The effectiveness of clawback adoptions in mitigating over-investments – Does board governance play a role?☆

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ABSTRACT

The adoption of clawbacks purports to mitigate harmful behavior to firms’ operation induced by incentive-based executive compensation contracts. While strong corporate governance is necessary to maximize the utility of clawback provisions, the current clawback literature does not sufficiently consider the impact of board governance on the effectiveness of clawback adoptions in improving corporate conduct (Addy, Chu, & Yoder, 2014). In this study, we examine the effect of board governance on the relation between firm-initiated clawback adoptions and firms’ propensity to over-invest. We first show that the presence of clawback provisions is significantly associated with a decreased level of corporate over-investments. More importantly, we find that the decrease in over-investments for clawback adopters is materially diluted in the presence of a weak board governance structure. Overall, our findings suggest that strong board governance is necessary to ensure the effectiveness of clawback provisions in mitigating over-investments.

1. Introduction

In this study, we examine whether the voluntary adoption of compensation clawback provisions is able to mitigate firms’ propensity to overinvest and how the strength of board governance plays a role in this relation. Clawback provisions were initially proposed in Section 304 of the Sarbanes-Oxley Act (SOX 304) of 2002, which authorizes the Securities and Exchange Commission (SEC) to recover top executives’ compensation earned as a result of misconduct during financial reporting. However, SOX 304 has not been successfully implemented due to the SEC’s limited resources (Chan, Chen, Chen, & Yu, 2012). Therefore, Section 954 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA 954) augments clawback enforcement by allowing boards of directors to recoup any ill-reaped compensation related to subsequent financial reporting failures (Chan et al., 2012). Since then, the number of voluntary clawback adopters has grown rapidly.

According to a study on clawback provisions conducted by PwC between 2009 and 2013, 90% of the Fortune 100 companies had clawback provisions in place for their executives’ compensation; if the clawback is triggered, 84% of the companies will recover both cash and stock compensation, and the recoupment policies of 89% of the companies will apply to all awards regardless of the vesting status (PwC, 2014). Although a growing stream of research examines the effectiveness of clawback provisions, prior studies do not provide conclusive results on the effectiveness of firm-initiated clawback adoptions. Some studies find that clawbacks have positive impacts on firms’ financial reporting quality (e.g., Chan et al., 2012; Dehaan, Hodge, & Shevlin, 2013; Iskandar-Datta & Jia, 2012) and on corporate investment strategies (Brown, Chen, & Kim, 2015; Brown, Davis-Friday, Guler, & Marquardt, 2015; Lin, 2017). However, others show that clawback adopters substitute real earnings management for accrual management (Chan, Chen, Chen, & Yu, 2015) and that insider trading is weakening the ability of clawbacks to deter fraudulent financial reporting (Fung, Raman, Sun, & Xu, 2015). In a show of apparent vigilance and oversight, firms can disclose that they have adopted certain corporate practices without actually imposing strong enforcement on executives (Addy et al., 2014; Fiss and Zajac 2006; Westphal & Zajac, 2001; Zajac & Westphal, 1995). Addy et al. (2014) thus argue that strong corporate governance is crucial in a clawback adoption context, because the adoption of governance features is separable from the decision to implement the features.

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According to the report (PwC, 2014), the top three triggers of clawbacks are employee misconduct during financial reporting processes, financial restatements involving top executives, and fraud.
Incentive-based compensation can impact management decisions on the level of corporate investment. Jensen (1986) suggests that managers have incentives to overinvest so that firms grow beyond their optimal sizes; such growth can lead to an increase in managers' compensation since changes in compensation are usually positively associated with firm size and sales growth (Bebchuk & Fried, 2003; Jensen, 1986; Murphy, 1985). In other words, incentive-based compensation, if extensively tied to firm performance, can prompt managers to overinvest for their private interests. In addition, Jensen (1986, 1993) argues that the empire-building incentive can also drive managers to overinvest for their private interests: managers are likely to overinvest in wasteful, negative net present value projects to derive personal benefits from controlling more resources, thereby damaging shareholders' long-term value. Inferior investment decisions expose firms to a higher likelihood of negative investment outcome. Substantial pressures from inferior investment outcomes can later induce managers to manipulate the earnings to cover the unfavorable consequences. Bar-Gill and Bebchuk (2003) and Bebchuk and Fried (2003) conjecture that managers who expand their firms by investing in value-decreasing projects are likely to misreport corporate performance and suppress bad news when the payoff will not be realized. Another empirical work, Bens, Goodman, and Neamtiu (2012), shows that managers that make inferior M&A decisions undergo investment-related pressures from their compensation contracts, so they are more likely to mistate financial statements in the post-investment period to mitigate such pressures, at least in the near term. As one corporate governance mechanism, clawback provisions require managers to relinquish their ill-reaped compensation after triggering events such as financial restatements. Therefore, we expect that the adoption of clawback provisions imposes higher costs to over-investment behavior, making overinvestment less attractive.

Although the adoption of clawbacks enhances the appearance of legitimacy for firms’ corporate governance, this does not necessarily mean that firms commit to effectively implementing the clawbacks (Addy et al., 2014). The board of directors is the supreme body of the firm charged with adopting and implementing clawbacks (Addy et al., 2014; Chan et al., 2012). Therefore, we need to consider board governance in a clawback adoption context (Addy et al., 2014). Furthermore, changes in board governance and the corresponding changes in executives' incentive compensation can impact managers' investment incentives and decisions (Cohen & Dey, 2013). In the absence of effective board monitoring and control mechanisms, managers can be motivated to provide upward-biased information to investors to engage in sub-optimal use of firms’ resources (e.g., empire building and perquisite consumption) to enhance their own personal wealth (Cheng, Dhaliwal, & Zhang, 2013). This potential agency problem of investment inefficiency can be mitigated by effective corporate governance mechanisms, such as a strong board monitoring function (Baysinger, Kosnik, & Turk, 1991; Richardson, 2006). Consistent with this view, Richardson (2006) finds that effective board governance mechanisms can materially alleviate managers’ incentives to overinvest. Cohen and Dey (2013) provide evidence that strong board governance can mitigate management risk-taking incentives on investments. Hence, the strength of board governance is highly likely to affect the effectiveness of clawback provisions in deterring corporate over-investments.

We test our predictions using a sample of voluntary clawback adopters and non-adopters in Russell 3000 Index firms during the period 2005 to 2014, as covered by the Morningstar Document Research database. 2 Clawback adoption has become increasingly popular in these firms in recent years following the passage of DFA 954. Specifically, our sample demonstrates that the number of firms adopting clawbacks increased from 39 at the end of 2006 to 636 at the end of 2010; overall, 1654 out of the Russell 3000 Index firms had adopted clawback provisions as of July 2015.

In order to investigate the effect of clawback provisions on firms' investment practices, we follow the research method of Biddle, Hilary, and Verdi (2009) and Cheng et al. (2013) and test our prediction on the association between clawbacks and firm investment levels conditioning on firms’ ex ante likelihood of over-investing. In order to analyze the changes in firm investment efficiency before and after the adoption of clawbacks, we follow prior literature on clawbacks (e.g., Chan et al., 2012) by using a difference-in-differences research design (DID). Consistent with our prediction, we find that the clawback-adopting firms experience a significant decrease in corporate over-investments following adoption, relative to non-adopters during the same time period.

Further, we examine whether board governance structure has an impact on the relation between clawbacks and corporate over-investments. We use five proxies for board governance structure: board independence, outside directors with accounting or financial expertise, interlocked directorship, audit committee size, and board size. Following prior literature, we perceive firms as having weak board governance if they have lower board independence, fewer outside directors with accounting or financial expertise, interlocked directorship, and smaller audit committee and board size. The results show that there is no significant decrease in corporate over-investments for clawback adopters with weak board governance structures. Taken together, these results suggest that poor board governance can materially weaken the deterrent effect of clawbacks on corporate over-investments.

Our paper differs from Lin (2017) in several ways. First, we follow the research method of Biddle et al. (2009) and Cheng et al. (2013) and test our prediction on the association between clawbacks and firm investment levels conditioning on firms’ ex ante likelihood of over-investing. Prior literature suggests that measures of investment-cash flow sensitivities can indicate either firms’ financial constraints or their excess free cash flow (Biddle et al., 2009; Richardson, 2006). Therefore, our tests, following the practice of Biddle et al. (2009), are more suitable for examining the potential impacts of firms’ accounting choices on mitigating over- and under-investment, and the net effects (Lara, Osma, & Penalva, 2016). Second, following prior studies (Biddle et al., 2009; Cheng et al., 2013; Lara et al., 2016), our analyses comprehensively control for the factors that can confound the findings on the relation between investment efficiency and clawbacks, such as financial reporting quality, firm size, the market-to-book ratio, volatility of cash flow from operations, volatility of sales, volatility of investments, bankruptcy risk, tangibility, firm-level capital structure, industry capital structure, operation cash flows to sales ratio, dividend payout ratio, length of the operating cycle, frequency of losses, and firm age.

In this paper, we contribute to a growing body of literature by studying the effects of clawbacks in two ways. First, this study provides evidence on whether implementing clawbacks can improve corporate performance by limiting firm-level over-investments. Although prior literature (Lin, 2017) provides evidence of the positive effect of clawback provisions on firm-level investment efficiency, our study shows that the effectiveness of clawbacks in lowering over-investments is contingent on the strength of board governance. We find that the effect of clawbacks on mitigating over-investments can be weakened or even disappear if a clawback adopter has weak board governance. In this sense, our study complements the existing literature by providing evidence that the strength of board governance matters in ensuring the

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2 DFA 954 requires all listed US firms to adopt clawback provisions in their executives’ compensation contracts. However, the implementation rules have not been finalized because of certain concerns (Chan et al., 2015). Following the practice of prior studies (e.g., Chan et al., 2012; Dehaan et al., 2013; Iskandar-Datta & Jia, 2012; Addy et al., 2014; Chan et al., 2015; Fung et al., 2015), we investigate the impact of the voluntary adoption of clawback provisions on firms’ investment efficiency.

3 For example, Beasley (1996); Dechow et al. (1996); Farber (2005); Erickson et al. (2006); DeFond & Francis, 2005; Guner et al. (2008); Hoitash et al. (2009); Kim et al. (2014); Hallock (1997); Fich and White (2003); Larcker et al. (2005); Kalbers and Fogarty (1993); Dalton et al. (1999); Carter et al. (2003); Xie et al. (2003).
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