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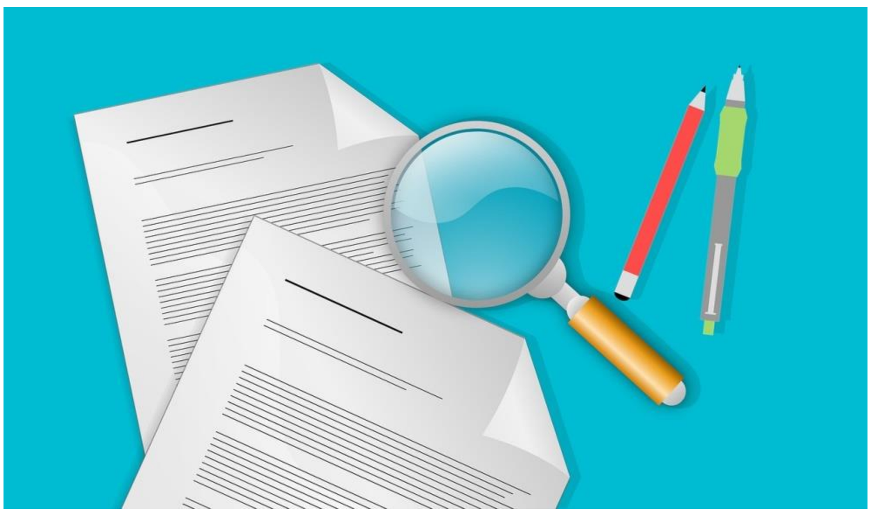
Effective tax rates: With fate of Dodd-Frank rule on clawbacks in doubt

Posted by Jacob Wolinsky

With fate of Dodd-Frank rule on clawbacks in doubt, study finds they prompt drops in corporate tax rates and effective tax rate



More subsidiaries in tax havens, more money for auditor tax services

Will the SEC ever finalize section 954, the clawbacks rule, of Dodd-Frank?

It has been nearly a decade since the much-heralded bill was signed into law and almost five years since the SEC proposed rules to implement section 954, a key provision that requires all firms listed on national securities exchanges to adopt "clawbacks" – policies to recover incentive compensation awarded to executives on the basis of erroneous company **financial statements**. Five years later, the proposals have yet to be finalized, and their future remains in doubt.

Should they be finalized? Research on the value of clawbacks has yielded mixed findings. As noted in a forthcoming paper in the January issue of ***The Accounting Review***, a peer-reviewed publication of the **American Accounting Association**, some studies have concluded that companies which have voluntarily adopted clawbacks improve their financial reporting, while other research has found that adoption pushes managers to juggle company operations in ways that may compromise long-term shareholder value.

The new paper seems likely to add to doubts about clawbacks. At a time of ballooning federal debt and claims that corporations don't pay their fair share of taxes, the study concludes that clawback adoption has had the unanticipated effect of prompting managers to drive down their companies' effective tax rates (ETRs).

The research, by Thomas C. Omer and Thomas R. Kubick of the University of Nebraska—Lincoln and Zac Wiebe of the University of Arkansas, compares 233 companies that adopted clawbacks voluntarily to similar firms that were non-adopters. They find that from soon after adoption companies are significantly more likely than non-adopters 1) to report a new subsidiary in a tax-haven country; 2) to increase payments for auditor-provided tax services; and 3) to increase board interlocks with companies with low effective tax rates.

Why the urgent push for tax savings among adopters? "Capital market pressures to meet earnings expectations do not subside following clawback adoption," the professors write. As they explain, executives feeling pressure to meet earnings goals or forecasts have often resorted to manipulating accruals, non-cash accounting items that commonly involve some element of estimation or guesswork. But "the potential costs of these [accrual-based] strategies are higher in a clawback environment because aggressive accruals can attract regulatory scrutiny and lead to forfeited compensation…Reducing **income-tax** expense is an attractive alternative."

Thus does ETR reduction become a substitute for aggressive accruals manipulation as clawback adoption makes the latter strategy more personally risky for managers.

The professors estimate that the 233 clawback adopters in their study lowered their ETRs enough in their clawback-adoption year to save an average of about $18 million. This amounted to about 1.6% of their average pre-tax net income of $1.1 billion and to a total decrease in income-tax expense for the 223 adopters of about $4.2 billion.

The study's findings, based on information from six databases, involved matching each of 233 firms that adopted clawbacks in the course of an eight-year period with a non-adopter in the same industry that was similar to the focal firm in 21 additional respects. Both the clawback adopters and the controls had almost the same effective tax rates in the year before adoption, but this quickly changed, as the ETRs of adopters dropped by an average of about 1.6 percentage points (or about 5%) in the adoption year, while those of the non-adopters were virtually unchanged. The swift effect on ETRs, the professors note, is consistent with prior research findings that changes in tax planning can occur over short periods.

The professors not only found lower ETRs to be achieved quickly but to be sustained in at least two post-adoption years, meaning that the loss to the federal treasury was more than just a one-time occurrence. They also found that **companies** that adopted a robust clawback policy (where recovery of compensation was contingent on material misreporting whether intentional or not) were more likely to lower their ETRs than firms where clawbacks were contingent on outright misconduct in reporting. In other words, a broader definition of clawbacks lit more of a fire under executives.

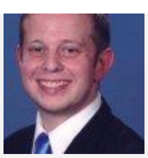
Given that the study employs data from before the Tax Cut and Jobs Act of December 2017, which reduced corporate tax rates sharply, has the effect of clawback adoption on ETR reduction changed from what the professors found it to be? Prof. Omer comments that it is too early to answer that question, while acknowledging change to be a possibility.

"On the one hand," he says, "corporate leaders are under no less pressure than before to meet earnings targets and forecasts. On the other hand, if lowering an ETR from 21% to 19% is more difficult and more expensive to achieve than lowering it from 32% to 30%, a tax-based strategy might be a less desirable option to meet earnings goals than it was before **tax** reform."

If the latter proves to be the case, he adds, it may very well result in increased resort to "real-transaction management," an option that was the subject of a paper in the January 2015 issue of *The Accounting Review*. This earlier paper found that, while clawback adoptions tend to reduce accruals manipulation, they increase real-transaction management, whereby company operations are altered to achieve a temporary **earnings** boost – for example, through cutting research and development or slashing prices or easing credit terms to accelerate sales. One of the authors of the 2015 study, Kevin C. W. Chen of the Hong Kong University of Science and Technology, commented that "mandating clawbacks, as Dodd-Frank does, is, at best, of dubious value and may actually be counterproductive in its encouragement of management practices, like reduced R&D, that can compromise the long-term competitiveness of a firm."

Indeed, Prof Omer and his co-authors cite this earlier study in their own paper, describing their new research as a complement to it in "examining an unexplored spillover effect of clawback adoptions."

The new study, "The Effect of Voluntary Clawback Adoptions on Corporate Tax Policy," is in the January 2020 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 Horizons, Issues in Accounting Education, Behavioral Research in Accounting, Journal of Management Accounting Research, Journal of Information Systems, Journal of Financial Reporting, The Journal of the American Taxation Association,* and *Journal of Forensic Accounting Research.*



Author: Jacob Wolinsky

Jacob Wolinsky is the founder of ValueWalk.com, a popular value investing and hedge fund focused investment website.