

## Study Warns of 'Unintended Consequences' in Dodd-Frank Clawback Provisions (January 26, 2015)

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**Today's News**

### SEC News

#### Study Warns of 'Unintended Consequences' in Dodd-Frank Clawback Provisions

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***Summary:** Clawback provisions have reduced one type of earnings manipulation, but increased the incidence of another, the American Accounting Association said. A study found that clawback provisions decrease accruals management but increase the incidence of real transactions management.*

While clawback provisions in the Dodd-Frank Act have reduced one type of earnings manipulation, the provision appears to have unintended consequences by increasing another type of manipulation, according to a study released in the January/February 2015 issue of *The Accounting Review*, published by the American Accounting Association.

Section 954 of the Dodd-Frank Act requires companies to recover from executives any incentive compensation they received that was based on erroneous financial statements. [Sec. 954 of PL111-203](#)

The study found that clawback provisions decrease "accruals management," noting that accruals, which are non-cash accounting items, are subject to exploitation because they often involve some kind of guesswork.

However, the study also found that the provisions increase the incidence of "real transactions management," which involves altering actual expenditures to get a temporary earnings boost, such as cutting research and development, slashing prices, or easing credit terms to spark sales.

The commission is expected to issue proposed versions for Dodd-Frank rules in the near future that cover clawbacks, which retrieve pay from executives at companies that have had accounting restatements, but many companies have voluntarily enabled or required themselves to implement them.

The SEC declined to comment on the study.

The clawback provisions discourage managers from using accruals management because high accounting accruals tend to attract more scrutiny from the SEC and auditors. Real-transactions management is considered less risky, the study said.

"The use of real transactions represents a deviation from optimal operating decisions," the study said, "but is not likely to be deemed improper by regulators or auditors. Thus, managers often resort to real transactions before turning to accruals to meet or beat earnings targets."

Kevin C. W. Chen, co-author of the study and head of the Accounting Department at the Hong Kong University of Science and Technology, said in a statement 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."

"Since the clawback policy mandated by section 954 is more rigorous than what many firms have adopted on their own," Chen continued, "it is reasonable to anticipate that the negative effects we saw in our study will be come to pass when the law is fully enforced."

Chen warned that "investors should be on the lookout for a switch from accrual-based manipulation to real-transactions management following clawback adoption, particularly among firms under high pressure to achieve short-term earnings targets based on analyst forecasts."

"Since companies commonly provide three years of financial data in annual reports," he said, "investors can easily determine whether there has recently been a decrease in R&D or SG&A expenses and whether managers provide credible justification for any that occur."

The study's findings are based on an analysis of financial reporting by companies included in the Russell 3000 index. The researchers compared data of 236 companies that adopted clawback provisions from 2005 through 2009--the five years preceding passage of Dodd-Frank--with an equal number of non-adopters closely matched with them in other respects.

The principal focus was on how the adopters modified their use of accruals management and real-transactions management from the years preceding clawback adoption to those following it and how that compared with the analogous data from non-adopters.

The study also found that clawback firms that increase real transactions management in the adoption year, compared with clawback adopters that do not increase real transactions management, see a short-term increase in profitability as measured by return on assets, as well as stock returns.