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Research Paper

The impact of clawback provisions on information processing and investment behaviour

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ABSTRACT

Proposals after the last financial crisis in 2008 have called for an extension of the scope of clawback provisions in compensation contracts beyond what is commonly legally required. Under such an extended scope, managers would be held accountable for losses. The reason for such an extended scope is to counter incentives for excessive risk-taking that are currently present in many bonus contracts. We argue that such a call for an extended scope of clawback provisions ignores implications from prospect theory and motivated reasoning. We propose that if an investment decision can lead to either a gain or a loss for a company, then clawback provisions have a restraining effect on risk-taking compared to bonus-only contracts. In contrast, if the outcome of a decision affects only the potential size of a company's loss, then clawback provisions lead to additional risk-taking compared to bonus-only contracts. In addition, we argue that additional accountability in a loss position leads to a motivated reasoning process. Managers overweigh positive project success factors and underestimate risk. We further propose that this effect occurs despite a higher risk tolerance, as suggested by prospect theory. Through an experiment, we find empirical evidence that is consistent with our predictions. Our findings contribute to the debate about extending the scope of clawback provisions in management compensation contracts. We also expand the research on prospect theory by showing that motivated reasoning processes occur even when prospect theory implies a higher risk tolerance, which conceptually should negate the need for motivated reasoning.

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1. Introduction

Performance-dependent bonuses are widely used in executive compensation contracts to align the interests of managers with those of a company's shareholders (Eisenhardt, 1989; Prendergast, 1999). However, such performance-dependent compensation adds risk for managers, which managers want to be compensated for. To avoid having to pay excessive risk premiums, companies commonly limit the downside of risk for managers in compensation contracts by having managers benefit from a company's profits, but not making them share equally in any losses. This asymmetric risk-sharing between managers and companies has been criticized for leading to an agency problem by providing incentives for excessive risk-taking among managers. The literature suggests that this asymmetric risk-sharing contributed to the financial crisis of 2008 (Blinder, 2009; Schneider, 2010; Bank of England Prudential Regulation Authority, 2014). In response, both institutional investors and regulators have lobbied to extend the scope of clawback provisions in executive contracts beyond what is currently commonly required (California Public Employees' Retirement System, 2009; Basel Committee on Banking Supervision, 2010; et al., 2014Bank of England Prudential Regulation Authority, 2014). The proposed extension of clawback provisions would entail holding executives financially liable when a company incurs a loss. This increase in liability removes the asymmetry in risk-sharing and is expected to decrease the incentive for managers to engage in risky investments.

In this study, we examine the effect of clawback provisions with an extended scope on managerial risk-taking when managers make investment decisions under uncertainty. In addition, we consider the effect of clawback provisions on information processing and on the perception of the riskiness of such investments. We examine the effect of clawback provisions in two very specific environments: a

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loss position that is characterized by an investment decision affecting only the size of a loss and a mixed position, where an investment can lead to either a gain or a loss for a company. We propose that if an investment decision can lead to either a gain or a loss for a company (we refer to this as a mixed position), then clawback provisions have a restraining effect on risk-taking compared to bonus-only contracts. In contrast, if the outcome of a decision affects only the potential size of a company's loss (we refer to this as a loss position), then clawback provisions lead to additional risk-taking compared to bonus-only contracts.

We further propose that in a loss position, the additional risk-taking from clawback provisions results from a process that is explained by a combination of prospect theory and motivated reasoning. Prospect theory implies that when individuals are faced with a decision in a loss domain, the potential of a loss motivates them to be risk-seeking due to a higher risk tolerance (Kahneman and Tversky, 1979; Kühberger, 1998). However, we argue that for decisions under uncertainty, a higher risk tolerance as an explanation for higher risk-taking does not fully describe the process. We propose that the desire to avoid a loss leads to a motivated reasoning process whereby individuals weigh information in a biased manner. This biased information processing in turn reduces the perceived riskiness of a risky choice. In other words, when faced with a risky choice to avoid a loss under uncertainty, individuals weigh factors in their decision process in a way that affects the perceived risk of their choice. Prospect theory alone would not explain this effect of additional liability on information processing because a higher risk tolerance should negate the need for biased information weights.

We use an experiment to examine the joint effects of clawback provisions and the financial position on investment behaviour, information processing, and risk perception. MBA students serve as a proxy for managers. We ask them to allocate a sum of $1 million between two investment projects. The investment decision involves a choice between two versions of a product that must be developed, with one option being riskier than the other. We operationalize risk in our setting such that the riskier option has a wider distribution of cash flow outcomes, whereas the less risky investment option has a narrower distribution of outcomes.

Consistent with our goal of examining information processing, we provide outcome ranges for cash flows for investment choices, but do not provide probabilities of occurrence for each outcome. This design choice distinguishes our study from many studies on prospect theory that provide probabilities for possible outcomes (Wakker, 2010). In addition, we provide information about positive and negative trends that may affect the commercial success of the investment. We ask the participants to rate the likelihood of each trend having an impact on the commercial success of the investment. Finally, we measure the managers' perception of the risk of the investment. We manipulate two factors between participants. The factors are 1) the presence of clawback provisions and 2) the financial position of the company. When clawback provisions are present, a manager loses compensation if the company incurs a negative cash flow. Specifically, the manager must cover 25% of the company's negative cash flow. Conversely, if the company has a positive cash flow, the manager receives 25% of the company's positive cash flow as a bonus. In the absence of clawback provisions, the manager receives 25% of the company's positive cash flows, but does not need to cover any negative cash flows. The financial position of the company is manipulated at two levels. In the first state, the investment leads to either a positive or a negative cash flow for the company when the investment outcome materializes (mixed position). The riskier investment option compared to the less risky investment option leads to a larger negative cash flow if the outcome of the investment is unsuccessful and to a larger positive cash flow if the outcome is successful. In the second state, the outcome of the investment leads to negative cash flows of different sizes for the company. In other words, the outcome of the investment decision changes only the size of negative cash flows (loss position). In this state, the riskier investment decision leads to a smaller negative cash flow if it is successful and to a larger negative cash flow if it is unsuccessful.

Consistent with our predictions, we find that compared to bonus-only contracts, clawback provisions lead to less risk-taking in a mixed position, but more risk-taking in a loss position. The effect in a loss position is counterintuitive to the originally intended effect of increasing management accountability. We further observe a motivated reasoning process in the loss position when compensation contracts contain clawback provisions. Managers assess factors indicating a positive outcome of the investment more positively than in the other conditions. In addition, we find that these managers do not perceive the riskiness of their investments differently than managers whose contracts do not include clawback contracts despite a higher level of investment in the riskier option. Taken together, our findings indicate that the motivated reasoning process leads managers to rationalize away the risk that is inherent in their riskier choices.

Our findings contribute to the current debate about whether the scope of clawback provisions in compensation contracts should be extended to hold managers accountable for losses. Thus far, the accounting literature has mostly focused on the effect of clawback provisions on accounting quality (Chan et al., 2012; Chen et al., 2013; Dehaan et al., 2013; Iskandar-Datta and Jia, 2013) and compensation design preferences (Brink and Rankin 2013). We expand this body of literature by examining the effect of clawback provisions on investment decisions. Although our results support the intended positive effect of an extended scope of clawback provisions in the mixed position, we also show an unintended consequence of such an extension that has not yet been considered and that occurs when decisions are made in a loss position. Our findings show that clawback provisions lead to a shift in risk-taking. In particular, the increase in risk-taking in a loss position resulting from clawback provisions is noteworthy because companies are less likely to withstand the unsuccessful outcomes of risky investments in such a state. This has potentially far-reaching consequences when such risk-taking occurs during recessions.

In addition, our findings expand the literature on decision-making under uncertainty, prospect theory, and motivated reasoning. We show that clawback provisions in a loss position lead to a motivated reasoning process when outcome probabilities of a decision are unknown. Our study extends research on prospect theory by showing that a higher risk tolerance does not preclude motivated reasoning. This finding shows that it is important to consider subjective probabilities, which individuals assign to outcomes for decisions under uncertainty, when making inferences about decision-making based on implications of prospect theory.

The remainder of the paper proceeds as follows. In part 2, we review previous proposals for changes in executive compensation and develop our hypotheses. In part 3, we provide information on our instrument and the data collection process. In part 4, we present our results, and part 5 concludes with a discussion of our findings.

2. Hypothesis development

2.1. Institutional background

Including clawback provisions in compensation contrasts first became popular in the US. Clawback provisions were introduced in compensation-setting practices on a large scale by the Sarbanes Oxley Act of 2002 (SOX). Section 304 of SOX provides an option for reimbursement to a company of "any bonus or other incentive-

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