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Pay

The warning is that CFOs whose pay is substantially geared to firm performance, as it commonly is, will be impelled by the prospect of clawbacks to resist restatements of corporate reports that overstated earnings, a development that would pose a ...

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Even as the chairman of the SEC continues to maintain that the clawbacks provision of the Dodd-Frank bill remains on the commission's to-do list, failure to finalize the rule eight years after the law's passage inevitably raises doubts about its ultimate

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of corporate reports that overstated earnings, a development that would pose a serious threat to the integrity of company accounting.

Valid though this concern may be, a new study in the current issue of ***The Accounting Review***, a peer-reviewed publication of the **American Accounting Association,** suggests that companies with clawback rules generally seek to protect accounting integrity while maintaining, and even enhancing, the advantages of performance-based CFO pay.

The study, by Peter Kroos and Frank Verbeeten of the University of Amsterdam and Mario Schabus of the University of Melbourne, finds clawback adoption to be associated not with weakened ties between pay and company performance but "with greater CFO bonus incentives tied to accounting measures."

On the surface this seems counterintuitive, given the presumptive risk a firm incurs any time a link is made between company performance and the pay of the corporate officer who oversees the measurement and reporting of that performance. But the study finds that on average the sensitivity of CFO bonus pay to company return on assets, a key measure of firm performance, nearly doubles following clawback adoption. The authors add that "compar[ing] the sensitivity of bonuses to return on assets following clawback adoption for CFOs relative to other named executive officers, we find the increase in bonus incentives to be more pronounced for CFOs."

These developments, the study concludes, have occurred because the severe penalties for misreporting that clawbacks impose on CFOs permit increased incentives affecting their creative role. As the authors explain, "CFOs perform dual roles within corporations. On the one hand, as members of the executive management team they have significant decision-making responsibilities. They make decisions on, e.g., financial planning and budgeting, cost reduction initiatives, debt versus equity financing, mergers and acquisitions, dividend and share repurchase policies, and treasury. On the other hand, CFOs play a key role in financial reporting. They have

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increasing their bonus incentives...without increasing their propensity to misreport."

As would be expected, the effect of clawbacks on performance-based CFO pay is not everywhere the same. The professors find that, in the words of the study, "the sensitivity of CFO bonuses to [company] return on assets varies systematically with the extent to which the firm's accounting system is susceptible to misreporting. Specifically, the increase in CFO bonuses tied to accounting measures after adoption of clawbacks is less pronounced in subsamples with internal control material-weakness disclosures, higher abnormal accruals [often a sign of accounting manipulation], higher CEO power, and lower audit committee power."

The study's findings draw on a large database that provides information on clawback adoption by companies in the Russell 3000, the 3,000 largest US public firms. In an analysis spanning the seven-year period 2007 through 2013, the professors compared CFO compensation of companies that had clawback rules during this period with that of firms that did not, controlling for such firm fundamentals as size, profitability, and indebtedness and such governance factors as board size, CFO tenure, and whether the CEO served as board chairman.

"In sum," the professors write, "the findings suggest that clawback adoption is associated with greater CFO bonus incentives tied to accounting measures... Clawback adoption leads to a 98 percent increase in the accounting-based pay-for-performance sensitivity."

The study, entitled "Voluntary Clawback Adoption and the Use of Financial Measures in CFO Bonus Plans," is in the May/June issue of ***The Accounting Review***, a peer-reviewed journal published six times yearly by the **American Accounting Association**, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *Auditing: A Journal of Practice and Theory, Accounting*

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