Clawback provisions, executive pay and accounting manipulation

A Discussion

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The Paper

- Very interesting and important topic: Clawbacks.
- Close link of theory and empirics.
- Well written and crystal clear.
- Ready to submit.

The Topic

- Clawbacks: Shareholders recover previously-awarded compensation from managers involved in accounting manipulations.
- Many interesting questions to ask:
  - Is it possible to clawback?
  - If clawback is difficult, why to award managers in the first place?
  - Are clawback provisions useful to deter accounting manipulations?
  - What is the influence on executive compensation?
  - Who will adopt clawback provisions?
- All the questions are well answered with a clean model and convincing regressions.

The Model

The Model

Timing

- three-period model, $t = 0, 1, 2$
- cash flow at $t = 2$, $\{y_L, y_H\}$
- earning announcement $\{x_L, x_H\}$, can be manipulated

Choices (backward)

- Managers
  - manipulate $m = \overline{m}$ from x_l to x_h with cost γ
  - effort $e = \overline{e}$ to lose private benefit B
- Shareholders
  - compensations $w_1 = \{w_H, w_L\}$, $w_2 = \{w_{HH}, w_{HL}, w_{LL}\}$
  - clawbacks $c = 1$ with fixed cost κ and recover probability l

Key Conditions

- Managers **manipulate** if benefits are higher than cost

$$\overline{m}[w_H + \beta w_{HL} - (w_L + \beta w_{LL})] \geq \gamma.$$

- Managers **take effort** if benefits are higher than cost

$$\overline{e}\Big\{(w_H+\beta w_{HH}-[m(w_H+\beta w_{HL})+(1-m)(w_L+\beta w_{LL})-\gamma(m)]\Big\} \geq B.$$

- Lemma 1

$$w_L = w_{LL} = 0, w_{HL} = -clw_H.$$

Contracting Problem

Shareholders choose $\{w_H, w_{HH}, c, m\}$ (assuming $e = \overline{e}$) to minimize

$$\overline{e}(w_H + w_{HH}) + (1 - \overline{e})m(1 - cl)w_H + \kappa c$$

subject to

$$\Big(1 - m(1 - \beta cl)\Big)w_H + \beta w_{HH} \geq \frac{B}{\overline{e}} - \gamma(m), \qquad \text{(effort)}$$

$$m = \overline{m} \text{ if } w_H \geq \frac{\gamma}{(1 - \beta cl)\overline{m}}. \qquad \text{(manipulation)}$$

Trade-off

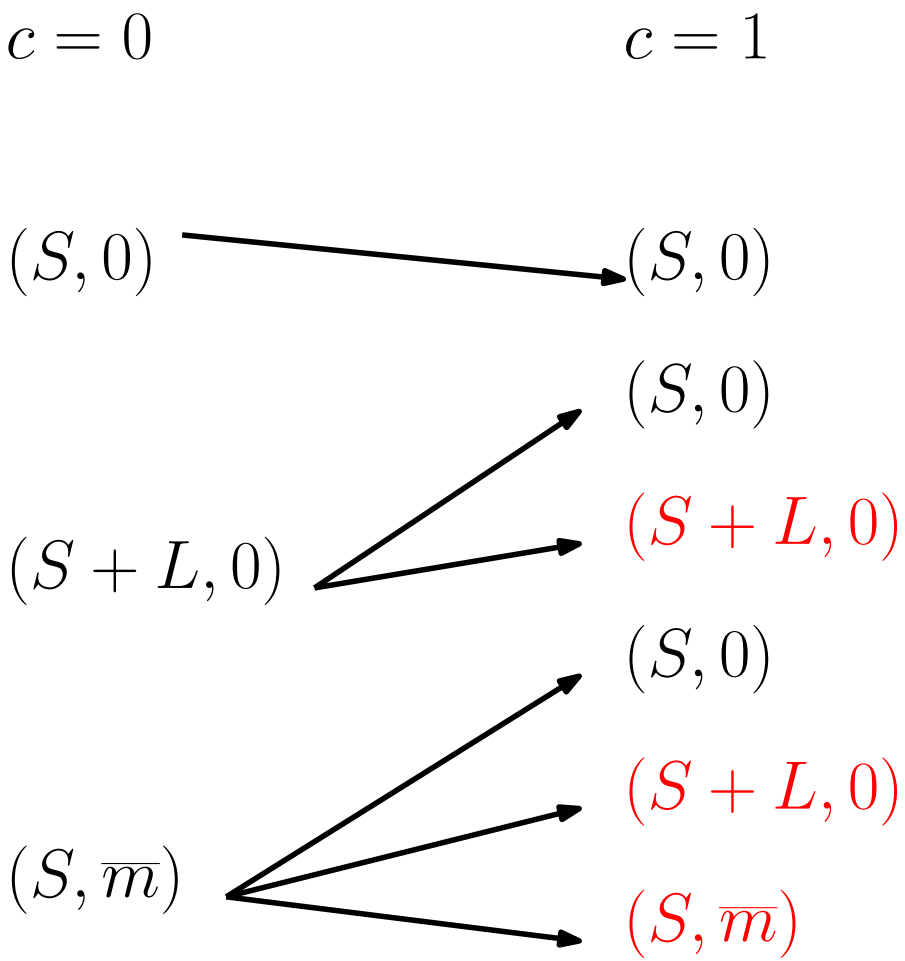
- To motivate effort, use either short-term incentives w_H or long-term incentives w_{HH}.
- Due to the impatience of managers ($\beta < 1$), w_{HH} is costly.
- However, if w_H is too high, the manager may manipulate

$$w_H \geq \frac{\gamma}{(1 - \beta cl)\overline{m}}.$$

The optimal contract

- $(S, 0)$, when moral hazard problem is not very severe or manipulation cost is relative high, w_H is enough to motivate the manager while not trigger manipulation.
- $(S + L, 0)$, when β is relatively large, then defer to w_{HH} so that manipulation is not triggered.
- $(S, \overline{m})$, when β is relatively low, only use w_H, and trigger manipulations.

From no clawbacks to clawbacks



Why from $(S, \overline{m})$ to $(S + L, 0)$?

- Complementarity between claw-backs and deferred compensation.
- Due to the adoption of claw-backs, w_H can be higher (without triggering manipulation).
- w_{HH} can be lower compared to the contract without claw-backs.
- The deferred compensation is less costly.

Comments

- Why it is important to stress the complementarity of claw-backs and long-term compensation?
  - Explore the policy implications.
  - Brief the intuition and policy implications in the introduction.
- Similarity between noisy signal and frictional recovery.
  - Chen et. al. (2015) argue that "A clawback contracts ... has the disadvantage of tying pay to the true-earnings level, which is a relatively noisy measure of effort."
  - In your paper, the recovery is noisy. (l)
  - In Chen et. al. (2015), the signal is noisy. ($\{y_H, y_L\}$)
  - Clarify the differences may help readers.

Comments

- Which is the key parameter, κ or l?
  - κ is the ex-ante enforcement cost.
  - l is the recovery capacity.
  - It seems that l is the key parameter in shaping optimal contract with limited recovery, while κ only influences whether adopt the provision.
  - May clarify this for readers.
- Voluntary v.s. Mandatory adoptions
  - Ignoring ex-ante cost κ, then clawbacks are good for all firms. Even firms with severe agency problem can benefit from it.
  - For these firms, account manipulation still occurs, but short-term pay becomes cheaper.
  - However, consider the ex-ante cost κ, these firms may not voluntarily adopt clawbacks.
  - Mandatory adoptions may make these firms (shareholders) worse.
  - The policy focus should be lowering κ.

Comments

- Manipulation or not?
  - Dodd-Frank requires a clawback to trigger after any material restatement, regardless of whether or not managerial misconduct was the root cause of the original misstatement.
  - Misreport without misconduct, $m \in \{\underline{m}, \overline{m}\}$
- Accounting manipulation can be punished in other ways. Why do we need clawbacks?
  - Less compensation in the next contracting period.
  - External fraud penalty by the authority.

The Empirical Evidence

The Design

- Test the adoption of clawbacks on
  - wealth-performance sensitivities, Δ_S and Δ_L
  - manipulations, `Meet` and `Restate`
- Effects are expected to depend on the pre-adoption status
  - measured by $\frac{\Delta_S}{\Delta_{Total}}$ 2002
  - firms respond differently
  - the key to check the model
- Adoption of clawbacks involves self-selection
  - IV: the adoption of clawbacks in other industries
  - clear and clever identification

Comments

The measurement of Δ_S and Δ_L.

- In the model, the short-run is very clear. But in a dynamic model, it is not clear what is short run and what is long run.
- And in the data, Δ_S and Δ_L is clearly generated dynamically.
- Grant one CEO 1000 shares, vested in 3 years. So now they are included in Δ_L. After 3 years, these shares are included in Δ_S.
- Correct me if I am wrong.

Comments

Pre-adoption status

- In the main regressions, the author tends to use $\Delta_S/\Delta_{\text{Total}}$ to measure the accounting manipulation.
- But why not use a proxy for initial level of accounting manipulation, such as `Meet` and `Restate`.

Measure account manipulation

- Use other variables to identify the manipulation, such as abnormal accruals.

Comments

Interpretation of regressions

- " In particular, firms at the 10th percentile of $\frac{\Delta_S}{\Delta_{Total}}_{2002}$ reduce the slope of long-term incentives by 60 percent. In contrast, firms at the 90th percentile of $\frac{\Delta_S}{\Delta_{Total}}_{2002}$ increase the slope of long-term incentives by 34 percent. "
- Strictly compare to the model's prediction, shouldn't the effect at 90th percentile on long-term incentives be insignificant?