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Insider sales and the effectiveness of clawback adoptions in mitigating fraud risk ☆

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ABSTRACT

In recent years, firms (and lawmakers) have sought to mitigate the dysfunctional effects of incentive-based executive compensation by adopting clawbacks. However, extant clawbacks (whether firm-initiated or as mandated by the 2010 Dodd–Frank Act) do not go far enough in that they seem to allow executives to retain trading profits linked to sales of their own companies' shares at a time of inflated earnings (Fried and Shilon, 2011). In this paper, we examine the moderating effect of insider sales on the relation between firm-initiated clawback-adoptions and fraud risk. Our results indicate that clawback-adopting firms experience a decrease in fraud risk following adoption relative to non-adopters during the same time period. However, this decrease in fraud risk for the clawback-adopting firms is materially weakened in the presence of insider trading. At this time (July 2014), the SEC is still working on rules for implementing clawbacks (one of nearly half of the rules yet to be completed under Dodd–Frank). Our findings suggest that clawback rules (as and when issued by the SEC) need to address insider sales for clawbacks to be fully effective in mitigating the risk of fraudulent financial reporting.

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1. Introduction

In this paper, we investigate two issues related to clawback adoptions: (1) the effectiveness of clawback adoptions (i.e., firm-initiated adoptions of excess compensation recoupment provisions) in reducing the risk of fraudulent financial reporting (fraud risk), and (2) the impact of net insider sales of company stock on the relation between clawback adoptions and fraud risk.

As background, in recent years firms have sought to mitigate the dysfunctional effects of incentive-based executive compensation by adopting clawback provisions. Specifically, by allowing firms to recoup excess incentive compensation (such as bonuses) in the event of a later restatement of previously issued financial statements, these provisions aim to both (1) *ex ante* deter fraudulent financial reporting, and (2) *ex post* penalize company executives who manipulate reported earnings. Consistent with this objective, recent studies (Chan et al., 2012; Dehaan et al., 2013) suggest that firms' voluntary adoption of clawback provisions are associated with improved financial reporting quality. In our study, we provide a more complete understanding of the effectiveness of clawback adoptions by examining a context (insider sales) where these adoptions appear to have a limited or no effect. Specifically, we examine the moderating effect of actual realized insider trading on the relation between clawbacks and financial reporting quality as measured by the risk of fraudulent financial reporting (fraud risk).

Bergstresser and Philippon (2006) argue that while the purpose of equity-based compensation is to increase managers' exposure to company stock as a way of better aligning management incentives with shareholder interests, these equity incentives may also motivate managers to intentionally inflate reported earnings in an attempt at maintaining a high stock price and boost their trading profits while strategically reducing their net holdings of company stock. Specifically, Bergstresser and Philippon (2006) use discretionary accruals to proxy for earnings management and document a positive association between discretionary accruals and insider trading. Consistent with this finding, prior research (Fried, 2008; Summers and Sweeney, 1998) suggests that managers utilize inside information including knowledge that the firm is manipulating its reported earnings to increase their personal trading gains from insider sales of company stock. In particular, Summers and Sweeney (1998) use actual instances of financial reporting fraud to proxy for earnings management and find that net insider sales are higher in years of fraud occurrence.

In our study, we assess the effectiveness of clawback adoptions by examining fraud risk using the scaled logistic probability *F*-score developed by Dechow et al. (2011). Basically, the *F*-score captures the likelihood of misstated earnings resulting from *intentional* misstatements (as opposed to errors) identified by the SEC in its Accounting and Auditing Enforcement Releases (AAERs). Utilizing the *F*-score (rather than actual instances of fraud) as a proxy for financial reporting quality allows us to increase the sample size for analyses and hence the generalizability of our findings. To the extent that the *F*-score is a fairly powerful predictor of fraud occurrence, the positive association between insider sales and financial reporting fraud documented in Summers and Sweeney (1998) serves as a useful foundation for our study. Consistent with Bergstresser and Philippon (2006) and Summers and Sweeney (1998), we define net insider sales as net sales (i.e., dollar sales minus dollar purchases) of company stock executed by the firm's top managers, scaled by beginning-of-year firm equity value.

Separately, Fried and Shilon (2011) suggest that extant clawback provisions – whether firm-initiated or as mandated by the 2010 Dodd–Frank Act – do not appear to go far enough in that they allow executives to keep the excess compensation (trading profit) arising from the unwinding of their equity incentives (shares) at a time of inflated earnings. They also suggest that given the complexities associated with estimating what the stock price would have been absent the earnings manipulation (and in determining the amount of excess sale proceeds), it could be difficult for firms to recover this particular form of excess compensation. Consistent with this view, a recent PwC (2014) survey of extant clawback policies notes the types of compensation that may be recouped but makes no mention of excess compensation from insider sales. Relatedly, Sprangler (2013) suggests that the potential benefits from trading on insider information likely exceed the costs of such trading (such as losing a few years' worth of deferred compensation) in the event of clawback i.e., as a practical matter clawback provisions may not be an effective deterrent against insider trading. Hence, to the extent

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