Research Assessment Exercise 2020
Impact Case Study

University: The University of Hong Kong (HKU)
Unit of Assessment (UoA): 20. Accountancy
Title of case study: The Impact of Clawback Research on Policymaking by the Securities and Exchange Commission (SEC) of the U.S.A.

(1) Summary of the impact

HKU research on clawback has been a major influence on the SEC's policy on implementing an important element of the Dodd-Frank Act in the USA, which would determine whether every company with equity listed in the USA had to introduce provisions to limit the rewards that executive management of listed companies could retain were their company to be forced to correct misstatements of their earnings. This international policy debate affects the regulated behaviours of management, accounting and regulatory professionals and investors across a broad swathe of commercial activity, giving impact with extensive reach and high significance.

(2) Underpinning research

The analysis of issues associated with companies' management of their reported earnings is a major branch of research in accountancy. The capability of management to manipulate their firm's reported earnings can significantly reduce the information value of reported earnings and affect investor decisions. If the firm is required to restate its financial statements due to fraud, clawback provisions (hereafter 'clawbacks') require executive officers to pay back excess incentive-based compensation. Dr Lilian **Chan** has been the lead researcher in continuing research at HKU since 2007, utilising databases purchased by the HKU Faculty of Business and Economics. Dr **Chan**'s research has focused on two aspects: clawbacks' benefits and costs. One of the earliest published work on the benefits of clawbacks is that by **Chan** et al. in the *Journal of Accounting and Economics* in 2012 **[3.1]**. This research showed that earnings quality improves, audit fees are lower, auditors are less likely to report material internal control weaknesses, and audit report lags are shorter for firms adopting clawbacks. The reason is that managers have less incentive to manipulate company earnings when they can anticipate the costs of restatements, such as loss of income and reputation. Therefore, firms are less likely to have to restate earnings after adopting clawbacks. As such, the accounting earnings reported by clawback firms are more credible and informative from an investor's point of view; and auditors are more likely to perceive these firms as having lower control risk. In addition, the borrowing costs of clawback firms are lower because of better earnings quality, again as shown by **Chan** et al. in their *Journal of Financial Economics* paper of 2013 **[3.2]**.

However, **Chan**'s research goes further, to show that there are costs associated with clawback adoption. One cost is that firms tend to adopt real earnings management, not accruals earnings management, making operating and investing decisions which may not be the most beneficial to the firms in the long run. **Chan** et al. **[3.3]** is the seminal published research, in the *Accounting Review*, to look at this aspect of clawback adoption. This research found that clawback firms are more likely to cut research and development spending and advertising spending to meet earnings targets. The reason for cutting these costs is that managers of clawback firms face higher penalties when they make use of the flexibility and judgments allowed in accounting rules to manipulate earnings (accruals earnings management). If excessive accrual management is uncovered, managers will be required to restate financial reports and pay back their excess compensation due to the clawback provisions. Therefore, managers tend to choose real earnings manipulation, such as cutting research and development or advertising spending to meet earnings targets to avoid financial reports misstatements. This can lead to suboptimal operating decisions and have an adverse effect on the firm's future performance in the long run.

(3) References to the research

[3.1] **Chan, L.H.**, K.C.W. Chen, T.-Y.Chen, and Y.Yu, 2012. The effects of firm-initiated clawback provisions on earnings quality and auditor behavior. *Journal of Accounting and Economics* 54 (2), 180–196.
- Impact factor: 6.875 (second highest in accounting journals); H index: 122*
- The first clawback research publication in the top three accounting journals.

[3.2] **Chan, L.H.**, K.C.W. Chen, and T.-Y.Chen, 2013. The effects of firm-initiated clawback provisions on bank loan contracting. *Journal of Financial Economics* 110, 659–679.
- Impact factor: 12.489 (third highest in finance journals); H index: 206*
- The first clawback research publication in the top three finance journals.

[3.3] **Chan, L.H.**, K.C.W. Chen, T.-Y. Chen, and Y. Yu, 2015. Substitution between real and accruals-based earnings management after voluntary adoption of compensation clawback provisions. *The Accounting Review* 90 (1), 147–174.
- Impact factor: 3.946 (third highest in accounting journals); H index: 125*
- The third clawback research publication in the top three accounting journals.

*Source: https://www.scimagojr.com/journalrank.php?category=1402

(4) Details of the impact

4.1. Impact on the SEC Policymaking Process

The reach of impact from this research is global. In order to reform the financial regulatory system of the United States after the financial crisis of 2007-2008, the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereafter the Dodd-Frank Act) was proposed in 2010. To comply with Section 954 of the Dodd-Frank Act the Securities and Exchange Commissions (SEC) in 2015 proposed a new regulation, Rule 10D-1, that from 2017 all listed companies in the USA would be required to recover the excess incentive-based compensation received by an executive officer, if the company were required to prepare an accounting restatement to correct a material error. This proposal, if implemented, would have significantly affected more than 4,000 firms in the USA, with a total market capitalization of US$32 trillion. Therefore, the Rule 10D-1 proposal was widely discussed and debated in the media and the regulatory community around the world.

The purpose of proposing Rule 10D-1 was to improve financial reporting quality: that is, to reduce the likelihood of restatements and to improve internal controls, in order to protect investors after the financial crisis of 2007-08. The evidence presented by the SEC was explicitly based on **Chan** et al. **[3.1]**. In the Rule 10D-1 proposal **[5.1]**, on pg. 115 under the section "Potential Effects on Financial Reporting", we see:

> "*The proposed rule and rule amendments may also provide executives with an increased incentive to take steps to reduce the likelihood of inadvertent misreporting…. One study*[281] *found that, after the implementation of a recovery policy, an auditor is less likely to report a material weakness in an issuer's internal controls over financial reporting, which is consistent with issuers devoting more resources to internal controls over financial reporting."*
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> Footnote 281: *"See **Chan**, Chen, Chen, and Yu,* The effects of firm-initiated clawback provisions on earnings quality and auditor behavior, *Journal of Accounting and Economics* 54 (2012) 180-196.*"*

One comment received by the SEC **[5.2]** cited **Chan** et al. **[3.1]** to support the proposal of the Rule.

> *"In the end, a well implemented and enforced claw back policy should help reduce the temptation of management to fudge the numbers. Researchers **Lilian H. Chan**, Kevin C.W. Chen, Tai-Yuan Chen and Yangxin Yu in the Journal of Accounting and Economics have*

affirmed that where firms have implemented a claw back policy, the auditor is less likely to report a material weakness."

Importantly, the SEC cited and discussed **Chan** et al. **[3.3]** as the only paper published in the top accounting journals that analyses the costs as well as the benefits of clawback adoptions: acknowledging that imposing mandatory recovery of excess incentive-based compensation from executive officers could result in an increased likelihood of the executives making suboptimal operating decisions **[5.1]**. On pages 118 and 119 of this SEC proposal we have:

"We are aware, however, that these potential benefits of the proposed rule and rule amendments are not without associated costs…

One study suggests that a compensation recovery policy could result in an increased likelihood of an executive making suboptimal operating decisions in order to affect specific financial reporting measures as a result of the decreased incentive to use accounting judgments to affect those financial reporting measures.[291]"

Footnote 291: *"**Chan**, Chen, Chen, and Yu document that after the implementation …."*

The recognition in **Chan**'s research that benefits were balanced against costs has resulted in the SEC decision not to introduce their Rule 10D-1 to date. This is a highly significant impact on the reporting of firms listed in the world's largest equities market. While the SEC referenced and discussed several accounting publications in the Dodd-Frank Act proposal **[5.1]**, only three of them directly and explicitly related to clawback research, including those by **Chan** et al. **[3.1; 3.3]** conducted at HKU.

4.2. Impact on the regulatory policy debate

Dr **Chan**'s HKU research on clawback has also fed significantly into the policy debate among the media and accountants, regulators, attorneys and top executives. One of the major concerns raised was whether the provision can really eliminate earnings management and improve financial reporting quality in order to protect investors. This doubt was raised based on the findings in **Chan** et al. **[3.3]** and has been discussed in several practitioner journals **[5.3-5.6]**.

One example evidencing this is *Accounting Today* (a website to provide updated information related to accounting for public accountants with a reach to over 325,000 professionals) in 2015 **[5.4]**:

"While previous research has found that such provisions reduce the number of corporate financial restatements and increase investor confidence in financial reports, the new research suggests that the gains implied by those findings may be more illusory than initially thought…

*The study appears in the January/February issue of The Accounting Review, a scholarly journal from the American Accounting Association, … by **Lilian H. Chan** et al."*

Or in *CFO.com*, an international forum for corporate finance matters **[5.3]**:

"In the study of corporate adopters of clawback provisions, published in the American Accounting Association's journal, Accounting Review, researchers … found that adoptions reduce the incidence of one kind of earnings manipulation known as 'accruals management.' However, clawback policies increase the incidence of another kind of earnings manipulation that is *"equally, if not more, adverse to investors — that is, 'real-transactions management'."*

And in *Corporate Finance Weekly* **[5.5]** and the *National Law Review* **[5.6]**:

"Academics in Hong Kong have found that companies that have adopted executive compensation clawback provisions tend to substitute one type of earnings manipulation for another, and that this trend is more pronounced in companies with high growth or transient institutional ownership.

*[**Lilian H. Chan**, et al.*, "Substitution Between Real and Accruals-Based Earnings Management After Voluntary Adoption of Compensation Clawback Provisions," *The Accounting Review* Vol. 90, No. 1 (Jan. 2015).*]* "

(5) Sources to corroborate the impact

[5.1] Securities and Exchange Commission, 2015. Listing Standards for Recovery of Erroneously Awarded Compensation. File No. S7-12-15. https://www.sec.gov/rules/proposed/2015/33-9861.pdf

[5.2] Public Citizen. 2015. Comments on Listing Standards for Recovery of Erroneously Awarded Compensation. https://www.sec.gov/comments/s7-12-15/s71215-9.pdf

[5.3] Adoptions of Clawbacks Tied to Earnings Manipulation. 2015. CFO.com. http://www.cfo.com/accounting-tax/2015/01/adoption-clawbacks-tied-earnings-manipulation

[5.4] Clawbacks Can Lead to Accounting Gimmicks. 2015. Accounting Today. https://www.accountingtoday.com/news/clawbacks-can-lead-to-accounting-gimmicks

[5.5] Corporate Financial Weekly. 2015. Study Finds Executive Compensation Clawback Provisions Do Not Eliminate Possible Earnings Manipulation. https://www.corporatefinancialweeklydigest.com/2015/01/articles/litigation/study-finds-executive-compensation-clawback-provisions-do-not-eliminate-possible-earnings-manipulation/

[5.6] The National Law Review. 2015. Hong Kong Study Finds Executive Compensation Clawback Provisions Do Not Eliminate Possible Earnings Manipulation. https://www.natlawreview.com/article/hong-kong-study-finds-executive-compensation-clawback-provisions-do-not-eliminate-po

The content of 5.6 is the same as in 5.5 but it appears in a different international reach outlet.