Mandatory Clawback Provisions, Information Disclosure, and the Regulation of Securities Markets[*]

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Abstract

Chan, Chen, Chen, and Yu (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.

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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, Chen, Chen, and Yu (CCCY, 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 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.

[1] See Dechow, Ge, and Schrand (2010) for a review of some of this literature.

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, Bennett, Bizjak, and Coles (BBBC, 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.

[2] See Adams, Hermalin, and Weisbach (2010) for a review of this literature.

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 provisions when there has been prior misbehavior at the firm. Such misbehavior could lead directors to become aware of the need for closer monitoring and/or could increase external pressure on them to monitor more carefully. Consistent with this, BBBC also find that adoption is positively related to the independence of the board of directors and to the extent to which the firm is externally monitored.

CCCY's findings are an important first step in our understanding regardless of what is driving their results. However, it is important to push further to understand what is driving their results, particularly in light of government mandates that all U.S. firms must claw back any gains from misreported financials.

3. Voluntary vs. Involuntary Provisions

While it is important to understand the impact that the voluntary adoption of clawback and other fraud-related provisions have on firm behavior, it is at least equally important to understand the impact of government mandates of such provisions. CCCY motivate their examination of clawback provisions in part as a way to understand the potential effects of the upcoming Dodd-Frank requirements. They conclude, though not without caveat, that Dodd-Frank will be effective in reducing material misstatements by firms whose directors are

mandated to uphold Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The government originally mandated clawback provisions with Section 304 of the Sarbanes-Oxley Act in 2002, signed into law in the wake of massive financial fraud by Enron and WorldCom. Section 304 requires that compensation to CEOs and CFOs that is related to earnings that are later restated must be recovered if the misstatement was material and resulted from misconduct. This section is still in effect; however it has rarely been enforced. CCCY attribute this to ambiguities as to what constitutes 'material misstatement' and 'misconduct', as well as to the fact that enforcement of Section 304 falls to the resource-constrained Securities and Exchange Commission. It is interesting to note that the firms in the sample who voluntarily adopted clawback provisions did so despite the fact that similar regulatory provisions were already in place. This is perhaps most consistent with the hypothesis that boards wished to signal their commitment to the market.

The weak enforcement of Section 304 illustrates one potential problem with regulatory solutions: they do not work if they are poorly written or poorly enforced. Section 954 of Dodd-Frank, enacted in the wake of the recent financial crisis, is designed to overcome some of the problems of Section 304. First, it requires the recovery of erroneously granted compensation following any financial restatement, whether or not there was misconduct involved. Second, the board of directors, rather than the SEC, is responsible for enforcement of Section 954.

CCCY suggest that the Dodd-Frank provisions will perhaps be even more effective than the voluntarily-adopted provisions, given that they are more stringent overall and also enforced at the firm level by the board of directors. However, it is not at all clear that boards of directors who have not chosen to adopt clawback provisions can be expected to enforce them with the same diligence as would directors who have adopted such provisions voluntarily.

It is tempting to argue that if Section 954 leads any firms to report their financial results more accurately, it is worth having enacted, even if it does not lead *all* firms to greater financial integrity. However, any regulation imposes costs as well as benefits and the ultimate value of a regulation depends upon the trade-off between those costs and benefits. Clearly, an increase

in the transparency and integrity of financial information is a benefit to the capital market. However, it is worth considering the potential costs of Dodd-Frank Section 954 as well.

Regulations have both intended and unintended consequences. The intended consequence of Section 954 is to reduce firms' incentives to make material misstatements by increasing the potential cost of doing so. However, one unintended cost of Section 954 is that, at the margin, it reduces the incentive to make a financial restatement. To the extent that management teams or boards of directors choose not to restate in order to avoid the need to make compensation recovery, the accuracy of financial information in the market is reduced.[3] Another potential unintended consequence arises because mandatory clawback provisions make incentive pay more risky to managers. To the extent that this leads firms to reduce their use of incentive-based compensation and, with it, the incentive-alignment benefits of such compensation, shareholder wealth may be reduced (Bhagat and Romano, 2009).

Another potential cost of regulation is that a prescribed action can override a more appropriate action that might otherwise have been taken. In the post-accident inquiry on the Titanic, it was established that the ship had only half the lifeboats needed to ferry everyone to safety because that was how many lifeboats the government indicated that they must have (Berg 2012). This is a cautionary tale about keeping regulations up to date – the Titanic was a much larger ship than any that had come before it. However, it is also a cautionary tale about the danger of regulatory prescriptions replacing careful consideration of the most appropriate course of action. In the context of clawback provisions, a board that might otherwise have imposed harsher penalties for a particularly egregious financial misstatement could instead default to the government-mandated penalty only.

Perhaps the most important concern about a government-mandated clawback policy is that it will create an unwarranted illusion of information quality. CCCY's results suggest that auditors, on average, respond to the voluntary adoption of clawback provisions by spending less time examining firms' financial statements and that the market responds by assigning greater credibility to their earnings announcements. To the extent that auditors and the

[3] Fried and Shilon (2011) argue that by only requiring compensation recovery when a financial restatement is made Dodd-Frank Section 954 does not go far enough.

market respond in the same way to the imposition of what appear to be stringent mandated provisions, material misstatements may be less likely to be discovered.

The basic issues on either side of a debate about the net impact of government imposition of clawback provisions are much the same as those associated with any other attempt to regulate corporate behavior. At one end of the spectrum is the argument that corporations operating in a free and competitive market will adopt contracts that best suit their own complex sets of circumstances. Consistent with this, BBBC provide evidence that the firms who voluntarily adopt clawback provisions are, on average, those to whom such provisions are expected to be most valuable. Under this view, government regulations that interfere with the ability of corporations to design their own best contracts ultimately prevent economic resources from being allocated to their best possible uses. At the other end of the spectrum is the view that frictions in the market are such that corporations cannot be counted upon to do what is best for society or even for their own shareholders. Fried and Shilon (2011) detail the potential negative shareholder valuation consequences of erroneous compensation of executives and point to the lack of enforcement of voluntary clawback provisions. They argue that Dodd-Frank Section 954 will increase shareholder wealth, regretting only that it does not go further than it does.

4. Conclusions

Top executive compensation, internal control systems, boards of directors, and regulation are all important components of corporate governance systems. From an extensive and still-expanding body of literature on corporate governance we know that the various governance mechanisms interact in potentially important ways. However, we have much left to learn about the specifics of these interactions.

The integrity of our market system is clearly enhanced when corporations have incentives to report their financial results accurately. One such incentive is a credible expectation that there will be negative consequences for failing to do so. Jensen (1993) characterizes the legal and regulatory system as being ". . . far too blunt an instrument to handle the problems of wasteful managerial behavior effectively." However, it is arguably in the area of consequences

for misbehavior that the legal and regulatory system has its most significant role to play. Open debate about what the nature and extent of that role should be is especially important in an era of increasing calls for the regulation of corporations and markets. It is incumbent upon empirical researchers to provide solid evidence to inform that debate.

CCCY help to inform the debate about the efficacy of government-mandated clawback provisions by providing evidence that the voluntary adoption of such provisions affects firms in ways that are consistent with a conclusion that clawback provisions increase financial statement integrity. Had CCCY found little or no impact for firms that choose to adopt clawback provisions, we might reasonably conclude that the likelihood that mandated adoption would be valuable is also low. However, the reverse does not hold: it does not necessarily follow from CCCY's results that the net impact of mandated clawback provisions on firms and the economy will be positive. Further evidence is needed if we are to better understand the impact of mandated clawback provisions in particular and regulation of corporations more generally.

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