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Why do Restatements Decrease in a Clawback Environment? An Investigation into Financial Reporting Executives' Decision-Making during the Restatement Process

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ABSTRACT: Prior archival studies find that firms that voluntarily adopted clawback policies have experienced a reduction in restatements. I experimentally examine this outcome by investigating the influence of two key factors (i.e., executive compensation structure and auditor quality) on financial reporting executives' (hereafter, "executives") decision-making regarding a proposed restatement that will lead to a clawback of their incentives. I find that executives (i.e., CFOs, controllers, and treasurers) facing a lower quality auditor are less likely to agree with amending prior financial statements when a higher proportion of their pay is incentive-based. However, this tendency is reduced when executives face a higher quality auditor, indicating that higher quality auditors can act as effective monitors. My results identify an *ex post* unintended consequence of clawback regulation that could at least partially offset the benefits of the *ex ante* deterrent effects of clawbacks, and that could contribute to findings of less frequent restatements when clawback policies are in place. I discuss potential implications regarding the role of executives during restatement decisions and auditors' risk assessments in a clawback environment.

Keywords: *clawbacks; executive compensation structure; auditor quality; financial reporting executive; restatements; Dodd-Frank Act.*

Data Availability: *Data are available from the author upon request.*

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I. INTRODUCTION

Clawback policies are designed to recover incentive compensation erroneously paid out to an executive as a result of previously misstated financial statements. One intention of clawbacks is to reduce future restatements by making financial reporting executives (hereafter, “executives”) mindful that misreporting could lead to a clawback of any compensation that they earn inappropriately. Early archival evidence documents the potential benefits of the *ex ante* deterrent effect of clawback policies, as restatements have decreased following adoption (deHaan, Hodge, and Shevlin 2013; Chen, Greene, and Owers 2015; Chan, K. Chen, T.-Y. Chen, and Yu 2012). However, clawback policies may incentivize executives to avoid restating the financial statements (deHaan et al. 2013; Denis 2012), and this *ex post* unintended consequence of clawback policies could partially offset the benefit of the *ex ante* deterrent effect. This study builds on the archival literature by experimentally investigating the potential *ex post* effects of clawback policies. Using an experiment allows me to investigate the executive-auditor interaction that produces the audited financial statements *during* a restatement process to examine whether the previously documented reduction in restatements could result, at least in part, from stronger executive opposition to restatements.

Management is responsible for the fair presentation of the financial statements in accordance with professional standards such as AU Section 110 (American Institute of Certified Public Accountants [AICPA] 2002). Further, the Sarbanes-Oxley Act of 2002 (SOX, U.S. House of Representatives 2002), Section 302, “Corporate Responsibility for Financial Reports,” requires that CFOs certify the financial statements. As part of this role, executives must resolve accounting disputes with their auditors (Brown-Liburd, Wright, and Zamora 2013; Chung and McCracken 2014; Gibbins, McCracken, and Salterio 2007). A financial executive is typically the sole member of management involved in dispute resolution, and some audit committees prefer to be informed only after a disagreement has been resolved (Chung and McCracken 2014; Gibbins et al. 2007; Gendron and Bédard 2006). Thus, executives have significant influence during a restatement process. I examine the *ex post* effects of clawbacks by investigating whether the likelihood that an executive will accept an auditor’s proposed restatement decreases during the restatement process when the executive faces the clawback of incentive-based pay, particularly when such pay makes up a high percentage of the executive’s total compensation and the company uses a lower quality auditor. I also examine whether a higher quality auditor can mitigate executives’ behaviors by increasing the likelihood that they will agree with the proposed restatement.

As proposed restatements are not disclosed, archival techniques cannot examine executive decision-making *during* a restatement process. Therefore, I recruited 112 executives (i.e., CFOs, controllers, and treasurers) from publicly traded companies to participate in my experiment. Participants assume the role of a CFO and consider an error restatement proposed by their auditors. They are provided with details about their new compensation contract, which includes a clawback provision. The hypothetical scenario requires professional judgment, since the error is due to an ambiguous accounting standard, ASC 360-10, *Property, Plant, and Equipment: Overall* (formerly, Financial Accounting Standards Board [FASB] Statement No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*). I limit the availability of strict, authoritative guidance because such guidance constrains accounting choice (Ng and Tan 2003).

I find that executive decision-making is negatively influenced during the restatement process when executive compensation structure is more heavily incentive-based, as executives are less likely to agree with a lower quality auditor’s proposed restatement. I also find that executives with the same high percentage of incentive compensation are more likely to accept the proposed restatement from a higher quality auditor. A supplemental analysis of executives’ qualitative

justifications for their restatement likelihood judgments provides additional support for these findings.¹

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act, U.S. House of Representatives 2010) requires that all publicly traded companies implement a clawback policy. Therefore, understanding the impact that compensation structure and auditor quality have on the effect of clawback policies on executive behavior is timely and important. My findings extend the archival literature showing that restatements decrease in a clawback environment (deHaan et al. 2013; Chen et al. 2015; Chan et al. 2012) by demonstrating that the reduction in restatements documented in prior research is likely the net effect of (1) the *ex ante* benefits of reduced errors, and (2) the *ex post* effects of greater management opposition to restating the financial statements. My findings also contribute to research on auditor quality. I find that higher quality auditors act as effective monitors on executives' behaviors, making them more likely to accept an auditor-proposed restatement in a clawback environment. My findings also suggest that executives' influence over restatement decisions may need to be limited in a clawback environment. For example, regulation that requires the audit committee's financial expert to play a greater role during restatements may be necessary. Finally, my findings suggest a potential unintended consequence of clawback policies for the auditing profession. When a client has a clawback provision, auditors may assess the risk of misstatement as lower because they expect that executives are less likely to be aggressive or to make errors when their incentive compensation is at risk. However, I find that clawback provisions cause executives to resist proposed adjustments and restatements, suggesting that auditors should actually assess the risk of misstatement as higher.

II. BACKGROUND AND HYPOTHESES DEVELOPMENT

Clawback Background

Clawback provisions were first introduced in Section 304 of SOX to recoup previously earned incentive compensation that had been erroneously paid based on a prior misstatement of the financial statements. Luis Aguilar, Securities and Exchange Commission (SEC) Commissioner, commented that clawbacks should instill "fear" in executives that their incentive compensation will be recouped and, as a result, create a financial reporting culture of enhanced honesty and integrity that leads to fewer future restatements (Aguilar 2010). However, the SEC did not actively enforce Section 304 after the enactment of the law, except for cases where an executive had already been convicted of criminal fraud (Markham 2007). As a result, Section 954 of the Dodd-Frank Act was introduced to provide a modified approach to clawback enforcement. Specifically, all firms must adopt a policy, both error and fraud restatements can trigger a clawback, all current and former executive officers are covered, and up to three years' of incentive compensation is recoverable.

Since the passage of the Dodd-Frank Act, voluntary adoption of clawback policies has increased as firms await the final clawback rules that are forthcoming from the SEC (2014). According to a survey of the Fortune 100, only 18 percent of firms had clawback policies in 2006, whereas approximately 87 percent had such policies in 2012 (Equilar 2012a). These firms have implemented and disclosed clawback policies without the benefit of specific guidelines from the SEC. As a result, Equilar's (2012a) survey finds a wide range of policies in practice. For example, a firm's clawback policy may cover one or more key types of incentive pay, such as cash incentives, equity incentives, outstanding options, vested options, and/or restricted stock. Most commonly,

¹ Prior studies examine whether stimuli affect judgments through intentional or unintentional cognitive effects (e.g., Frederickson and Miller 2004). However, this type of analysis is not the focus of this study.

both cash and equity are covered, which is the case in 80 percent of policies. Clawback triggers also can differ greatly by firm, with a mix of ethical misconduct, restatements, or non-compete violations. For example, only 10.4 percent of firms with clawback policies explicitly state that executive misconduct is not required to trigger a clawback (Equilar 2012a).

Clawback Literature

As passage of the Dodd-Frank Act is a recent event, there is a paucity of accounting literature investigating clawback provisions. The first set of studies examines determinants for voluntarily adopting a clawback policy. Addy, Chu, and Yoder (2014) show that voluntary adopters have lower management entrenchment, a higher likelihood of directors interlocked with other firms having clawbacks, and lower accruals. Babenko, Bennett, Bizjak, and Coles (2012) find that firms are more likely to adopt a clawback policy when there is evidence of prior executive misconduct at the firm. A working paper by Brown, Davis-Friday, and Guler (2013) finds that the likelihood of adopting a clawback is significantly associated with the frequency of merger and acquisition activity and goodwill impairments. They do not find a significant relationship between prior restatements and the likelihood of adopting a clawback policy. Chen et al. (2015) find that firms are more likely to adopt a policy when they have risk-averse CEOs, lower earnings volatility, and good internal accounting information.

Prior studies also investigate outcomes influenced by early adoption of clawbacks. Iskandar-Datta and Yonghong (2013) find that voluntary adopters experience positive valuation impacts on their stock price and that firms with previous restatements experienced greater economic gains. Several studies find that firms that voluntarily adopted a clawback policy experienced a decrease in restatements and an increase in the perceived quality of the financial statements (deHaan et al. 2013; Chen et al. 2015; Chan et al. 2012). I extend this latter research by examining whether a reduction in restatements due to the *ex ante* deterrent effects of clawbacks may be partially offset by the *ex post* unintended consequence of executives avoiding restatements due to an aversion to losing their incentive compensation. As *potential* restatements are not disclosed, archival data are not available to test my research question. Therefore, I use an experiment to examine executives' decision-making *during* a restatement process when they are faced with a clawback.

To my knowledge, the only other experimental study of clawbacks is a working paper by Hodge and Winn (2012). In their experiment, the authors examine the riskiness of executives' financial reporting choices (i.e., revenue recognition decisions) after a restatement that triggers the enforcement of a clawback or holdback clause.² Enforcement of the clawback requires the executive's bonus to be recouped, whereas the bonus is canceled under a holdback. Overall, the authors find that executives make less risky decisions after a restatement regardless of whether they have a clawback or holdback. Hodge and Winn (2012) find that executives who previously made relatively aggressive reporting decisions felt more responsible for the restatement and made less risky decisions after the restatement, as compared to executives who were relatively conservative prior to the restatement. Further, previously conservative executives covered by a clawback make riskier decisions after the restatement than conservative executives covered by a holdback. This finding is consistent with executives feeling angry when they are required to pay back their bonus, but do not believe they were responsible for the restatement.

Prior research has only investigated the *ex ante* deterrent effects of voluntarily implementing clawback policies after adoption and after a restatement. No study has examined how executives

² Hodge and Winn (2012) also study holdbacks, which are an alternative method of recouping incentives. With a holdback, incentives are deferred for a period of time with the goal of simplifying future recoupment. Conversely, clawbacks maintain the current practice of distributing incentives when earned and then subsequently recovering them after a restatement. Although some firms have adopted holdbacks, 87 percent of Fortune 100 firms interpreted the Dodd-Frank Act as requiring a clawback (Equilar 2012a).

behave when presented with a potential restatement that will cause a loss of previously earned incentives due to a clawback.

Executive Compensation Structure in a Clawback Environment

Executive compensation at publicly traded companies has consistently been a focus of corporate governance reformers since the 1930s (Markham 2007). Clawbacks are one of the latest attempts by regulators to strengthen the corporate accountability of executives and to reduce future restatements. Prior research finds that executive compensation can be used as an effective means of reducing the agency costs between managers and shareholders when compensation is directly linked to shareholder wealth (Jensen and Meckling 1976). For example, stock options can motivate a manager to make riskier investments to increase a firm's value and to minimize their aversion to risk (Efendi, Srivastava, and Swanson 2007; Morgan and Poulsen 2001; Smith and Stulz 1985). Conversely, Efendi et al. (2007) find that as agency costs increase due to overvalued equity, managers take aggressive actions to maintain the overvalued stock. Executives also are significantly more likely to misreport when their option portfolios are sensitive to the firm's stock price (Fried and Shilon 2011; Burns and Kedia 2006). Watts and Zimmerman (1979) find that managers have incentives to utilize accounting standards to present financial information in ways that support their best interests, even at the risk of negatively impacting shareholders. Thus, it is important for regulators and academics to understand if executives will use ambiguous accounting standards to exhibit similar behaviors in a clawback environment.

The majority of compensation research has heretofore analyzed CEO compensation (e.g., Chhaochharia and Grinstein 2009; Burns and Kedia 2006). Yet, a recent study by Jiang, Petroni, and Wang (2010) finds that CFO compensation has a greater effect on aggressive accounting practices (i.e., accruals management and the likelihood of beating analyst forecasts) than CEO compensation. CFO compensation commonly includes a base salary, plus one or more incentives, such as option awards, stock awards, and cash bonuses. If CFO compensation is closely aligned with earnings, then clawback policies should play a significant role in their decision-making. In a 2010 study of Standard & Poor's (S&P) 500 firms, the percentage mix of total CFO compensation was shifting toward more stock-based awards and bonuses (37.3 percent) (Equilar 2011). When a clawback is triggered, CFOs may lose a significant percentage of their overall compensation, depending on the design of their compensation structure. Thus, when faced with the loss of a significant portion of their compensation, executives may consider making reporting decisions with the intention of avoiding the restatement.

Executive Compensation Structure and Auditor Quality in a Clawback Environment

Clawback provisions are intended to improve financial reporting by decreasing the amount of error in management's pre-audit financial statements. However, given that an error has already occurred, clawbacks might affect how aggressively managers negotiate with their auditors to avoid restatements.

During a negotiation, the psychology and accounting literatures find that the process and outcome of the dispute are influenced by the negotiators' relationship (McCracken, Salterio, and Gibbins 2008; Iyer and Rama 2004; Pruitt and Carnevale 1993). For example, Iyer and Rama (2004) find that management believes they can persuade an auditor to agree with their position when the auditor has had a shorter tenure with the client and when retention is important to the auditor.³ In a financial reporting disagreement context, Gibbins et al. (2007) find in a survey of

³ To control for potential tenure effects, I use a moderately long audit firm tenure of six years in the experimental instrument.

executives that the audit firm's expertise and their relationship with, and the competence of, the audit partner are significantly important contextual factors. For example, the competence of an audit partner is critical when executives evaluate the quality of the audit firm's accounting positions. Therefore, I expect that auditor quality will influence executive behaviors during the initial phase of a restatement process, which typically involves the auditor and executive taking positions prior to involving any additional parties (Chung and McCracken 2014).

McCracken et al. (2008) find in a study of actual CFO-auditor dyads that CFOs determine the relationship existing between the two parties. Two distinct relationships tend to exist between the parties: proactive or reactive. In a proactive relationship, CFOs rely on their auditors as "expert advisors" to ensure high quality financials. CFOs in a reactive relationship take ownership of the financials, actively question the auditor's proposed adjustments, and challenge the validity of the auditor's positions. If an auditor is perceived to lack expertise and, therefore, is a lower quality auditor, then executives may believe that they hold the stronger position. This, in turn, may lead executives to be more likely to disagree and dispute a recommended restatement. At the same, prior research suggests that executives may also consider making more aggressive reporting decisions when a significant portion of their compensation is at risk of being recouped with a clawback (Jiang et al. 2010; Watts and Zimmerman 1979). Consequently, I expect that when there is a lower quality auditor, executives will be more likely to act in a reactive manner and challenge the expertise of the audit team, especially when they are faced with a certain loss of a higher percentage of their compensation in the form of previously earned incentives:

- H1:** Financial reporting executives will be less likely to accept a lower quality auditor's restatement recommendation that will lead to a clawback when the executives' total compensation consists of a higher percentage of incentives than a lower percentage of incentives.

The Monitoring Role of Higher Quality Auditors in a Clawback Environment

Higher quality auditors make better judgments based on the development of domain-specific expertise gained through industry-specific knowledge, training, and general auditing experience (Bonner and Lewis 1990). Therefore, audit firms seek to enhance the quality of their audit work by developing higher quality auditors along these dimensions.

Prior research finds that industry-specialist auditors are more knowledgeable and perform better in their industry than non-specialists (Moroney and Simnett 2009; Solomon, Shields, and Whittington 1999). When auditors are industry specialists at both the national and local level, they provide higher audit quality (Reichelt and Wang 2010). The market prices the increase in audit quality with positive abnormal returns when a client switches to an industry-specialist auditor (Knechel, Naiker, and Pacheco 2007). Two-thirds of Fortune 1000 companies surveyed believe that expertise or industry specialization is a very important factor in choosing an auditor (General Accounting Office [GAO] 2008), and companies will pay a fee premium for specialists to monitor the quality of their financial reporting process (Fung, Gul, and Krishnan 2012). Executives may agree with higher quality auditors more often and push back less during negotiations, as executives may perceive that they hold less power.

In H1, I predict that executives with a higher percentage of incentives in their compensation structure will be less likely to accept a lower quality auditor's proposed restatement that will lead to a clawback, as compared to executives with a lower percentage of incentives in their compensation. Executives with higher incentives are expected to use the flexibility afforded to them in interpreting an ambiguous accounting standard to disagree with the proposed restatement. However, when executives consider their auditors to be "expert advisors," they rely on the auditors' judgments to

ensure the quality of the financial statements (McCracken et al. 2008). Therefore, in the presence of a higher quality auditor who has more expertise and power in the relationship than a lower quality auditor, I predict that executives with higher incentives will be more likely to agree with the auditor:

H2: Financial reporting executives with total compensation that consists of a higher percentage of incentives will be less likely to accept a restatement recommendation that will lead to a clawback from a lower quality auditor than a higher quality auditor.

Further, when H1 and H2 are combined, I posit the following specific interaction:

H3: Relative to financial reporting executives' likelihood of accepting a lower quality auditor's restatement recommendation that will lead to a clawback when the executives' total compensation consists of a higher percentage of incentives, executives will be more likely to accept a restatement recommendation when they either have a lower percentage of incentives or there is a higher quality auditor.

III. METHOD

Research Design and Independent Variables

I experimentally investigate executive decision-making after the external auditors have proposed a restatement that will lead to a clawback of previously earned incentive compensation. Executive participants are asked to make their decisions as the CFO of a hypothetical large, publicly traded company in the medical manufacturing industry. Using a 2×2 between-subjects design, I manipulate two factors: executive compensation structure (i.e., a higher or a lower percentage of total compensation based on incentives) and auditor quality (i.e., a higher or a lower quality auditor).

In the experimental case, the external auditor proposes a restatement of the previous year's (2010) financial statements due to an accounting error. If the restatement is made, then the company's clawback policy requires the CFO to pay back any incentives that were earned in 2010 based on the erroneously stated financials. The CFO earned the incentives in 2010 when the firm beat the consensus analyst forecast for earnings per share (EPS). The proposed restatement causes the 2010 financials to no longer beat EPS; consequently, the CFO would be required to pay back all of the incentives under the clawback policy. I manipulate the amount of incentives susceptible to the clawback at two levels: a higher (80 percent) or a lower (40 percent) percentage of total compensation (\$2.5 million). Both conditions use the same mix of equity (85 percent) and cash bonus (15 percent) for total incentives. Equity incentives include stock options and stock awards. The remaining non-incentive compensation is comprised of salary, a discretionary bonus, and perquisites.⁴

I manipulate auditor quality based on the extent of the auditor's industry specialization, training, and overall auditing experience because auditors develop domain-specific knowledge and expertise based on these dimensions (Moroney and Simnett 2009; Solomon et al. 1999; Bonner and Lewis 1990). For the higher quality condition, the experiment describes an audit team (i.e., one partner and two senior managers) that has substantial auditing experience, including significant experience working on clients in the medical manufacturing industry throughout their careers, has attended industry-specific training during their careers, and has had extensive experience leading engagements of large public clients in the company's industry. In the lower quality condition, the audit team has substantial auditing experience, including some experience on clients in the medical

⁴ To ensure the realism of the manipulation, I based the compensation amounts on 2010 compensation survey data for S&P 500 CFOs and Section 954 of the Dodd-Frank Act (Equilar 2011).

manufacturing industry early in their careers, has just attended their first industry-specific training to prepare for the audit, and has extensive experience leading engagements of large public clients, yet this is the first time they will lead an audit in the company's industry

Dependent Measures

When auditors propose a restatement, the audit team presents documentation for the misstatement, including its materiality, to the executive, and then the executive takes a position on the misstatement and reports it to the auditors, CEO, and audit committee (Chung and McCracken 2014). Thus, the executive's initial position is important because it establishes expectations for the negotiation, significantly influences the strategies utilized by both parties, and, ultimately, shapes the outcome (e.g., Hatfield, Houston, Stefaniak, and Usrey 2010; Hatfield, Agoglia, and Sanchez 2008; Gibbins et al. 2007; Rubin and DiMatteo 1972). Therefore, the dependent variable used to test H1, H2, and H3 is the executives' assessment of the likelihood that they will agree with the external auditor's recommendation to restate the previously released financial statements ("0 percent = No Likelihood," "50 percent = Moderate Likelihood," and "100 percent = Absolutely Certain").

Additionally, participants are required to briefly explain the reasons why they took their position regarding the potential restatement. To test their free responses in a supplemental analysis, I code the answers by assessing the total number of distinct justifications provided by the participants to support their respective agreeing or disagreeing positions regarding the proposed restatement. This analysis provides supporting evidence for the main dependent variable by testing the number of distinct justifications. I expect that executives who are more (less) likely to disagree with the proposed restatement will provide more (fewer) justifications to dispute it.⁵ I examine the number of disagreeing justifications, agreeing justifications, and a difference measure (number of disagreeing justifications less agreeing justifications).

Participants

Participants were 112 experienced financial reporting executives.^{6,7} A web-based research organization, Research Now (see: <http://www.researchnow.com>),⁸ recruited 106 participants and

⁵ Consistent with prior research that examines qualitative responses (e.g., Lynch, Murthy, and Engle 2009; Chung, Cohen, and Monroe 2008), the focus of this analysis is the number of justifications provided by the participants. The analysis will not focus on justification quality because no theory exists to determine differences in quality between the participants' relevant justifications.

⁶ An additional 27 participants started, but did not successfully complete, the study and, therefore, are not included in the sample. These participants were relatively evenly distributed across all experimental groups and throughout the data-collection time period. There is no clear indication that a specific cell or the timing of their participation affected their decision to not complete the study.

⁷ Approval to use human subjects was granted at the institution where this experiment took place.

⁸ In the recent accounting literature, web-based research organizations have been used to recruit experimental subjects (e.g., Brazel, Carpenter, Jones, and Thayer 2012; Brown-Liburd, Cohen, and Zamora 2012). Research Now (RN) provides online research solutions, including the recruitment and use of its research panels, which currently have approximately 8,000,000 participants. Panel participants are recruited by invitation only through a controlled member verification process that enrolls only previously validated individuals from RN's business partners (e.g., major airlines and hotel brands). This approach allows RN to strategically obtain access to hard-to-reach audiences, such as the executives in this study that typically do not seek out and join online panels. RN incentivizes executives with nonmonetary rewards (e.g., airline mileage or hotel points) based on their expertise, the instrument's complexity, and the length of the study. However, the majority of executives instead opt to donate the monetary equivalent of the rewards to charity organizations. RN also seeks to maintain responsive subjects by limiting the number of participation requests sent to each executive. Last, executives in this study indicated their job title during RN's member verification process. Thus, participant job information was collected before my study was initiated.

six participants were obtained through personal contacts.⁹ The executives consisted of both CFOs (58.0 percent) and controllers/treasurers (42.0 percent) from publicly traded companies.^{10,11} Consistent with prior accounting research, I use these participants to represent management because as key members of financial reporting negotiations, they should have experience with the external auditors (Tan and Trotman 2010; Gibbins et al. 2007). Moreover, the Dodd-Frank Act indicates that “executive officers” will be covered in the upcoming clawback rules. Based on this terminology, 93.7 percent of Fortune 100 firms that voluntarily adopted clawback policies have covered additional key members of management beyond the CEO and CFO (Equilar 2012a). Therefore, it is reasonable to anticipate that controllers and treasurers will be subject to the new clawback regulation.

Participants have significant professional business experience (20.4 years), substantial experience discussing audit adjustments with external auditors (10.0 years), and some experience professionally as external auditors (2.5 years). The majority of participants (75.0 percent) considered their current audit firms to be a “specialist” audit firm. The mean approximate annual revenue of the participants’ companies is \$5.3 billion, which is comparable to Fortune 500 firms (Cable News Network [CNN] 2012). The average compensation structure for the participants is 68 percent base pay and 32 percent incentive pay. I find that 42 of 112 participants (37.5 percent) have a clawback policy at their company.¹² The most frequently noted characteristics in the policies are the following: (1) covers only key executives (57.1 percent), (2) requires misconduct (fraud) to be triggered (50.0 percent), (3) covers stock awards (38.1 percent), and (4) covers cash bonuses (38.1 percent). The first two characteristics provide some evidence that firms have begun enacting policies that reflect the pending requirements from the Dodd-Frank Act.

Last, I find that 42 participants (38 percent) have experienced a restatement¹³ during their career in a wide range of positions, including from both the company and auditor perspectives. Consistent with Chung and McCracken (2014), I find that the circumstances surrounding the participants’ experiences varied widely, including having no prominent role in resolving the restatement, being involved in discussions during the process with various parties (i.e., the SEC, external auditors, audit committee, other executives, and legal counsel), or taking oversight responsibility for the restatement process.¹⁴

Materials and Procedure

Participants completed the experiment using a web-based instrument administered by Qualtrics. They were randomly assigned to the four conditions created by the 2 × 2 design. The

⁹ Participants from personal contacts were relatively evenly distributed across all experimental groups.

¹⁰ Two participants indicated that they are divisional controllers. All statistical inferences remain the same when these participants are excluded; thus, I included them in the final sample.

¹¹ I do not find any significant differences (all $p > 0.05$) between CFO and controller/treasurer participants for the demographic variables, with the exception of the percentage of participants that have a clawback policy at their company (49 percent versus 21 percent), years of business experience (21.7 versus 18.6), years of experience discussing audit differences with the external auditors (11.2 versus 8.3), and compensation structure (72.9 percent base pay and 27.1 percent incentive pay versus 64.0 percent base pay and 36.0 percent incentive pay). These differences are not unexpected, as it is reasonable to expect that CFOs are more likely to have greater experience with clawbacks, in business, and with auditors, and receive compensation that includes more incentives. I controlled for these variables in the analysis and found that all statistical inferences remain the same.

¹² Participants with clawback policies consisted of 32 CFOs and ten controllers/treasurers.

¹³ Participants with restatement experience were relatively evenly distributed across experimental groups.

¹⁴ There were no statistically significant differences (all p -values > 0.05) across the experimental groups for the demographic variables, with the exceptions of whether participants perceive their company’s auditor to be a specialist and the percentage of participants that have a clawback policy at their company. I controlled for the variables in the analysis and found that all statistical inferences remain the same.

experimental case provided the following information: (1) company background information and summary financial statements, (2) specifics about the CFO's compensation and the clawback policy, (3) description of the external audit team, and (4) details on the external auditor's proposed restatement. After reading the case, participants responded to a series of questions regarding the dependent variable, manipulation checks, and post-experiment questionnaire.

Participants were asked to assume the role of CFO at a large publicly traded company with multiple subsidiaries in the medical manufacturing industry. They were able to review key financial statement amounts from 2011 and 2010. They learned that the company had performed well during their tenure as CFO and that it was on track to meet the consensus analyst forecast in 2011. Participants also read that the audit committee was objective (i.e., not favoring either the auditor or management) and that there had been no significant disagreements between management and the auditors during the CFO's tenure. The materials then described the company's clawback policy, CFO compensation, and the quality of the audit team.

Next, participants were told that the external auditors had recommended an error restatement based on an impairment loss identified in the 2010 financial statements. The restatement decision requires professional judgment because the error amount is quantitatively immaterial (less than 5 percent of pretax income), yet participants read that the auditor viewed the restatement amount as qualitatively material (i.e., the company's EPS will fall below analyst forecast after the restatement). Therefore, the auditors recommend that a restatement is necessary according to SEC Staff Accounting Bulletin No. 99 (SEC 1999; Ng and Tan 2003). Furthermore, because the error amount causes EPS to fall below the analyst forecast, the CFO earned incentive-based compensation erroneously and will have to pay it back. After reviewing the proposed restatement, participants were asked to respond to the dependent measure question. Participants next responded to three manipulation check questions and then completed a post-experiment questionnaire, which included the demographics questions.¹⁵

IV. RESULTS

Manipulation Checks

Participants responded to three manipulation check questions. First, I asked the following "Yes/No" question: "Was any of your incentive-based compensation subject to the company's clawback policy?" Next, I asked participants to recall the exact dollar amounts of their base pay and incentive pay.¹⁶ Last, for the manipulation check of auditor quality, I asked the participants to rate the extent to which they believed the auditors were specialized in the company's industry in the case ("0 = Not at All," "5 = Somewhat," and "10 = Highly Specialized"). Participants in the higher quality auditor group viewed their auditors as significantly more specialized than participants in the lower quality group (6.5 compared to 5.7; $F = 4.391$, $p = 0.038$).

¹⁵ To ensure that the case materials, clawback policy, and proposed restatement were realistic, I developed the case with the assistance of five audit partners from Big 4 firms, a corporate attorney with experience in writing and developing clawback policies for public companies, and a CFO at a Fortune 400 company.

¹⁶ Sixty-two of 112 (55.4 percent) participants correctly responded to the first two manipulation checks. Participants that failed the manipulation checks were relatively evenly distributed across all experimental groups. When I include the 50 participants that incorrectly responded to the checks in the analysis, all statistical inferences remain the same. I included all of the participants in the final sample.

Hypothesis Tests

To test H1, H2, and H3, I examine participants' responses to the dependent measure, their likelihood of agreeing with the proposed restatement.¹⁷ Table 1, Panel A provides descriptive statistics for their likelihood of agreeing assessments, Panel B provides results from an analysis of variance, and Panel C provides results from simple effects tests.

H1 predicts that executives will be less likely to agree with a lower quality auditor's proposed restatement that will lead to clawback when the executives' total compensation consists of higher incentives as compared to lower incentives. Consistent with H1, in Table 1, when there is a lower quality auditor, executives are significantly less likely to agree with the auditor's proposed restatement that will lead to a clawback when executives have higher incentives (31.25 percent) than when they have lower incentives (50.97 percent) ($F = 8.988$, $p = 0.002$, one-tailed).

H2 predicts that executives with higher incentives will be less likely to agree with a proposed restatement that will lead to a clawback when there is a lower quality auditor as compared to a higher quality auditor. I find a marginally significant simple effect for H2 in Table 1, as executives with higher incentives make lower likelihood assessments when there is a lower quality auditor (31.25 percent) as compared to a higher quality auditor (41.15 percent) ($F = 2.092$, $p = 0.076$, one-tailed).

Taken together, the simple effects predicted in H1 and H2 result in the hypothesized interaction in H3. Specifically, H3 predicts that auditor quality will mitigate the executives' decision-making because a higher quality auditor should increase the executives' likelihood of agreeing when they have higher incentive compensation. Results from the analysis of variance in Table 1 are consistent with the predicted interaction of compensation structure and auditor quality in H3 ($F = 3.953$, $p = 0.025$, one-tailed). Taken as a whole, results from the simple effects tests for H1 and H2 and the significant interaction effect for H3 support the predicted interaction (see Figure 1).

Although not hypothesized, I also examine whether executives with lower incentives facing a higher quality auditor may differentially agree when they have higher incentives or there is a lower quality auditor. I perform simple effects tests, but do not find significant differences (both $p > 0.10$).

Supplemental Analysis

Executives' Free Response Justifications: Supplemental Analysis of H1, H2, and H3

Participants were asked to briefly explain the reasons why they took their respective positions regarding the proposed restatement. Responses were coded into justification categories based on whether the reasons agreed or disagreed with the proposed restatement.¹⁸ Table 2 shows the most commonly provided justifications for why the executives disagreed (Panel A) and agreed (Panel B) with the proposed restatement. As noted in Panel A, 36 of 112 participants (32.1 percent) utilized the ambiguity from the subjective accounting standard to take the financial reporting position of not restating the financials. This finding shows that the executives used the latitude afforded to them with the interpretation of a subjective standard to disagree with the auditor's proposed restatement. As noted in Panel B, 84 of 112 participants (75.0 percent) did not provide any justification to

¹⁷ There was not a significant difference ($p > 0.10$) between CFO participants and controller/treasurer participants for the dependent measure.

¹⁸ The author and an independent coder analyzed the free responses without knowledge of the experimental conditions to which a participant had been assigned. The coders agreed with each other on 87.5 percent of the disagreeing justifications (Kappa coefficient = 0.78) and 95.5 percent of the agreeing justifications (Kappa coefficient = 0.89). Kappa coefficients indicate substantial agreement between the two coders (both significant at $p = 0.000$) (Cohen 1960; Landis and Koch 1977). All differences were resolved by mutual agreement between the coders.

TABLE 1
Results for Executives' Likelihood of Agreeing with the Restatement
(H1, H2, and H3)

Panel A: Mean (Standard Deviation)

	Higher Quality Auditor	Lower Quality Auditor	Totals
Lower Incentives	42.58 (24.90) n = 31	50.97 (25.61) n = 31	46.77 (25.40) n = 62
Higher Incentives	41.15 (23.55) n = 26	31.25 (21.93) n = 24	36.40 (23.10) n = 50
Totals	41.93 (24.09) n = 57	42.36 (25.82) n = 55	42.14 (24.84) n = 112

Panel B: Analysis of Variance^a

Variable	SS	Df	F-ratio	p-value (two-tailed)
Executive Compensation Structure ^b	3,090.97	1	5.283	0.023
Auditor Quality ^c	15.91	1	0.027	0.869
Executive Compensation Structure * Auditor Quality (H3)	2,312.97	1	3.953	0.049

Panel C: Simple Effects Tests^d

Comparisons	F-ratio	p-value^e
H1: Higher Incentives Lower Quality Auditor < Lower Incentives Lower Quality Auditor	8.988	0.002
H2: Higher Incentives Lower Quality Auditor < Higher Incentives Higher Quality Auditor	2.092	0.076
Higher Incentives Higher Quality Auditor versus Lower Incentives Higher Quality Auditor	0.049	0.825
Lower Incentives Higher Quality Auditor versus Lower Incentives Lower Quality Auditor	1.863	0.175

^a ANOVA was performed with the dependent variable "Likelihood of agreeing with the restatement" (assessed on the scale: "0 percent = No Likelihood," "50 percent = Moderate Likelihood," and "100 percent = Absolutely Certain").

^b Executive Compensation Structure variable: a higher or a lower percentage of total compensation based on incentives.

^c Auditor Quality variable: a higher or a lower quality auditor.

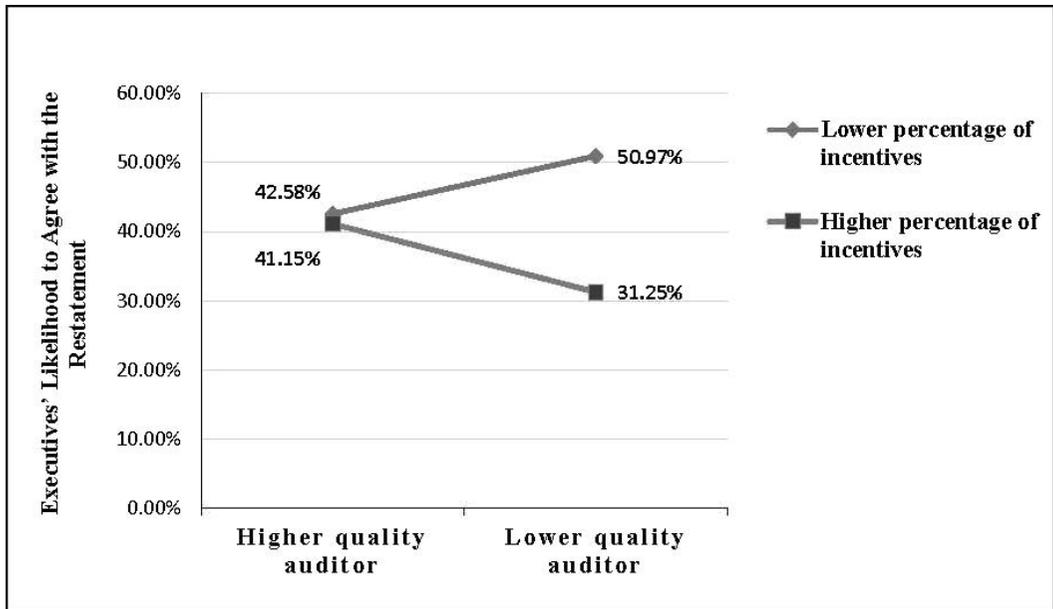
^d Simple effects tests were performed to analyze differences between the groups.

^e Reported p-values are one-tailed for H1 and H2, given my directional predictions, and two-tailed for the remaining simple effects tests.

restate. This is an expected finding since the participants' overall likelihood assessment for restating was less than the midpoint (50 percent likelihood) (Table 1).

I perform a further analysis of the qualitative responses to determine whether the number of justifications provided is consistent with their likelihood assessments. To test the executives' free responses for the number of justifications *disagreeing* with the restatement, I perform simple effects

FIGURE 1
Interaction of Executive Compensation Structure and Auditor Quality on Executives' Likelihood of Agreeing with the Restatement



This figure represents the observed interaction of executive compensation structure (i.e., a higher or a lower percentage of total compensation based on incentives) and auditor quality (i.e., a higher or a lower quality auditor) on executives' likelihood of agreeing with an auditor-proposed restatement that will lead to a clawback (assessed on the scale: "0 percent = No Likelihood," "50 percent = Moderate Likelihood," and "100 percent = Absolutely Certain").

tests and analysis of variance. Based on the theory utilized to develop the hypotheses, I expect that executives will provide more justifications against restating as they become less likely to restate. Table 3, Panel A provides descriptive statistics and Panel B provides results from an analysis of variance. Consistent with my findings for H1, when there is a lower quality auditor, the number of executive justifications is greater when executives have higher incentives (1.25) than lower incentives (0.58) ($F = 6.233, p = 0.014$, two-tailed, untabulated). Further, when executives have higher incentives, the results for the number of disagreeing justifications when there is a lower quality auditor as compared to a higher quality auditor are directionally consistent with hypothesis testing for H2, but not significant (1.25 compared to 1.00) ($F = 0.802, p = 0.372$, two-tailed, untabulated). Table 3, Panel B shows a marginally significant interaction ($F = 3.500, p = 0.064$, two-tailed) of compensation structure and auditor quality. Based on further examination of the marginal interaction, I find a marginally significant simple effect for executives with lower incentives providing fewer justifications when there is a lower quality auditor (0.58) than a higher quality auditor (1.03) ($F = 3.251, p = 0.074$, two-tailed, untabulated). This result is directionally consistent with that of the main dependent variable.

Next, I perform simple effects tests and an analysis of variance on the number of *agreeing* justifications for restating the financials. Table 4, Panel A provides descriptive statistics and Panel B provides results from an analysis of variance. Consistent with hypothesis testing for H1, the number of agreeing justifications when there is a lower quality auditor is smaller with higher incentives (0.17) as compared to lower incentives (0.58) ($F = 9.506, p = 0.003$, two-tailed, untabulated). I find

TABLE 2
Free Response Analysis
Executives' Justifications for Disagreeing or Agreeing with the Restatement

Panel A: Executives' Justifications that Disagree with the Restatement

	<u>n = 112</u>	<u>Percent</u>
Methodology is subjective (both methods are acceptable within GAAP)	36	32.1
Proposed impairment is a current-year issue	16	14.3
Issue needs further analysis	14	12.5
Analysis was done in good faith with best professional judgment	12	10.7
Previous audit team gave a clean opinion	6	5.4
Proposed restatement is not material	6	5.4

Panel A summarizes the categories and the number of disagreeing justifications provided by executive participants when asked to provide reasons supporting their position for the main dependent variable, likelihood of agreeing with the restatement. The six reasons listed above are the most commonly provided justification categories from all 112 participants. Overall, participants provided 107 distinct responses across 12 categories; 47 participants did not provide a justification that disagreed with the proposed restatement.

Panel B: Executives' Justifications that Agree with the Restatement

	<u>n = 112</u>	<u>Percent</u>
Agree with the audit team's recommendation	16	14.3
Likely to agree, but issue needs to be reviewed by an additional party	10	8.9
Restating is the most conservative approach	5	4.5
Audit team has appropriate expertise	4	3.6
Audit team was recently trained on the subject matter	1	0.9

Panel B summarizes the categories and the number of agreeing justifications provided by executive participants when asked to provide reasons supporting their position for the main dependent variable, likelihood of agreeing with the restatement. The five reasons listed above consist of all of the categories and responses provided from all 112 participants; 84 participants did not provide a justification that agreed with the proposed restatement.

a directionally consistent result with H2, but it is not significant, as there is no difference in justifications provided by executives with higher incentives for a lower quality auditor than a higher quality auditor (0.17 compared to 0.19) ($F = 0.034$, $p = 0.855$, two-tailed, untabulated). Table 4, Panel B indicates a significant interaction ($F = 4.104$, $p = 0.045$, two-tailed) of compensation structure and auditor quality. Based on further investigation of the significant interaction, I find that executives with lower incentives offer significantly more agreeing justifications for a lower quality auditor (0.58) than a higher quality auditor (0.23) ($F = 8.002$, $p = 0.006$, two-tailed, untabulated).

Last, I perform simple effects tests and an analysis of variance on a difference measure for executives' justifications (the number of disagreeing justifications less the number of agreeing justifications). The difference measure provides evidence as to how much the executives favor their position by directly comparing the number of disagreeing and agreeing justifications. Table 5, Panel A provides descriptive statistics and Panel B provides results from an analysis of variance. Consistent with results for H1, when there is a lower quality auditor, executives have a higher difference measure with higher incentives (1.08) than lower incentives (0.00) ($F = 9.384$, $p = 0.003$, two-tailed, untabulated). Results are directionally consistent with H2; however, executives with higher incentives do not provide a significantly greater difference measure for a lower quality auditor than a higher quality auditor (1.08 compared to 0.81) ($F = 0.560$, $p = 0.456$, two-tailed,

TABLE 3

Results for the Number of Executives' Justifications that Disagree with the Restatement

Panel A: Mean (Standard Deviation)

	Higher Quality Auditor	Lower Quality Auditor	Totals
Lower Incentives	1.03 (1.08) n = 31	0.58 (0.85) n = 31	0.81 (0.99) n = 62
Higher Incentives	1.00 (0.89) n = 26	1.25 (1.11) n = 24	1.12 (1.00) n = 50
Totals	1.02 (0.99) n = 57	0.87 (1.02) n = 55	0.95 (1.00) n = 112

Panel B: Analysis of Variance^a

Variable	SS	Df	F-ratio	p-value (two-tailed)
Executive Compensation Structure ^b	2.81	1	2.886	0.092
Auditor Quality ^c	0.28	1	0.289	0.592
Executive Compensation Structure * Auditor Quality	3.40	1	3.500	0.064

^a ANOVA was performed with the dependent variable number of executives' justifications that agree with the auditor proposed restatement that will lead to a clawback.

^b Executive Compensation Structure variable: a higher or a lower percentage of total compensation based on incentives.

^c Auditor Quality variable: a higher or a lower quality auditor.

untabulated). Table 5, Panel B shows a significant interaction ($F = 4.785$, $p = 0.031$, two-tailed) of compensation structure and auditor quality (see Figure 2). Based on further investigation of the significant interaction, I find that executives with lower incentives provide a significantly lower difference measure when there is a lower quality auditor (0.00) as compared to a higher quality auditor (0.81) ($F = 5.959$, $p = 0.016$, two-tailed, untabulated).

Executives' Expected Impact of a Restatement on their Reputation and the Shareholders

Executives were asked to assess the impact that the restatement in the case would have on their personal reputation and on the shareholders ("−5 = Very Negatively," "0 = No Impact," and "5 = Very Positively"). Executives believe that the impact of the restatement will have a significantly more negative effect on their personal reputation when they have higher incentives (−1.26) as compared to lower incentives (−0.11) ($F = 6.361$, $p = 0.013$, two-tailed, untabulated). This finding indicates that executives believe that their reputation will be more negatively impacted after repaying a greater percentage of incentive compensation earned based on misstated financial statements. In other words, executives may believe that outside parties will be more likely to suspect that they reported aggressively when they had a higher incentive payout.

I also find that executives believe that the impact on the shareholders will be marginally more negative when they have higher incentives (−1.62) as compared to lower incentives (−0.73) ($F =$

TABLE 4

Results for the Number of Executives' Justifications that Agree with the Restatement

Panel A: Mean (Standard Deviation)

	Higher Quality Auditor	Lower Quality Auditor	Totals
Lower Incentives	0.23 (0.43) n = 31	0.58 (0.67) n = 31	0.40 (0.59) n = 62
Higher Incentives	0.19 (0.40) n = 26	0.17 (0.38) n = 24	0.18 (0.39) n = 50
Totals	0.21 (0.41) n = 57	0.40 (0.60) n = 55	0.30 (0.52) n = 112

Panel B: Analysis of Variance^a

Variable	SS	Df	F-ratio	p-value (two-tailed)
Executive Compensation Structure ^b	1.38	1	5.676	0.019
Auditor Quality ^c	0.75	1	3.072	0.082
Executive Compensation Structure * Auditor Quality	1.00	1	4.104	0.045

^a ANOVA was performed with the dependent variable number of executives' justifications that agree with the auditor proposed restatement that will lead to a clawback.

^b Executive Compensation Structure variable: a higher or a lower percentage of total compensation based on incentives.

^c Auditor Quality variable: a higher or a lower quality auditor.

3.876, $p = 0.052$, two-tailed, untabulated), and marginally more negative when there is a lower quality auditor (-1.53) as compared to a higher quality auditor (-0.74) ($F = 3.040$, $p = 0.084$, two-tailed, untabulated). These findings are consistent with executives believing that the market will react more negatively when a greater amount of their incentive compensation is clawed back and when investors question the current auditor's ability to adequately monitor the firms' financial reporting (Hennes, Leone, and Miller 2013).

Executives' Interactions with Additional Parties during the Restatement Process

The restatement process may eventually involve the interactions of other parties beyond the executive and the audit team (Chung and McCracken 2014). I inquired about the participants' likelihood of involving any additional parties in their decision-making process ("0 percent = No Likelihood," "50 percent = Moderate Likelihood," and "100 percent = Absolutely Certain"). Interestingly, when there is a lower quality auditor as compared to a higher quality auditor, I find that executives are significantly more likely to request the involvement of the CEO (85.5 percent versus 76.0 percent, $F = 3.999$, $p = 0.048$, two-tailed, untabulated) and the board of directors (74.0 percent versus 59.3 percent, $F = 6.798$, $p = 0.010$, two-tailed, untabulated). Further, they are marginally more likely to request the involvement of the audit committee (84.6 percent versus 75.8 percent, $F = 3.149$, $p = 0.079$ two-tailed, untabulated) and the corporate attorney (81.8 percent

TABLE 5

Results for the Difference between the Number of Executives' Justifications that Disagree and Agree with the Restatement

Panel A: Mean (Standard Deviation)

	Higher Quality Auditor	Lower Quality Auditor	Totals
Lower Incentives	0.81 (1.30) n = 31	0.00 (1.37) n = 31	0.40 (25.40) n = 62
Higher Incentives	0.81 (1.17) n = 26	1.08 (1.35) n = 24	0.94 (1.25) n = 50
Totals	0.81 (1.23) n = 57	0.47 (1.45) n = 55	0.64 (1.35) n = 112

Panel B: Analysis of Variance^a

Variable	SS	Df	F-ratio	p-value (two-tailed)
Executive Compensation Structure ^b	8.13	1	4.81	0.030
Auditor Quality ^c	1.95	1	1.15	0.286
Executive Compensation Structure * Auditor Quality	8.10	1	4.79	0.031

^a ANOVA was performed with the dependent variable number of executives' justifications that agree with the auditor proposed restatement that will lead to a clawback.

^b Executive Compensation Structure variable: a higher or a lower percentage of total compensation based on incentives.

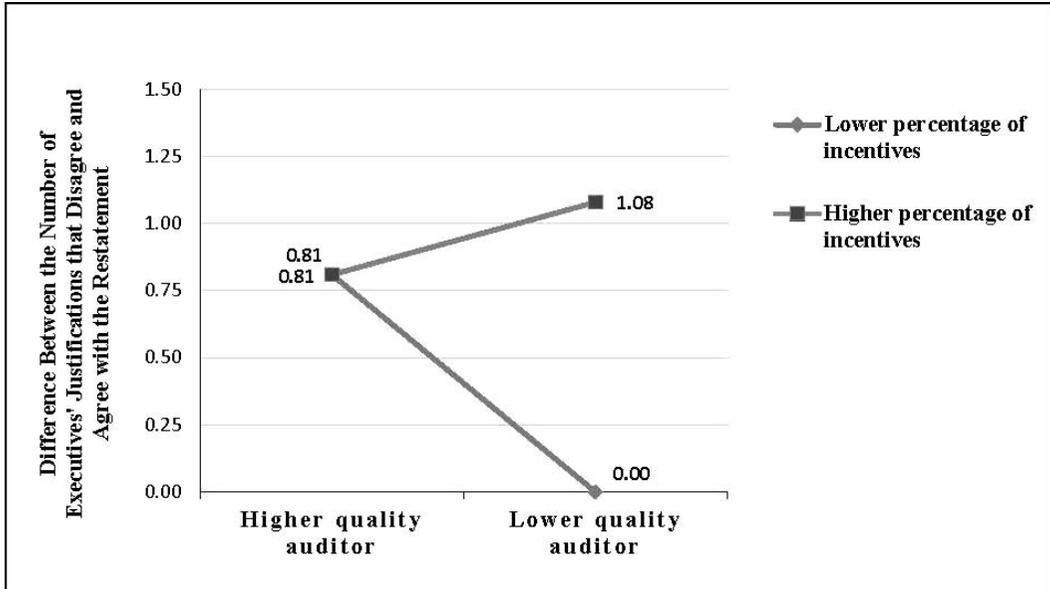
^c Auditor Quality variable: a higher or a lower quality auditor.

versus 72.5 percent, $F = 3.576$, $p = 0.061$ two-tailed, untabulated). These findings suggest that executives may not want to burn the reputational capital necessary to request the involvement of these additional parties when contesting a higher quality auditor's proposed restatement. However, when there is a lower quality auditor, executives may believe that they have a better chance of successfully challenging the proposed restatement and, therefore, will seek other parties' support in the dispute. Overall, executives' responses indicated the importance of including other parties in the discussion.

V. CONCLUSIONS

Clawbacks are designed with a goal of reducing future earnings restatements by deterring executives from engaging in unscrupulous financial reporting. Early archival evidence suggests the potential benefit of the *ex ante* deterrent effects of clawbacks, as voluntary adopters of clawbacks have experienced fewer restatements after adoption (deHaan et al. 2013; Chen et al. 2015; Chan et al. 2012). However, with a clawback in place, a potential *ex post* unintended consequence that could partially offset the *ex ante* benefit is that executives facing a clawback of their incentives may now be incentivized to avoid amending the financial statements during the restatement process (deHaan et al. 2013; Denis 2012). My experiment allows me to examine whether the *ex post* effects

FIGURE 2
Interaction of Executive Compensation Structure and Auditor Quality on the Difference between the Number of Executives' Justifications that Disagree and Agree with the Restatement



This figure represents the observed interaction of executive compensation structure (i.e., a higher or a lower percentage of total compensation based on incentives) and auditor quality (i.e., a higher or a lower quality auditor) on the difference between the number of executives' justifications that disagree and agree with the auditor-proposed restatement that will lead to a clawback.

of clawbacks influence executives' decision-making during the restatement process based on their executive compensation structure and the quality of the auditor. My findings extend the archival literature that finds fewer restatements in a clawback environment by demonstrating that the reduction in restatements is likely the net effect of (1) the *ex ante* benefits, and (2) the *ex post* effects of clawback policies. To my knowledge, this is the first study that investigates the *ex post* effects of clawback policies on executives' behaviors *during* the restatement process. My findings are timely because the Dodd-Frank Act will require that all public firms implement a clawback policy.

My results suggest that executives faced with a lower quality auditor are less likely to agree with amending the financial statements when their incentive-based pay makes up a higher percentage of their total compensation. Further, I find that executives bolster their directional goal of avoiding the proposed restatement and clawback by providing a greater number of disagreeing justifications than agreeing justifications. This suggests that executives may be using motivated reasoning, as that theory proposes that individuals with incentives to reach a preferred conclusion will search for, process, and assess information in a way that increases the possibility of achieving their desired conclusion (Kunda 1990; Jollineau, Tanlu, and Winn 2014; Mayhew and Pike 2004).

My study also contributes to the auditor quality literature (e.g., Moroney and Simnett 2009; Solomon et al. 1999; Bonner and Lewis 1990) by showing that higher quality auditors can act as more effective monitors during a restatement process when a clawback policy is in place. Specifically, executives' behavior is influenced by the quality of the external auditors when they

have a higher percentage of incentives, as they are less likely to disagree with a restatement when a higher quality auditor proposes it as opposed to a lower quality auditor. Audit committees selectively hire higher quality auditors for the purpose of having more knowledgeable monitors of their financial reporting process, which is evidenced by the committees' willingness to pay industry specialists an audit fee premium (Fung et al. 2012). As a result, executives may anticipate that a higher quality auditor will carry more clout during a financial reporting negotiation and, thus, be more reluctant to challenge the auditor's restatement recommendation.

My findings should be useful to regulators and auditors. I provide evidence of an *ex post* unintended consequence of clawback regulation that can at least partially offset the benefits of the *ex ante* deterrent effects. Regulators may want to consider limiting executives' restatement decision-making power and responsibilities when they are subject to a clawback. For example, it may be beneficial to enact regulation that requires the audit committee's financial expert to assume a formal role during the restatement process, such as being required to sign-off on restatement decisions. A potential unintended consequence for the audit profession is that auditors may assess the risk of misstatement as lower when executives face a clawback provision if they expect executives to be less aggressive and to produce fewer errors when the executives' compensation is at risk. As a result, auditors may reduce their audit work. Yet, my study provides evidence that auditors should be even more attentive to executives' resistance to booking audit adjustments and restating the financial statements in a clawback environment.

My findings may also be important for companies considering how to structure their executive compensation in a clawback environment. For example, firms may want to structure compensation with higher base salaries as a percentage of total compensation to deter negative behaviors in response to clawbacks. Early evidence suggests that voluntary adopters of clawback policies have increased their CEOs' compensation (Chen et al. 2015; deHaan et al. 2013; Babenko et al. 2012). Specifically, deHaan et al. (2013) find that the increase was due mainly to an increase in base salary, which is typically not vulnerable to a clawback. Firms may also consider using more incentives linked to nonfinancial performance targets, such that a clawback cannot recoup the compensation. For example, Equilar (2012b) finds that 38.5 percent of CEOs at S&P 1500 firms were awarded a portion of their incentives in the years 2008–2010 based on metrics tied to nonfinancial strategic objectives, such as quality or safety. However, companies will need to consider that these changes may also reduce the benefit of the *ex ante* deterrent effect of clawback policies.

My study also suggests an opportunity for future research. Gibbins et al. (2007) find that negotiations over accounting disagreements can be a complex process that requires research and analysis by the parties that are involved, such as management, the external auditor, and the audit committee. The main dependent variable in this study obtained the executives' initial position regarding the restatement recommendation from the auditors. This initial position begins the process that eventually may lead to negotiations with the auditor and the audit committee. Thus, future research could explore the subsequent negotiation that ensues among the three parties.

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