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Mandatory clawback provisions, information disclosure, and the regulation of securities markets ☆

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ABSTRACT

Chan et al. (2012) find that voluntary adoption of compensation clawback provisions is followed by fewer financial restatements and fewer auditor reports of material internal control weaknesses, higher earnings response coefficients, and reduced auditing fees and lags. They conclude that voluntary adoption of clawback provisions leads to increased financial integrity. Based on these findings they suggest that U.S. government mandated clawback provisions will be effective in reducing material financial misstatements. I offer possible alternative interpretations of CCCY's results and discuss issues surrounding government regulation of clawback provisions in particular and corporate behavior more generally.

1. Introduction

Transparency and accurate information disclosure are fundamental characteristics of developed capital markets. The primary responsibility for firms' information disclosure policies lies with their top executives, the boards of directors who are charged with monitoring them, and the accounting firms who audit them. However, the interests of these parties are not necessarily aligned with those of shareholders with respect to these fundamental goals. A large body of accounting literature establishes that material misstatements, whether deliberate or not, occur regularly and for a number of potential reasons.[1] To the extent that incentives to report accurately can be increased, the integrity of the capital market will be enhanced.

One way in which to increase managements' incentives to report truthfully is to increase the cost to them of doing otherwise. Beginning in 2005, many firms have chosen to adopt provisions requiring that managers who are discovered to have made material misstatements in their financial statements return to their firms any compensation gained through such misstatement. Chan et al. (2012) analyze firms that adopt such provisions in order to provide evidence on the effectiveness of these so-called clawback provisions. CCCY find that firms that voluntarily adopt clawback provisions experience reduced incidences of accounting restatements following adoption. Furthermore, their results suggest that auditors and investors view firms who have adopted clawback provisions as having increased their accounting quality and lowered their auditor risk.

While the clawback provisions studied by CCCY are adopted voluntarily, they are based in, and potentially have implications for, regulatory initiatives of the U.S. government. Section 304 of the Sarbanes–Oxley act (SOX), adopted in

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[1] See Dechow et al. (2010) for a review of some of this literature.

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2002, authorizes the Securities and Exchange Commission to recover bonuses paid to CEOs or CFOs whose financial statements are restated for reasons of material noncompliance with any financial reporting requirements. Moreover, Section 954 of the 2010 Dodd–Frank wall street reform and consumer protection act, signed in 2010 and scheduled to take effect in 2012, also provides for the recovery of erroneously awarded compensation from executives.

Even if the voluntary adoption of clawback provisions is associated with more accurate financial statements for the voluntary adopters, this does not necessarily imply that mandating such provisions will produce the same outcome. Based on their findings, CCCY suggest that government-mandated clawback provisions will increase financial statement integrity, though they stop short of a definitive conclusion. In the remainder of this paper, I discuss some of the issues surrounding government-mandated clawback provisions in particular, and financial regulation more generally. In Section 2, I discuss the CCCY results in somewhat more detail and offer potential alternative implications. In Section 3, I compare voluntary and involuntary clawback provisions and discuss issues of regulation more generally. I conclude in Section 4.

2. Empirical design, findings, and implications

The fundamental question that CCCY seek to address is whether the voluntary adoption of clawback provisions causes top executives to adhere more closely to financial regulations than they would otherwise have done. They hypothesize that if such causality exists, firms with voluntary clawback provisions in place will exhibit a lower incidence of accounting restatements than firms who do not adopt such provisions. Furthermore, if auditors believe that firms with clawback provisions have more incentive to report accurately, they should respond by examining clawback firms less carefully, resulting in lower audit fees and less time spent auditing. Finally, they suggest that the market should attach more credibility to the earnings of such firms, resulting in higher earnings response coefficients (ERC).

CCCY recognize that evidence consistent with these predictions might simply imply that only better quality firms voluntarily adopt a clawback provision; i.e., adoption could signal already-high accounting quality rather than cause accounting quality to improve. For this reason, CCCY focus on a differences-in-differences approach, which allows them to measure changes in adopting firms from prior to following adoption. They find that firms that voluntarily adopt clawback provisions experience statistically significant decreases in the likelihood of a financial restatement, fewer auditor reports of material internal control weaknesses, and higher earnings response coefficients following clawback adoption. In addition, they find that audits of these firms are accomplished more quickly and at lower expense following adoption than they were before. Based on these findings, CCCY conclude that the voluntary adoption of a clawback provision causes firms to report their financial results more truthfully.

The strength and uniformity of CCCY's results are somewhat surprising for at least a couple of reasons. First, boards of directors have the power to set top executives' compensation contracts and, ultimately, to fire poorly performing managers. Thus, even in the absence of a clawback provision, a board can renegotiate the compensation contracts of a management team that engages in fraudulent reporting such that their compensation going forward is reduced. Relative to such longer-term compensation changes and to the possibility of being fired, having to return the excess pay associated with material restatement would seem to be the lesser consequence. Second, Fried and Shilon (2011) indicate that 81% of the voluntary clawbacks adopted by S&P 500 firms as of mid-2010 gave boards discretion to forego clawbacks of excess pay. Babenko et al. (2012) examine 232 firms that restate earnings following the voluntary adoption of a clawback provision and find no instance in which the board of directors enforced the clawback provision. Why, then, does the adoption of these seemingly weak provisions lead to measurable improvement in firms' financial reporting and in the credibility assigned to that reporting by auditors and the market?

One possibility is that while directors can, in theory, renegotiate future compensation or fire a manager following financial restatement, they are reluctant to do so and therefore more likely to take the lesser step of requiring repayment of any ill-gotten gains. Even a diligent board could consider this to be a punishment that more appropriately fits the crime. Alternatively, a large body of literature in the corporate governance arena provides evidence that boards can be reluctant to take action against CEOs even if such action is warranted.[2]

Another possibility is that the voluntary adoption of clawback provisions does not, in fact, lead to more accurate financial statements. CCCY's findings are also consistent with a scenario in which auditors' erroneous belief that a firm who adopts clawback provisions will issue more accurate reports leads them to examine the firm's financial statements less carefully, thereby reducing the likelihood that they will find a material misstatement that requires a restatement.

Yet another possibility is that boards of directors adopt clawback provisions as part of a broader plan to increase the integrity of firms' reporting. In this scenario, clawback adoption is likely to be accompanied by, and may serve as an external signal of, a board's decision to adopt more careful board monitoring overall. This is a signaling argument of another sort. Rather than signal already-high reporting quality, clawback adoption signals the board's larger commitment to greater financial integrity. Thus, it is the board's new-found commitment, rather than the clawback provision in and of itself, that leads to more accurate financial reporting. This difference is subtle but has potentially important implications for the effectiveness of government-mandated clawback provisions. As CCCY point out, the signaling value of a particular action is lost once that action becomes mandated. BBBC document that firms are more likely to adopt voluntary clawback

[2] See Adams et al. (2010) for a review of this literature.