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A recent study, "Why Do Restatements Decrease in a Clawback Environment? An Investigation into Financial Reporting Executives' Decision-Making during the Restatement Process," shows that clawbacks may have unintended consequences. The study, conducted by an academic at Miami University of Ohio and published in ***The Accounting Review***, showed that financial executives who receive substantial incentive-based pay are more likely to resist their auditors' recommendations to restate financial statements if their companies have clawback policies. The implication is that, to the extent that additional clawback policies are mandated under new SEC rules (see this PubCo post), we may see a further reduction in restatements, but perhaps not entirely for the right reasons.

Earlier studies found a reduction in the level of restatements for companies that had voluntarily adopted clawback policies, largely attributed to the deterrent effect of clawbacks. Commonly, clawbacks were thought to reduce restatements because they led financial executives to be more diligent in their efforts to prevent errors and fraud. This new study looked at the effect of clawbacks on restatements *after* the misstatements have been discovered: as reported in CFO.com, according to the study's author, by looking at the "'back end,…what we may be seeing is that the executives are fighting restatements' in order to avoid clawbacks of their pay.'"

According to the study press release, the study involved 112 senior corporate financial officers, 58% of whom were CFOs and the remainder controllers or treasurers, with an average of 20 years of professional experience. The author examined the influence of two factors — executive compensation structure and auditor quality — on decisions to restate financial statements that could lead to compensation clawbacks. As reported in CFO.com, these participants were presented with a hypothetical in which, as CFOs, they were confronted with an auditor's proposal to restate the previous year's financias because, in the auditor's view, the company had used an excessively aggressive methodology to calculate impairment of equipment. As a result, the press release indicated, the auditors proposed a restatement that would reduce earnings to a level that would trigger a clawback of incentive compensation (40% of total compensation of $2.5M for half of the participants and 80% for the other half). For half of the participants, the auditors had extensive industry experience, while, for the other half, the auditors were well-seasoned but had limited industry experience. Participants were then asked to indicate, on a sliding scale, the likelihood of their agreeing with the auditor's restatement proposal.

Where auditors had extensive industry experience, the likelihood of agreement by the CFOs with the restatement proposal was about the same regardless of the amount of incentive-based pay. However, where the auditors had limited industry experience, there was a significant decrease in the level of agreement with the proposal. Why did they protest? Most often, the reason given was that the auditor's methodology was subjective. According to the study, the officers "used the latitude afforded them with the interpretation of a subjective accounting standard to disagree with the auditor's proposed restatement" and thereby "reach a preferred conclusion."

As concluded in the press release, "when the auditor proposing a restatement has limited knowledge of the client company's industry[,] executives with high incentive pay (in this study, compensation contingent on the firm's beating analysts' consensus earnings forecast) prove about 40% less likely than those with lower incentive pay to agree with the auditor's restatement proposal. This is critical, the study explains, because a top financial officer's view strongly influences the shape of restatements or, indeed, whether there is a restatement at all."