PRACTITIONER SUMMARY

The Influence of Auditor Quality and Executive Compensation Structure on Financial Reporting Executives’ Restatement Decisions in a Clawback Environment

Jonathan S. Pyzoha
Miami University

J. Gregory Jenkins
Auburn University

SUMMARY: Based on a recent SEC proposal, publicly traded companies will be required to adopt a clawback in accordance with the Dodd-Frank Act. In response, firms have been voluntarily adopting clawbacks at an increasing rate. Prior research finds one benefit of voluntarily adopting a clawback is a decrease in restatements. A recent study by Pyzoha (2015) uses an experiment to further investigate restatements in a clawback environment by studying executives’ restatement decisions based on auditor quality and executive compensation structure. Results show there may be an unintended consequence of clawbacks that partially offsets the aforementioned benefit. The study finds executives are less likely to agree with restating financial statements when their pay consists of a higher percentage of incentives and there is a lower quality auditor. Importantly, the study shows this tendency is reduced with a higher quality auditor. This article summarizes the study’s motivation, research method, results, and practical implications.

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

This article summarizes a recently published study titled “Why do Restatements Decrease in a Clawback Environment? An Investigation into Financial Reporting Executives' Decision-Making during the Restatement Process” (Pyzoha 2015). We discuss the study’s motivation, hypotheses, research method, and results. Furthermore, we discuss important aspects of the current and proposed clawback rules, common practices for clawback adoption, and potential implications of clawbacks for the audit profession, financial reporting executives (hereafter referred to as “executives”), boards of directors, and regulators.

II. MOTIVATION

After a rash of financial reporting scandals and the significant increase in the number of restatements in the late 1990s and early 2000s, shareholders and regulators sought ways to hold executives more accountable. An all too common experience for shareholders during this time was an inevitable decline in stock price after a company issued a restatement for previously misstated financial statements. At the same time, executives who had earned incentive compensation based on the misstated financial statements were shielded from the full negative effects of the restatement because they were allowed to keep their erroneously earned incentive compensation. Partially, as a result of this inequity, the first clawback provision was introduced in the Sarbanes-Oxley Act of 2002 (hereafter referred to as “SOX”) in Section 304, “Forfeiture of Certain Bonuses and Profits” (U.S. House of Representatives 2002).

Clawbacks are put in place so that companies can recoup incentive compensation paid to executives based on financial statements that are later found to be misstated. Thus, the goal of this section of SOX was to reduce future restatements by increasing executive accountability for their financial reporting decisions. Specifically, one objective of including a clawback provision in SOX was to deter future restatements by increasing executive accountability for their financial reporting decisions. Specifically, one objective of including a clawback provision in SOX was to deter future restatements by increasing executive accountability for their financial reporting decisions. Specifically, one objective of including a clawback provision in SOX was to deter future restatements by increasing executive accountability for their financial reporting decisions. Specifically, one objective of including a clawback provision in SOX was to deter future restatements by increasing executive accountability for their financial reporting decisions. Specifically, one objective of including a clawback provision in SOX was to deter future restatements by increasing executive accountability for their financial reporting decisions. Specifically, one objective of including a clawback provision in SOX was to deter future restatements by increasing executive accountability for their financial reporting decisions. Specifically, one objective of including a clawback provision in SOX was to deter future restatements by increasing executive accountability for their financial reporting decisions.

The SOX clawback provision requires the U.S. Securities and Exchange Commission (SEC) to recover on a company’s behalf any incentive compensation a CEO or CFO earned during the 12 months following the company’s issuance of fraudulently misstated financial statements. Notwithstanding this requirement, there was relatively little SEC enforcement action related to clawbacks in the early 2000s. In the five years following the passage of SOX, the SEC used the provision only when the CEO or CFO had already been convicted of criminal fraud (Markham 2007). However, in recent years, the SEC has started employing the provision more frequently to recoup ill-gotten gains. Three recent examples of SEC enforcement include Ian McCarthy and James O’Leary from Beazer Homes USA, Inc. and Maynard L. Jenkins from CSK Auto Corporation (McGrath 2011; Carton 2011). At Beazer Homes, McCarthy, CEO, repaid $6.5 million in bonuses, equity, and stock profits while O’Leary, CFO, returned $1.4 million in bonuses and stock profits. The SEC recouped $2.8 million in bonuses and stock profits from Jenkins, CEO of CSK Auto.

Clawbacks were subsequently proposed to be modified with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (hereafter referred to as the “Dodd-Frank Act”) in Section 954, “Recovery of Erroneously Awarded Compensation” (U.S. House of Representatives 2010). The existing clawback rules under SOX will not only be enhanced with stricter rules, but more importantly the SEC will now only oversee enforcement because each
publicly traded company will be required to create and enforce their own clawback policy. Once the new regulations are fully implemented by the SEC, executive officers at all public companies will be susceptible to having their incentive compensation clawed back by their employer.\footnote{In recent years, there has been progress toward finalizing the Dodd-Frank Act rules. In 2015, the SEC released proposed Rule 10D-1 for implementing the specific requirements outlined in the Dodd-Frank Act (SEC 2015). The SEC goes into significant detail about the new rules, including two areas of interest for publicly-traded companies and specifically for accountants, the recovery process, and how the SEC defines “executive officer.” Most recently, in June 2018, SEC Chairman Jay Clayton indicated “it is the SEC’s obligation to complete the rules mandated by Congress in Dodd-Frank, and I intend to do so” (SEC 2018).} The Dodd-Frank Act clawback provision also requires clawbacks to be triggered after material restatements from either fraud or error. Thus, by adding errors, executives will now be held accountable for unintentional mistakes and those made by subordinates. Further, the policy will apply to excess incentive compensation paid to current and former executive officers during the three years preceding the date on which the company is required to restate its financial statements.\footnote{An article published by Willis Towers Watson provides interested readers more insights about potential changes related to clawbacks (Seelig and Kalten 2017).} While these rules will directly apply to publicly traded companies, it is not out of the question that large private companies may also find this type of policy appealing as they seek ways to disincentivize executive misconduct, minimize errors in the financial statements, and implement industry best practices. Last, as the SEC works on finalizing the Dodd-Frank Act clawback rules, the SEC continues to enforce the SOX clawback provision and companies have also been voluntarily adopting their own clawback policies.

In the aftermath of the passage of the Dodd-Frank Act, companies increasingly began to voluntarily adopt clawback policies in anticipation of the SEC rulemaking process. Equilar, an executive compensation research firm, has conducted various surveys in recent years to track whether the largest companies have adopted clawbacks and to identify current implementation practices. At the Fortune 100 companies, 18 percent had a clawback policy in 2006, whereas nearly 90 percent had adopted such a policy by 2013 (Equilar 2012). Comparatively, 50 percent of companies in the S&P 500 had a policy in 2011 immediately after the passage of the Dodd-Frank Act, whereas 77 percent had adopted a policy by the end of 2015 (Equilar 2016). Along with the rapid increase in voluntary adoption, Equilar also found that there was a wide range of current practices being used while companies await the SEC rules to be finalized. Triggers for clawbacks range from a mix of ethical misconduct and restatements to violations of non-compete agreements. For example, despite the large number of S&P 500 companies with clawbacks in 2015, only 51 percent of the policies are triggered by a restatement. Policies also cover a wide range of compensation types, including cash and equity-based compensation such as stock options and restricted stock. Thus, despite the increase in voluntary adoption, the majority of publicly traded companies will still either need to adopt a new policy or will need to revise an existing policy to comply with the final SEC rules.

Since the passage of the Dodd-Frank Act, several studies have examined the influence of clawback policies. One area of research includes company characteristics that are associated with the likelihood of voluntarily adopting a clawback policy. For example, one study finds companies are more likely to adopt a policy when they have risk-averse CEOs, low volatility in their earnings, and higher quality accounting information (Chen, Greene, and Owers 2015). Additionally, this stream of literature has examined the benefits of clawbacks on financial reporting decisions. One of the major intentions of the clawback provisions in SOX and the Dodd-Frank Act is to reduce future restatements by enhancing the quality of executives’ financial reporting decisions.
research finds that clawback policies can be successful in this respect, providing support for the legislators’ intentions. Specifically, deHaan, Hodge, and Shevlin (2013) find that restatements decreased for companies that voluntarily adopted a clawback policy compared to companies that did not adopt such a policy. Yet, prior to Pyzoha (2015), no study had previously examined executive behavior during the restatement process when their incentive compensation was at risk of being clawed back.

III. HYPOTHESES

After a clawback is triggered via a restatement of previously issued financial statements, executives covered by a clawback policy are susceptible to losing any incentive compensation that was erroneously earned based on the misstatement. When a significant proportion of their compensation is based on incentives, prior research suggests executives may become more aggressive in resisting a restatement during negotiations with the external auditors to avoid the loss of the compensation (Watts and Zimmerman 1979; Jiang, Petroni, and Wang 2010).

Prior psychology and accounting literature indicate that the negotiators’ relationship can also play a critical role in influencing a negotiation process such as one that arises when an auditor proposes a restatement (Pruitt and Carnevale 1993; Iyer and Rama 2004; Gibbins, McCracken, and Salterio 2007; McCracken, Salterio, and Gibbins 2008). For example, when an audit firm has had a shorter tenure at the client and retention is critical for the auditor, Iyer and Rama (2004) find that management believes the auditor can be persuaded to agree with management’s accounting position. Gibbins et al. (2007) show that executives interpret the quality of an auditor’s accounting positions based on the expertise of the audit firm and the audit partner and their relationship with the audit partner. Last, McCracken et al. (2008) find CFOs determine the type of relationship (i.e., either proactive or reactive) that exists between management and the auditor. CFOs in a proactive relationship rely on their “expert advisors” (i.e., the auditors) to establish high quality financial statements, whereas CFOs in a reactive relationship do not rely on their auditors and actively challenge the auditor’s positions.

Collectively, if an executive deems the auditor as lacking expertise (i.e., a lower quality auditor), they will likely believe they hold more power in the relationship and in turn will be more likely to disagree with a proposed restatement. Further, this effect will be amplified when the executive is faced with the loss of a relatively high percentage of their compensation based on previously earned incentives than a relatively lower percentage. Thus, Pyzoha (2015) predicted the following hypothesis:

**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.

Based on a survey of Fortune 1000 firms, approximately two-thirds of the firms consider the audit firm’s expertise and/or industry specialization when deciding which firm to engage (GAO 2008). As a result, prior research finds that firms pay audit fee premiums for industry specialists (i.e., higher quality auditors) to monitor and ensure higher quality financial statements (Fung, Gul, and Krishnan 2012). This is not surprising because prior research also finds, compared to non-industry-specialist auditors, that industry-specialist auditors provide higher audit quality via better performance and improved judgments (Bonner and Lewis 1990; Solomon, Shields, and Whittington 1999; Moroney and Simnett 2009).
Therefore, if an executive believes the auditor has significant expertise (i.e., a higher quality auditor), they will likely believe they have less power in the relationship and in turn will be more likely to rely on their “expert advisors” to ensure financial statement quality even when the executive is faced with the loss of a relatively high percentage of their compensation based on previously earned incentives (McCracken et al. 2008). Therefore, Pyzoha (2015) predicted the following hypothesis:

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.

The study then combines H1 and H2 to predict the following interaction between auditor quality and executive compensation structure:

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.

IV. METHOD

To test the predictions discussed above, Pyzoha (2015) performed an experiment with 112 experienced executives (i.e., CFOs, controllers, and treasurers) from publicly traded companies. Participants were asked to assume the role of a CFO at a hypothetical large, publicly traded company in the medical manufacturing industry. In the experiment, the external auditors identify a material error in the previous year’s financial statements and propose a restatement. If there is a material restatement, the company’s clawback policy requires the CFO to pay back incentive compensation that was erroneously earned based on the error. After reading the case, participants were asked to assess their likelihood of agreeing with the external auditor’s proposal to restate last year’s financial statements and to briefly explain why they took this position.

The experiment manipulated two factors: (1) Auditor Quality and (2) Executive Compensation Structure. For Auditor Quality, participants were given information describing either a higher or lower quality auditor based on the extent of their industry specialization (significant or some), industry-specific training (attended throughout their careers or just attended their first one), and experience leading large publicly traded companies in this industry (extensive or this is the first time). These dimensions were used because they have been identified in prior research as indicators of auditors’ expertise and domain-specific knowledge (Bonner and Lewis 1990; Solomon et al. 1999; Moroney and Simnett 2009). For Executive Compensation Structure, participants were given information describing the CFO’s compensation structure as having either higher (80 percent of overall compensation) or lower incentive compensation (40 percent of overall compensation). These percentages were derived from a compensation survey for S&P 500 CFOs and the Dodd-Frank Act (Equilar 2011).

V. RESULTS

Pyzoha (2015) finds results that support the predictions presented above. Consistent with H1, the study finds that executives are 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 (31.25 percent) than a lower percentage of incentives (50.97). For H2, the study finds executives with total compensation that consists of a higher percentage of incentives are less likely to accept a restatement recommendation that will lead to a clawback from a lower quality auditor (31.25 percent) than a higher quality auditor (41.15 percent). The study next finds support for H3 such that there is a significant interaction between auditor quality and executive compensation structure. Last, the study does not find any differences between higher and lower auditor quality auditors when there are lower incentives and between higher and lower incentives when there is a higher quality auditor. See Figure 1 for a graphical representation of the experimental results.

Recall that participants were also asked to briefly explain the reasoning for their likelihood assessments. The analysis for the responses included coding the participants’ reasons into two justification categories: (1) agree or (2) disagree with restating the financial statements. Pyzoha (2015) examined whether participants’ justifications were consistent with their likelihood assessments for agreeing with the proposed restatement. Results from the study show that executives reinforced their directional goal of avoiding a restatement and subsequent clawback (i.e., lower likelihood of agreeing with the proposed restatement) by discussing more disagreeing than agreeing justifications. Based on these findings, motivated reasoning theory suggests that because the executives were incentivized to avoid the restatement and clawback, they searched, processed, and assessed the case information to enhance the likelihood of achieving their goal (Kunda 1990; Jollineau, Tanlu, and Winn 2014; Mayhew and Pike 2004).

VI. IMPLICATIONS

Pyzoha (2015) provides experimental evidence that clawbacks may have the unintended consequence of causing executives to be less likely to amend previously issued financial statements when there is a lower quality auditor and their pay consists of a higher percentage of incentives. However, the study also finds this tendency is reduced when there is a higher quality...
auditor. While prior research suggests that a reduction in restatements is a positive development for firms that voluntarily adopt a clawback policy (e.g., deHaan et al. 2013), results from Pyzoha (2015) suggest there is more to the reduction in restatements than initially meets the eye. That is, the reduction in restatements is likely the net effect of fewer financial reporting errors and greater executive opposition to restatements. With any new significant piece of financial reporting legislation, it is important to understand how it may impact behavior and financial reporting decisions. Thus, the study discusses how its findings related to clawbacks have important implications for the audit profession, boards of directors, executives, and regulators.

Two important areas where clawbacks may have an impact on auditors’ judgment and decision-making include during auditors’ assessments of risk of material misstatement and when auditors identify audit adjustments that may lead to a restatement. With a clawback in place, auditors may determine that they can lower the risk of material misstatement because they expect executives to be less aggressive or to make fewer errors when their incentives are at risk of being recouped at some point in the future. However, the findings from Pyzoha (2015) suggest auditors should be aware of the unintended consequence of clawbacks leading to potentially more aggressive executives. This unintended consequence is also important for auditors to consider when they propose restatements to executives because executives are likely going to be more resistant to correcting previous financial statements when their incentives can be clawed back. For example, this may cause executives to be more aggressive in utilizing “stealth restatements” to avoid triggering a clawback (e.g., Newquist 2019).

Results from the study also show that higher quality auditors can act as an effective monitoring function during the restatement process when a company has adopted a clawback. This has important implications for the audit profession as results from the study show the critical role that higher quality auditors can play in mitigating one type of aggressive executive behavior (i.e., avoiding a restatement to retain their incentive compensation). This also supports audit committees’ willingness to pay higher audit fees for industry specialist auditors who can act as a more expert monitor over the financial reporting process and potentially carry more clout during restatement discussions (Fung et al. 2012).

The study’s findings have important implications for public companies and those charged with governance, particularly compensation committees, as they determine how to structure executive compensation after adopting a clawback policy. To minimize the negative effects of clawbacks, the study indicates companies may want to include a higher percentage of base salaries and a lower percentage of incentives as base salary cannot be clawed back. Prior research finds preliminary support for this suggestion as voluntary adopters have increased their CEOs’ base salary (deHaan et al. 2013). Additionally, Pyzoha (2015) suggests companies may consider linking compensation to nonfinancial performance metrics such as safety or quality measures, which are not susceptible to a clawback.

The study’s results also have important implications for regulators and audit committees. Regulators and audit committees should now be more broadly aware that executives are more likely to avoid triggering a clawback as their incentives increase. Thus, regulators may need to consider whether the unintended consequence identified in Pyzoha (2015) should drive modifications to the proposed legislation from the Dodd-Frank Act. For example, one potential implication could be increasing the responsibilities of the audit committee’s financial expert(s) during restatement discussions between the executives and the audit committee, such as giving the financial expert(s) the power to sign-off on restatement decisions.

Lastly, as the SEC finalizes clawback rules, it will be important to continue investigating the variation in clawbacks being voluntarily adopted and the dynamics related to who is creating and
enforcing these policies. Thus, accounting researchers should consider exploring hypotheses related to this variation, such as the influence of different triggering mechanisms (e.g., fraud or error versus only fraud) on behavior.

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