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THE IMPACT OF CLAWBACK RESEARCH ON POLICY MAKING BY THE SECURITIES AND EXCHANGE COMMISSION (SEC) OF THE U.S.

LILIAN CHAN

FACULTY OF BUSINESS AND ECONOMICS

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Summary of the Impact

In order to reform the financial regulatory system of the United States after the financial crisis happened in 2007-2008, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act hereafter) was proposed in 2010.

To comply with Section 954 of the Dodd-Frank Act, in 2015 the Securities and Exchange Commission (SEC) of the U.S. proposed Rule 10D-1 that all listed companies (over 4,000 firms), in the U.S. will be required to recover the excess incentive-based compensation received by an executive officer starting from 2017 if the company is required to prepare an accounting restatement to correct a material error, i.e. clawback provision.

Chan’s clawback research in accounting played a significant role in this proposal **– the findings motivated the formulation of the rule and were cited in debates among policy makers, legislators, industry leaders, and market participants afterwards.**

Underpinning Research

Explain the **quality of the knowledge** embodied in your KE project
1. An outline of what the underpinning research was

- What is clawback provisions?

  Clawback provisions (hereafter clawbacks) require top executive officers to recover their excess incentive-based compensation when the firm is required to restate its financial statement due to fraud.

- Topics examined:
  - **Benefits** of clawback adoptions including financial reporting quality, auditor behavior, and bank loans terms
  - **Costs** of clawback adoptions including long term operating performance and operating decisions

Underpinning Research

2. When your research was undertaken, and your role in the creation of such knowledge

- The research started in 2010 and Chan's role was to identify which are the clawback firms, execute the empirical analyses, and write up the papers

Underpinning Research

3. Any relevant key contextual information about this area of research

- The co-authors of the papers are faculty members at The Hong Kong University of Science and Technology and City University of Hong Kong

Underpinning Research

4. Innovativeness of the knowledge arising from your research at HKU

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The effects of firm-initiated clawback provisions on earnings quality and auditor behavior☆

Lilian H. Chan[a], Kevin C.W. Chen[b,*], Tai-Yuan Chen[b], Yangxin Yu[c]

[a] The University of Hong Kong, Hong Kong
[b] Hong Kong University of Science and Technology, Kowloon, Hong Kong
[c] The Australian National University, Australia

- The research is **one of the first published work related to clawback adoptions** in the accounting and finance areas

Underpinning Research

5. Significance of the key insights or findings from the research that relate to the impact achieved by the KE project

- **Benefits of clawback**
  - Earnings quality improves
  - Audit fees are lower
  - Auditors are less likely to report material internal control weaknesses
  - Audit report lags are shorter for firms adopting clawbacks
  - Borrowing costs of clawback firms are lower because of better earnings quality

Source: Chan et al. (2012, 2013)

Underpinning Research

- **Costs of clawback**
  - Clawback firms tend to choose real earnings manipulations, i.e., they are more likely to cut research and development expenses and advertising expenses, to meet earnings targets.
  - This will lead to suboptimal operating decisions and will have adverse effect on future performance in the long run.

Source: Chan et al. (2015)

Engagement

1. Explain the **engagement process** through which the knowledge arising from the research described above was shared with or transferred to the target beneficiaries

➢ **Papers published in top accounting and finance journals**

- 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*

- 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*

- 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*

Impacts Achieved

1 & 3. **Beneficiaries** - the non-academic sector(s) or organizations that have benefitted or been impacted on; and description of the **evidence** or indicators of the extent of the impact

i. Informing policy makers such as SEC and legislators

The research informed the policymakers while formulating the proposed rule.

The SEC first cited the work by Chan and others (2012) to illustrate the reasons of proposing the 10D-1 rule is to improve financial reporting quality in order to protect investors after the financial crisis in 2007-2008.

"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."* (SEC, 2015: 115).

*Footnote 281 referred to Chan et al. (2012)

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

Impacts Achieved

1 & 3. **Beneficiaries** - the non-academic sector(s) or organizations that have benefitted or been impacted on; and description of the **evidence** or indicators of the extent of the impact

i. <u>Informing policy makers such as SEC and legislators</u>

In the same document, it cited and discussed, **the only published paper in top accounting journals**, about the costs of clawback adoptions (SEC, 2015: 119):

"One study[291] 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"

*Footnote 291 referred to and elaborated Chan and others' research on the cost of clawback.

Source: 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)

Impacts Achieved

1 & 3. **Beneficiaries** - the non-academic sector(s) or organizations that have benefitted or been impacted on; and description of the **evidence** or indicators of the extent of the impact

ii. Informing the civil society in the debate

Public Citizen, a sizeable non-profit consumer advocacy organization representing the voices of more than 400,000 members and supporters in the US, cited our 2012 research in its reply to the SEC's call for comment on the proposed rule (p.1):

"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."

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

Impacts Achieved

1 & 3. **Beneficiaries** - the non-academic sector(s) or organizations that have benefitted or been impacted on; and description of the **evidence** or indicators of the extent of the impact

iii. Informing practitioners and accounting professions

In addition, the proposal has been widely discussed in media and among practitioners and accounting professions

- Adoptions of Clawbacks Tied to Earnings Manipulation. 2015. CFO.com. (http://www.cfo.com/accounting-tax/2015/01/adoption-clawbacks-tied-earnings-manipulation/)
- Clawbacks Can Lead to Accounting Gimmicks. 2015. Accounting Today. (https://www.accountingtoday.com/news/clawbacks-can-lead-to-accounting-gimmicks)
- 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/)
- 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)

Impacts Achieved

2. Nature and extent of the impact

The motivations, discussions, rationales, and the comments received of the SEC proposal of Rule 10D-1 in 2015, together with the discussions in the public, are based on the academic research conducted in the area of the effects of clawback provisions published in top accounting journals.

This proposal, if passed, **would affect all publicly listed companies (more than 4,000 firms with a total market capitalization of US$32 trillion) in the U.S**.

The proposal was expected to be in effect in 2017. However, it is not yet passed by the Congress due to the ongoing debates among policy makers, legislators, practitioners, and lawyers, and change in government administration.