focus on changes of CEO compensation. Prior literature finds that adopting of clawback provisions appears to increase executive compensation, deduce CEO tenure and increase CEO pay-performance sensitivity [2] [4], [6].

Despite the fact that most studies conclude that clawbacks adoption strengthens earnings quality [4], [6] and investors have positive reaction to clawback provisions adoption [7], a lack of research discusses what particular category of clawback provisions is most beneficial to improve financial reporting quality. Since the content of clawback provisions may vary widely with the language of any particular contract, different triggers result in varying administrative responsibilities when the clawbacks are applied. It is reasonable to expect that differential clawback triggers shall constitute a variety of disincentives that may affect firms' financial reporting.

## III. RESEARCH DESIGN

### A. Regression Model

We use the likelihood of restatements to proxy for financial reporting quality:

We use restatement likelihood to proxy for financial reporting quality because SOX expends CEOs' responsibilities to assure that financial statement accurately portray companies' economic activities.:

$$\begin{aligned} RESTATED_{i,t} = & \alpha_0 + \beta_1 LnASSET_{i,t} + \beta_2 BIG4_{i,t} + \beta_3 GOING_{i,t} \\ & + \beta_4 M \& A_{i,t} + \beta_5 ROA\_ind_{i,t} + \beta_6 MB_{i,t} \\ & + \beta_7 ACSIZE_{i,t} + \beta_8 ACCEXP_{i,t} \\ & + \beta_9 ACEQUITY_{i,t} + \beta_{10} CEOEQUITY_{i,t} \\ & + \beta_{11} DEFINITE_{i,t} + \beta_{12} TRIGGER\_Variables_{i,t} + \varepsilon_{i,t} \end{aligned}$$

(REST)

The dependent variable, *RESTATED*, is a dummy variable that equals 1 if a firm's year *t* financial statements are restated and 0 otherwise.<sup>6</sup> We thus use *RESTATED* to proxy for clawback provisions efficiency and predict negative association between the use of clawback provisions and restatements likelihood. We include two natures of clawback

<sup>4</sup>The recoupment at SEC level is triggered in two cases. UnitedHealth Group recently recouped more than \$450 million in compensation from its CEO, Dr. William McGuire, as a result of a stock options backdating scandal that was disclosed in 2006 (SEC 2007). In addition, Maynard Jenkins, former CEO of the car parts manufacturer CSK Auto Corp., was ordered to repay over \$4 million in connection with firm financial reports for 2004 and 2007 that were subsequently restated (SEC 2009). It has been reported that the agency is contemplating similar action in a case against Ian McCarthy, CEO of Beazer Homes (Esme 2009). While SOX does not directly address the enforcement authority of firms to recoup the compensation, it directs the regulators to introduce rules that address firms' enforcement responsibility on clawback provisions.

<sup>5</sup>Under the employment agreement, the CEOs are required to repay certain bonus and incentive- or equity-based compensation they receive if firms are required to restate their financial statements as a result of CEOs' misconduct, consistent with Section 304 of the Sarbanes-Oxley Act of 2002.

<sup>6</sup>Instead of using whether or not firms announce restatements in year *t*, variable *RESTATED* provides a more appropriate test of the association between compensation contract and restatement likelihood because firms' CEOs are responsible for the year *t*'s financial statements and receive year *t*'s compensation. The use of restatement announcement year will mismatch the year CEOs exercise their responsibility and the year they receive compensation.

provisions in the model: triggers and definite enforcement authority. In order to examine the total effects of clawback provisions adoption, we include an indicator variable *CLAWBACK*, which is equal to one if firms adopt the clawback provisions in the year  $t$ , and 0 otherwise into

TABLE I  
REGRESSION MODEL

| Variables         | Coefficient<br>( <i>t</i> statistics) | Coefficient<br>( <i>t</i> statistics) |
|-------------------|---------------------------------------|---------------------------------------|
| <i>INTERCEPT</i>  | -3.029*<br>(-1.89)                    | -1.516***<br>(-2.82)                  |
| <i>LnASSET</i>    | 0.135<br>(0.89)                       | -0.110<br>(-0.16)                     |
| <i>BIG4</i>       | -0.809*<br>(-1.88)                    | -1.011<br>(-0.62)                     |
| <i>GOING</i>      | 0.293**<br>(2.17)                     | 0.286*<br>(1.72)                      |
| <i>M&amp;A</i>    | 0.150<br>(0.68)                       | 0.228<br>(1.07)                       |
| <i>ROA_Ind</i>    | -0.067*<br>(-1.77)                    | -0.043*<br>(-1.81)                    |
| <i>MB</i>         | 0.208<br>(0.92)                       | -0.179#<br>(-1.42)                    |
| <i>ACSIZE</i>     | -0.098**<br>(-2.09)                   | -0.058***<br>(-2.66)                  |
| <i>ACCEXP</i>     | -0.577*<br>(-1.84)                    | -0.275*<br>(-1.80)                    |
| <i>ACCEQUITY</i>  | 0.015*<br>(1.77)                      | 0.050#<br>(1.65)                      |
| <i>CEO EQUITY</i> | 1.372*<br>(1.76)                      | 1.133**<br>(2.02)                     |
| <i>CLAWBACK</i>   | -0.542**<br>(-2.01)                   |                                       |
| <i>FRAUDS</i>     |                                       | -0.421*<br>(-1.70)                    |

the REST model. Following Chan et al. [4], we predict that the coefficient on *CLAWBACK* to be negative. Restatements could be decomposed into two types: fraud/miscounts (denoted by *FRAUD*) and restatements due to unintentional error (denoted by *ERROR*). Empirical Results

#### B. Regression Results

The regression results using restatements likelihood as the dependent variable are shown in Table I. Firms with higher restatements likelihood are audited by non-Big 4 auditors (*BIG4*), involve more going-concern opinions (*GOING*), and suffer worse financial conditions (*ROA\_ind*). The significance of the coefficient on *ACCEXP* contributes to the growing studies that focus on the controversy of the SEC's broadly-defined financial expertise. The first column reveals that *CLAWBACK* has significantly negative coefficient (-0.213,  $p < 0.10$ ). This implies that the adoption of clawback provisions improve financial reporting quality.

Because restatements trigger may be decomposed into two types: frauds and unintentional error (i.e., restatements due to

frauds or not limited to fault). It is possible that the decreased restatement likelihood may be driven by one type of terms. The third column indicates that the coefficient on *FRAUDS* is significantly negative but *ERROR* has insignificant coefficient. When firms adopt the trigger, any restatements regardless of executives' intention and knowledge is not effective in improving financial reporting quality. The significant coefficient on *FRAUDS* may possibly due to the fact that, fraud triggers are more specific and clear-cut for executives. Clawback provisions adopters enhance the overall compensation strategy by establishing a viable disincentive against "fraud and misconduct".

#### C. Sensitivity Analyses

In addition to the various specifications tested above, we perform several sensitivity tests. First, we eliminate the control variables that are not statistically significant in voluntary adoption model (e.g., *PROFIT*, *EXTRA\_Bonus*, and *CEO\_Chair*), and we re-collect propensity score matched sample to re-run all models. Second, we drop the control variable (i.e., *GOING*) because of a small frequency of occurrence. Third, we exclude 105 firms with prior restatements prior to the initial adoption of clawback provisions. Finally, we further study 2006-2009 time periods because it includes the announcement of many restatements and allows for more clawback adopters period to obtain resolution data. The clawback provision results are largely robust to several sensitivity tests that attempt to control for the potential bias of research design.

#### IV. CONCLUSION

We examine what types of clawback provisions improve financial reporting quality. The findings meet the prediction that different clawback triggers cause differential effects. When restatement-based triggers are separated into trigger types: fraud and erroneous misstatement, we find that fewer restatements and earnings management are driven by frauds triggers. When Dodd-Frank Act directs listed firms to adopt clawback provision based on "erroneous data," we find no indication that there are benefits of "any restatements, including unintentional errors" triggers. Several potential implications of the findings should also interest regulators addressing issues related to compensation contracts.

This paper points to several directions for future research. Hennes et al. [8] classifies restatements as either errors or irregularities and reports that market reaction to restatements due to irregularities is more negative than restatements due to errors. Brown et al. [3] finds that only restatements resulting from *irregularities* are significantly related to the likelihood of adopting *fraud*-based clawback provisions. We further consider separately restatements resulting from irregularities and errors, and therefore, future research might examine the relation between the adoption of clawback provisions and restatements types.

REFERENCES

- [1] N. Addy, and T. Yoder. "The decision to adopt a clawback provision," *The CPA Journal* (January), 2011, pp. 58-63.
- [2] I. Babenko, B. Bennett, J. M. Bizjak, and J. L. Jeffrey, "Clawback provisions," 2012, Available at SSRN: <http://ssrn.com/abstract=2023292>
- [3] A. B. Brown, P. Y. Davis-Friday, and L. Guler, "Economic determinants of the voluntary adoption of clawback provisions in executive compensation contracts," 2011, SSRN eLibrary.
- [4] L.H. Chan, K.C.W. Chen, T. Chen and Y. Yu, "The effects of firm-initiated clawback provisions on earnings quality and auditor behavior," *Journal of Accounting and Economics*, 2012a.
- [5] L.H. Chan, K.C.W. Chen, T. Chen and Y. Yu, "Substitution between real and accrual-based earnings management after voluntary adoption of compensation clawback provisions," Working paper, Hong Kong University of Science and Technology, 2012b.
- [6] E. DeHaan, F. Hodge, and T. Shevlin, "Does voluntary adoption of a clawback provision improve financial reporting quality?" *Contemporary Accounting Research*, forthcoming, 2012.
- [7] X. Gao, M. Iskandar-Datta and Y. Jia, "Piercing the corporate veil: The case for clawback provisions" Working paper, Wayne State University, 2010.
- [8] K. Hennes, A. Leone, and B. Miller, "The importance of distinguishing errors from irregularities in restatement research: The case of restatements and CEO/CFO turnover," *The Accounting Review* 83 (6): 1487–1519, 2008.