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## ***Executive pay clawbacks could backfire, says study***

BY MICHAEL COHN

Clawbacks on incentive-based compensation for executives could lead to misconduct and misreporting of financial results, according to a new academic study.

The study, by Jennifer E. Nichol of Northeastern University, examined trends such as the clawback provisions of the Dodd-Frank Act of 2010, as well as penalty clauses in executive compensation contracts. The paper, which appears in the May/June issue of the **American Accounting Association** journal *The Accounting Review*, backs up an earlier study in the same journal that questioned whether clawback policies have decreased the prevalence of financial misreporting or instead only increased managers' resistance to clawback-triggering restatements that correct misreporting.

For her study, Nichol conducted a behavioral experiment comparing two groups of participants who take a test and report their results. She found that twice as many of the "penalty group" than of the "bonus group" lied about their scores on the test and their lies elevated their scores by significantly larger amounts.

"While penalty contracts may sometimes encourage greater effort than bonus contracts as prior literature has shown, penalty contracts can also lead to greater dishonesty when effort is not successful," she wrote.

The new study may shed further light on the way executives view penalties for misreporting financial results in terms of the bonuses available to them. "Prior studies did not investigate possible alternative means of avoiding a penalty or acquiring a bonus outside of increased effort," Nichols wrote. "In reality, there are often options available to employees beyond increasing effort, options that may include undesirable behaviors such as misreporting."

Her research, she pointed out, didn't "find that penalty framing causes people to substitute effort with misreporting but suggests they will invest at least as much effort as they would under a bonus contract before resorting to dishonesty. This highlights the importance of setting targets that can be achieved through the greater exertion of effort when using penalty framing."

Nichol noted that some companies now use an escrow account that is a kind of compromise midway between a bonus and penalty, rewarding excellence while providing less incentive to lie.

"When companies use bonuses, their controls should focus on increasing effort," she advised. "When companies use penalties, their controls should focus on reducing dishonesty."



Former Rep. Barney Frank, D-Mass., and former Sen. Chris Dodd, D-Conn., before passage of the Dodd-Frank Act of 2010

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