

The Effects of Executive Compensation and Auditor Industry Specialization on Financial Reporting Executives' Decision-Making during a Potential Restatement That Will Lead to a "Clawback"

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ABSTRACT

In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the Securities and Exchange Commission is required to propose and adopt clawback rules. After a financial statement restatement, a clawback is utilized to recover incentive compensation that was previously paid out to a manager based on the misstatement. My study investigates financial reporting executives' (FREs') decision-making after the external auditors have proposed a restatement that will lead to a clawback. I performed a web-based experiment that was electronically distributed to sixty FRE participants (i.e., CFOs, controllers, and treasurers) and manipulated executive compensation structure (i.e., a higher percentage of total compensation based on incentives or a lower percentage of total compensation based on incentives) and auditor industry specialization (i.e., industry-specialist or non-industry specialist) in a clawback environment.

I hypothesized that higher incentives or the presence of a non-specialist auditor would cause FREs to be less likely to agree with an auditor's proposed restatement, more likely to involve the external auditor's national office, and more likely to request termination of the external auditors. Further, I posited that the two factors would interact for each of the three dependent variables. As predicted, my results reveal that FREs are less likely to agree with the restatement due to loss aversion when a higher proportion of their pay is incentive-based; however, auditor specialization does act to mitigate the influence of loss aversion by increasing

their likelihood to accept the restatement. Additionally, I find that FREs are highly likely to request the involvement of the national office and very unlikely to request termination of the auditors across all conditions.

In consideration of the upcoming clawback rules, this is a timely study that makes important contributions. First, I find an unintended negative consequence of clawback regulation, as my results indicate that clawbacks may exacerbate aggressive financial reporting decisions by FREs during a restatement negotiation. Further, I find that specialist auditors can act as effective monitors of FREs' behaviors in a clawback environment. Last, my results provide evidence for firms regarding the influence of executive compensation structures on FREs' decision-making in a clawback setting.

DEDICATION

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CHAPTER ONE

INTRODUCTION

This study investigates the impact of executive compensation structure and auditor industry specialization on financial reporting executives' (FREs') decision-making during a potential earnings restatement that will lead to a "clawback" of their incentive compensation. A clawback policy is used to recover incentive compensation that was erroneously paid out to a manager as a result of previously misstated financial statements. I use prospect theory to predict and find that FREs will be loss averse in the presence of a clawback policy when the executive compensation structure is more heavily incentive-laden (Kahneman and Tversky 1979). Yet, I show that when audited by an industry specialist, FREs will have a reduced aversion to loss and thus inclined to make less aggressive decisions. In the past decade, regulators have attempted to make management increasingly accountable for the integrity of financial statements by passing legislation that includes new corporate governance mechanisms. Clawbacks were originally passed in the Sarbanes-Oxley Act of 2002 (SOX) and then were further developed and expanded in 2010 in the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereafter "the Dodd-Frank Act"). Section 954 of the Dodd-Frank Act (see Appendix A) requires the Securities and Exchange Commission (SEC) to develop clawback regulations and mandates that all publicly-listed firms must disclose and implement a clawback policy. The plan to propose and adopt rules is currently a pending action according to the SEC's Dodd-Frank Act implementation timeline (SEC 2012). Thus, this study makes a timely and important contribution regarding the impact that two factors, compensation design and auditor industry specialization, have on FREs' behavior in a setting where a clawback policy is present.

When effectively designed, executive compensation structures align the interests of managers with the interests of shareholders (Jensen and Meckling 1976). Therefore, it is important for academics and regulators to understand how economic settings may cause a manager's interests to diverge from those of shareholders. Clawbacks are designed to deter inappropriate behavior, as the Dodd-Frank Act requires that a manager loses up to three years' worth of incentive-based compensation when it was erroneously paid out due to an intentional earnings misstatement or an accounting error. In this study, FREs are asked to make judgments regarding a restatement recommendation made by the external auditors, one which will result in a clawback. Prospect theory predicts that FREs' aversion to losing their incentive compensation will motivate them to avoid the restatement (Kahneman 2003). Paying back incentive compensation would increase the collective utility of the firm and its shareholders yet is contrary to the interests of the manager (Kirchler and Maciejovsky 2001). Thus, a FRE's compensation structure may lead to an increase in riskier, more aggressive reporting decisions (i.e., attempting to avoid a restatement) when the FRE faces a clawback. As a result, an unintended negative consequence of clawback legislation may be more aggressive FRE behavior in this setting.

As loss aversion has been widely studied in the literature with robust results, research in psychology and accounting now examines contextual factors that alter its effects (Sawers et al. 2011; Moreno et al. 2002; Fagley and Miller 1987; Wang 1996). In the accounting literature, research finds managers' loss aversion in capital budgeting decisions is reduced by risk-bearing in stock option compensation and reversed by affective reactions (Sawers et al. 2011; Moreno et al. 2002). During the restatement process, FREs need to consider various other decision-relevant factors beyond the potential loss of their incentive compensation. FREs may be motivated by the risk of reputational loss, job loss, or litigation. I minimize these potential concerns by using a

proposed error restatement caused by a lower-level manager at a subsidiary, which research finds significantly reduces these risks (Hennes et al. 2008). Another key factor that they will consider is the expertise of the audit team, as FREs and the audit team are key negotiating parties during a financial reporting dispute, such as a restatement process (Chung and McCracken 2012; Gibbins et al. 2007). Thus, the relationship that exists between a FRE and the audit team may impact the FRE's judgment and decision making. For example, McCracken et al. (2008) finds when a CFO utilizes an auditor as an "expert advisor,"¹ the CFO relies on that auditor to ensure high quality financial statements. Research shows that industry-specialist auditors are more knowledgeable and provide higher audit and financial reporting quality (Reichelt and Wang 2010; Moroney and Simnett 2009). Therefore, I posit that an industry-specialist auditor will reduce the effects of loss aversion on FRE behavior, as FREs will be less likely to challenge their "expert advisors."

I perform an experiment in a clawback setting with a 2x2 between-subjects design. The two manipulated variables are executive compensation structure (a higher percentage of total compensation based on incentives or a lower percentage of total compensation based on incentives) and auditor industry specialization (industry-specialist or non-industry specialist). I recruited 60 financial reporting executives from publicly-traded companies (i.e., CFOs, controllers, and treasurers) to complete the study. The participants are asked to make judgments as a CFO regarding a proposed error restatement identified by their external auditors. I use an error restatement as it is the most common cause for a restatement (Hennes et al. 2008). The participants are provided with details about their new compensation contract, which includes a clawback policy. The hypothetical scenario also requires professional judgment from the FRE participants, as the accounting error is due to an ambiguous accounting standard. I hold

¹ McCracken et al. (2008) use the term "expert advisor" to describe an external auditor who upholds best accounting practices, challenges CFOs when they want to be aggressive with GAAP interpretations, endorses early adoption of new GAAP, and is utilized by CFOs to provide high quality financials.

ambiguity constant by limiting the availability of strict, authoritative guidance because the presence of specific guidance constrains accounting choice (Ng and Tan 2003).

As the requirement that all publicly-listed firms implement clawback policies approaches, understanding the impact that compensation structure and a key contextual factor, auditor industry specialization, have on the effectiveness of clawback policies increases in importance. Clawbacks were introduced in SOX with the goal of limiting future restatements and improving corporate governance. The findings in this dissertation extend recent literature that shows restatements decrease in a clawback environment (deHaan et al. 2013; Chan et al. 2012), yet I find that the reduction may be caused by reasons that are contrary to the intentions of the legislation. I show that FRE decision-making during the restatement process becomes more aggressive when they have higher incentives, as they are less likely to agree with the auditor's restatement recommendation. However, the presence of a specialist auditor mitigates aggressive FRE decision-making by reducing their loss aversion in a clawback setting. This finding extends the auditor industry specialization literature by showing that specialist auditors can act as effective monitors during a potential restatement in a clawback environment, as they ameliorate the FREs' aggressive behavior. Further, my study contributes to the limited stream of research on clawbacks, including the findings of Hodge and Winn (2012). They find that conservative executives may become angry after losing incentive compensation to a clawback as compared to a holdback, which then leads to an increase in risky behavior *ex post*.² I extend their findings by studying FRE behavior *during* a potential restatement in a clawback environment.

² The authors also study "holdback" clauses, which are an alternative method of recouping incentives. With a holdback, incentives are deferred for a period of time with the goal of simplifying future recoupment. Conversely, clawbacks maintain the current practice of distributing incentives when they are earned and then subsequently recovering them from an employee after a restatement. Although some firms have adopted holdbacks, 87% of Fortune 100 firms interpreted Section 954 as requiring a "clawback" (Equilar 2012a). Therefore, this study will focus on clawbacks.

The remainder of this dissertation proceeds as follows. Background, theory, and hypotheses are provided in Chapter Two. The research methodology for the experiment is provided in Chapter Three. Chapter Four provides details on the data analysis, including the descriptive statistics, tests of hypotheses, and supplemental analysis. Finally, a discussion of the contributions, limitations, and implications for future research are provided in Chapter Five.

CHAPTER TWO

BACKGROUND, THEORY, AND HYPOTHESES

2.1 Literature Review

The first section of this chapter reviews background information regarding the purpose and development of clawback provisions at publicly-traded companies, as well as the limited research on clawbacks in the accounting literature. I discuss how clawbacks relate to the literature on earnings restatements, reputational losses, executive compensation, and corporate governance. The second half of this chapter is devoted to hypothesis development and the integration of the accounting and psychology literatures.

2.1.1 Clawback Provisions

The initial clawback provision was established in Section 304 of SOX. Section 304 requires that the SEC recoup any incentive compensation paid to chief executive officers (CEOs) and CFOs within the 12 months following the misstated financial statements resulting from the misconduct of any employee at their firm. Luis Aguilar (2010), SEC Commissioner, recently noted the purpose of Section 304:

Congress put the clawback in Sarbanes-Oxley to enhance the responsibility of CEOs and CFOs for financial reporting. When CEOs and CFOs fear their bonuses and other incentive-based compensation will be paid back to the company, they are incentivized to be diligent in establishing an honest culture of reporting...

Thus, clawbacks are designed to deter managers from engaging in unscrupulous financial reporting.

Prior to the introduction of clawback provisions, an executive's erroneously earned incentive compensation was not recouped after a restatement. Yet, the negative market reaction after an earnings restatement directly impacts shareholders, as their investment in the firm

decreases with a declining stock price (Hennes et al. 2008; Palmrose et al. 2004). As only the shareholders are negatively impacted, an inequity exists between them and the executives (Fehr and Schmidt 1999). Some have taken advantage of this asymmetry. For example, executives have profited from fraudulently misstated financials through increased insider trading (Summers and Sweeney 1998). Executives are also significantly more likely to misreport financial statements when their option portfolios are sensitive to the firm's stock price (Fried and Shilon 2011; Burns and Kedia 2006). Due to the inequity, the popular press and shareholders concluded that executives should have to pay back incentives that they did not legitimately earn (Morgenson 2008). As a result, clawback provisions were designed to eliminate the inequity by reclaiming "unearned" incentive compensation from executives.

Despite public pressure, the implementation of clawback policies by public companies after SOX was a slow process. Also, the SEC did not actively enforce Section 304 for five years after the enactment of the law, except for cases where the executive had already been convicted of criminal fraud (Aguilar 2010; Markham 2007). Due to the rarity of cases, SEC Commissioner Aguilar (2010) commented that the SEC had ignored a congressional mandate required in SOX. However, as the SEC finalizes regulations from the Dodd-Frank Act, it has become increasingly aggressive in utilizing Section 304 in SOX. In 2011, the SEC settled clawback suits with three executives who were not charged with criminal wrongdoing in relation to frauds perpetrated at their respective companies. Maynard L. Jenkins, CEO of CSK Auto Corporation, and James O'Leary, CFO of Beazer Homes USA, Inc., repaid \$2.8 million and \$1.4 million, respectively, in bonus compensation and stock profits (McGrath 2011; Carton 2011). Ian McCarthy, CEO of Beazer Homes USA Inc., repaid a total of \$6.5 million in bonuses, equity-based compensation (i.e., 76,000 restricted shares), and stock sale profits for the 12 months after the 2006 fraudulent

financial statements were filed (Gallu 2011). The SEC found four employees, including the former controller, at CSK and the senior vice president and chief accounting officer at Beazer responsible for the frauds. Yet, the SEC still pursued the three executives with the Section 304 clawback provision.

Clawback policies have also become increasingly common at firms, according to a survey of Fortune 100 companies by Equilar, an executive compensation data firm. In 2006, only 18% of firms had clawback policies, whereas in 2012 approximately 87% had such policies (Equilar 2012a). These firms have implemented and disclosed clawback policies without the benefit of specific guidelines that may be included in the finalized regulation from the SEC. As a result, Equilar's 2012 survey finds a wide range of clawback policies that have been adopted (see an example clawback policy in Appendix B for Starbucks Corporation). For example, firms may have clawback policies that cover one or more key types of incentive pay such as cash incentives, equity incentives, outstanding options, vested options, and/or restricted stock. Most common is for both cash and equity to be covered, which is the case in 80% of policies. Clawback triggers can also differ greatly by firm, as they may include a mix of ethical misconduct, restatements, or non-compete violations. Despite the recent actions in 2011 by the SEC indicating that executive misconduct is not required to trigger a clawback, only 10.4% of firms with clawback policies have rules to reflect such a position (Equilar 2012a). In this study, the CFO is not the one directly responsible for the potential restatement in the experiment, as it results from actions of a lower-level manager at a subsidiary.

The Dodd-Frank Act also does not specifically define what employees will be targeted under the new rules, which is a change from the SOX provision that only applies to CEOs and CFOs. Section 954 indicates that "executive officers" will be subject to the new clawback

legislation (Dodd-Frank Act 2010), which is a broader category of employees than specified by SOX. For example, the SEC previously defined “executive officer” in Rule 3b-7 of the Securities Exchange Act of 1934 as a president, vice president, or other person at a registrant that is in charge of a principal business unit, division, or policy making function (e.g., administration or finance) (SEC 1934). However, the SEC has not yet indicated how they will define the term in the new clawback rules.³ Due to the existing ambiguity, voluntary adopters have utilized varying approaches to interpreting the terminology. Overwhelmingly, the firms collectively agree that the upcoming clawback rules will cover a greater breadth of employees, as only 6.3% of current clawback policies cover only CEOs and CFOs. In practice, clawback policies may cover all or selected executives, non-employee directors, or employees who receive incentive compensation. The majority of policies, 67.4%, cover key executives in the disclosure, which is a broad category of senior management employees that includes CFOs, controllers and treasurers (Equilar 2012a). Thus, I utilize these three types of financial reporting executive participants in this dissertation, as it is reasonable to expect that they will be in the target subject pool when the clawback rules are finalized.

Last, there is a common feature that ultimately weakens many of the currently adopted clawback policies. In a 2010 study of Fortune 500 firms, 81% of firms with clawback policies provide discretion to the board of directors as to whether or not to use the policy even when the board determines misconduct has occurred. Giving boards such discretion is problematic because board members’ interests may conflict with the directive to recoup excess pay from current and former executives. For example, directors may consider litigation costs, the potential loss of a personal and business relationship with the executive, and concerns about personal reputation

³ The SEC may also draw from the clawback rule included in the Emergency Economic Stabilization Act of 2008. The clawback rule therein covered the top 25 most highly paid employees from any firm that received assistance from the U.S. government under the Troubled Asset Relief Program (TARP).

should they be labeled as disloyal. The disincentive to recoup pay is great; therefore, boards rarely use a clawback to reclaim incentives (Fried and Shilon 2011). The new provision under the Dodd-Frank Act does not allow for this type of discretion; consequently this study provides insight into FRE behavior when they are aware that a clawback is mandated without discretionary leeway.

As the passage of the Dodd-Frank Act is a recent event, there is a paucity of accounting literature investigating the effects of clawback provisions. Extant archival research examines determinants and outcome implications for firms that have voluntarily adopted clawbacks. Specifically, deHaan et al. (2013) and Chan et al. (2012) find firms that voluntarily adopted a clawback policy experienced a decrease in restatements and an increase in the perceived quality of the financial statements. I extend this research by examining whether the reduction in restatements may be partially driven by managers avoiding restatements due to an aversion to losing their incentive compensation. As potential restatements are not disclosed, data does not exist that would allow my research question to be investigated through archival techniques. Thus, by using experimental techniques, I can examine FRE decision-making when a restatement is proposed in a clawback setting.

To my knowledge, the only experimental study of clawback policies examines executive decision-making after the enforcement of an earnings restatement (Hodge and Winn 2012). The authors perform an experiment using a clawback or holdback policy that covers the executive's bonus if a restatement occurs. In general, the authors find that the executives become more risk averse after enforcement of the restatement (i.e., become more conservative with revenue recognition decisions). Yet, previously conservative executives may become angry after having their compensation clawed back, as compared to having the compensation recovered by a

holdback. Their anger leads them to make riskier *future* financial reporting decisions. My study extends this research by investigating the impact a clawback has on FRE judgment *during* a potential restatement. To date, the extant research has only investigated the effects of voluntarily implementing clawback policies after adoption and after a restatement. No study has examined how a FRE behaves when presented with a potential restatement that will cause a loss of previously earned incentives. Therefore, my study makes an important contribution to the academic literature and to regulators.

2.1.2 Earnings Restatements and Reputational Losses

Clawback policies are intended to reduce future restatements, strengthen corporate accountability of executives, and improve corporate governance. Carcello et al. (2011) and Cohen et al. (2004) provide thorough reviews of the extensive research on corporate governance and both note that past studies find associations between weak governance and financial reporting.⁴ Specifically, earnings restatements are indicators of low quality corporate governance and, as such, restatements can signal weak governance to the marketplace (Agrawal and Chadha 2005; Myers et al. 2004). In recent years, regulators have been focused on improving corporate governance. They have made strides in holding management increasingly accountable for the integrity of financial statements and for the improvement of corporate governance.⁵ Clawbacks are one of the latest attempts by regulators to enhance corporate governance and therefore decrease future restatements. However, FREs may now be incentivized to avoid correcting misstatements in previous financial statements, which would negatively impact corporate governance.

⁴ Weak corporate governance is associated with low financial reporting quality, earnings manipulation, financial statement fraud, and weak internal controls (Dhaliwal et al. 2010; Zhao and Chen 2008; Krishnan 2005; Beasley et al. 2000; Beasley 1996; Dechow et al. 1996).

⁵ Section 302 of SOX requires public company CEOs and CFOs to certify the financial statements for the appropriateness and fair presentation of the company's operations and financial condition.

FREs may be motivated to avoid a restatement due to the risk of significant losses, including loss of credibility and reputation. Using data from 1997 to 1998, Desai et al. (2006) find that a majority (60%) of firms remove at least one manager within 24 months after a restatement. Also, the subsequent employment prospects of the displaced managers are worse when compared to managers terminated for reasons other than restatements. Yet, utilizing more recent data from 2002–2005, Hennes et al. (2008) find that there has been a decreasing rate of overall turnover for CEOs and CFOs, which is attributable to the recent increase in restatements due to *errors*. In the 13 months surrounding a restatement, the authors find that a CFO is more likely to be terminated after a restatement due to an intentional misstatement (64%) as compared to an error (12%) and even less likely to be terminated when the error is isolated at a subsidiary (9.1%). They find that restatement announcements due to fraud have a more severe market reaction (-13.64%) as compared to non-fraud restatements (-1.93%). Lastly, they find only one firm with a contemporaneous class action lawsuit resulting from an error restatement, as compared to 80% of firms that had restatements due to intentional misstatements. These results suggest that error restatements have less reputational effects as compared to restatements due to fraud. To minimize the effects of reputational losses for FREs in this study, I attribute the potential restatement to an accounting error caused by a lower-level manager at a subsidiary. This approach was used to help isolate experimental effects to the target factors of interest.

2.1.3 Executive Compensation and Corporate Governance

Executive compensation at publicly-listed firms has consistently been a focus of corporate governance reformers since the 1930s (Markham 2007). Extant research finds that executive compensation can be used as an effective means of reducing the agency costs between managers and shareholders when compensation is directly linked to shareholder wealth (Jensen

and Meckling 1976). For example, stock options used as executive compensation can motivate a manager to make riskier investments that will increase the value of the firm and minimize a manager's tendency for risk aversion (Efendi et al. 2007; Morgan and Poulsen 2001; Smith and Stulz 1985). Conversely, Efendi et al. (2007) find that as agency costs increase due to overvalued equity, managers will take aggressive actions to maintain the overvalued stock price. In general, Watts and Zimmerman (1979) find that managers have incentives to utilize accounting standards to present financials in ways that support their best interests, even at the risk of negatively impacting shareholders. It is therefore important for regulators, academics, and firms to understand economic settings where the interests of executives and shareholders are not aligned, thereby potentially leading to a negative impact on corporate governance.

In recent years, regulators have taken steps to improve corporate governance by implementing regulations related to executive compensation.⁶ In 2006, the SEC mandated new disclosures for executive compensation which required that firms describe how CFO compensation is determined and how performance measurements underlie compensation decisions. The disclosure was intended to make CFO compensation more transparent, to reign in excessive compensation practices, and to deter a CFO from manipulating the financials. A recent study finds evidence supporting the intended goal of the disclosure, as CFO equity incentives are positively associated with accruals management and the likelihood of beating analyst forecasts (Jiang et al. 2010). Further, the authors find that CFO compensation has more effect on aggressive accounting practices, as these earnings management techniques are more associated with CFO equity incentives than with those of the CEO. Although the majority of compensation

⁶ One example is Section 951 of the Dodd-Frank Act which includes a provision for say-on-pay. Say-on-pay is designed to add a new layer of monitoring and oversight by requiring a shareholder vote on executive compensation at least every three years.

research has heretofore analyzed CEO compensation,⁷ the results indicate the importance of studying the influence of CFO compensation on management's decision-making. This dissertation examines FRE behavior in an experiment where they are asked to act as a CFO.

2.2 Hypothesis Development

The hypothesis development section extends the literature review to develop and present formal hypotheses. The section advances the hypotheses based on a review of the literature on prospect theory and auditor industry specialization. First, I begin by discussing my initial set of hypotheses regarding the effect of executive compensation structure on judgments made by FREs when faced with a clawback during the restatement process. Next, I provide the second set of hypotheses based on the impact of auditor industry specialization on FRE decision-making. Finally, I consider a set of predicted interactions where auditor industry specialization mitigates the influence of loss aversion on FRE judgments.

2.2.1 Executive Compensation and Clawback Policies

FRE compensation commonly includes a base salary plus one or more incentives, such as option awards, stock awards, and bonuses. If FRE compensation is closely aligned with earnings, a priori, clawback policies should play a significant role in their decision-making. In a 2010 study of S&P 500 firms, the mix of CFO compensation was found to be moving more towards stock-based awards and bonuses, as these compensation methods increased to 37.3% of the total compensation mix in 2010 (Equilar 2011). When a clawback is triggered, CFOs may potentially experience the loss of a significant percentage of their overall compensation, depending on the design of their compensation structure. Thus, when facing the loss of incentives, a CFO or other

⁷ Higher CEO compensation has been found in the literature to be associated with weaker corporate governance, restatements, misreporting, and less independent boards (Chhaochharia and Grinstein 2009; Cheng and Farber 2008; Burns and Kedia 2006; Core et al. 1999).

financial reporting executive may consider making riskier, more aggressive reporting decisions (i.e., attempting to avoid a restatement) based on loss aversion.

Loss aversion is a key concept in prospect theory, as it predicts that an individual's utility increases and decreases from gains and losses in wealth (Kahneman 2003; Kahneman and Tversky 1979). Further, an individual responds to definite losses much more aggressively than gains, as the individual weighs the gains and losses based on a reference point. Prospect theory has been studied extensively in the academic literature finding robust results for loss aversion. For example, Cohen and Trompeter (1998) find that auditors will make riskier decisions to avoid the loss of a current client in the interest of maintaining the status quo. In other words, auditors attempt to avoid a loss that drops them below their reference point, which is current asset position. Additionally, the economics literature uses prospect theory to predict and understand behavior related to tax evasion (Kirchler and Maciejovsky 2001; Dhimi and al-Nowaihi 2007). Kirchler and Maciejovsky (2001) find that tax compliance is lower when an entrepreneur has an expected tax payment and when a self-employed individual has an unexpected surprise payment. Business entrepreneurs use expected asset position as their reference point, and self-employed individuals use their current asset position. Both took the riskier, more aggressive position of evading taxes when faced with an additional tax payment. Recent research finds loss aversion to be more complex, as key contextual factors may alter or remove its effects. Later in this dissertation, I will discuss the impact that a key contextual factor, auditor industry specialization, has on FREs' loss aversion.

In this study, I predict FREs will use a reference point of the status quo, as they are asked to make judgments while considering the loss of currently held compensation. Prospect theory indicates that the FREs are expected to display risk-seeking behaviors when faced with a certain

loss. Further, the FREs will be considering a proposed restatement due to an error, one that offers no recourse to strict, authoritative guidance. Extant accounting and psychology research find that ambiguity and uncertainty may cause more aggressive judgments. The research also shows that incentives tend to influence how someone responds to ambiguity (Nelson and Kinney 1997; Hackenbrack and Nelson 1996; Einhorn and Hogarth 1985). As such, the imprecise guidance in this study will create latitude for FREs to exercise their professional judgment. Therefore, I predict that FREs with higher incentives will have greater loss aversion and will use the discretion afforded by the ambiguity of the accounting standards to act more aggressively when faced with a clawback. In other words, FREs will be less likely to accept a restatement recommendation when they have more to lose.

In addition, FREs who are less likely to accept a proposed restatement will be more likely to take additional actions to bolster their position. FREs who are attempting to avoid a restatement may seek additional input on the proposed restatement. Specifically, they may request the consultation of the auditor's national office technical group (McCracken et al. 2008). An audit firm's national office technical group is tasked with assisting engagement partners when difficult judgments are required for the financial statements of their clients. For example, the national office technical group will help resolve disagreements on accounting issues that include choices in the accounting standards (Salterio and Denham 1997). In addition, FREs may also take the more aggressive action of recommending to the audit committee that the audit firm should be replaced. During the years 1997—2006, Hennes et al. (2010) find that firms dismiss approximately one out of every four Big 4 auditor during the twelve months before or after restatements due to errors. Therefore, FREs may determine that an audit firm can no longer provide sufficient service and subsequently request the resignation of the auditor (Chung and

McCracken 2012). I predict that the likelihood of these two actions will be greater for loss averse FREs when they are facing a potential restatement that will lead to a clawback. I posit the following:

H1a: When FREs' compensation consists of a higher percentage of incentives, they will be less likely to accept an auditor's restatement recommendation that will lead to a clawback.

H1b: When FREs' compensation consists of a higher percentage of incentives, they will be more likely to request the involvement of the external auditor's national office technical group when the auditor recommends a restatement that will lead to a clawback.

H1c: When FREs' compensation consists of a higher percentage of incentives, they will be more likely to recommend that the audit committee considers replacing the external auditors when the auditor recommends a restatement that will lead to a clawback.

2.2.2 Auditor Industry Specialization

In addition to being motivated by a potential loss of incentive compensation, a FRE may well be influenced by other contextual factors during the decision-making process. In a study that examines 20 actual restatements, Chung and McCracken (2012) find that the process of determining if there will be a restatement can be contentious at large firms, contention that can lead to negotiations between the auditor and client. They find that CFOs may be embarrassed; they may claim it is immaterial; or they may blame the audit team for being inexperienced and poorly trained. Therefore, it is no surprise that the psychology and accounting literature finds that the process and outcome of a negotiation is greatly influenced by the relationship between the negotiators (i.e., auditor and FRE) (McCracken et al. 2008; Iyer and Rama 2004; Pruitt and Carnevale 1993). Further, Gibbins et al. (2007) find in a survey of FREs, that the audit firm's

expertise and its relationship with, and the competence of, its audit partner were all significantly important contextual factors in negotiations over financial reporting disagreements. To provide insight into the influence of auditor expertise on FRE decision-making during the restatement process, I manipulate auditor industry specialization. Extant research finds that industry-specialist auditors are more knowledgeable and perform better than non-specialists in their industry of specialty (Moroney and Simnett 2009).

The Big 4 firms have structured their audit practices to provide more efficient and higher-quality audits by training and developing industry-specialist auditors (Solomon et al. 1999). From the beginning of their careers, staff auditors are placed into specific industry segments. They receive training and gain experience with clients belonging to one accounting environment. This exposure thus allows the auditors to develop industry-specific knowledge as well as the general domain knowledge that all auditors possess (Bonner and Lewis 1990). For example, Moroney and Simnett (2009) find that auditors acquire more specialized knowledge as the complexity of an industry increases. Specifically, industry specialists in complex environments perform better in the identification of business risks, in their use of information sources, and in their gathering of evidence during an audit. Further, the experimental research finds evidence that industry-specialist auditors evaluate pattern cues for identification of misstatements more effectively, assess audit risk more accurately, detect mechanical and conceptual errors more effectively, and have greater confidence when making inherent risk assessments (Hammersley 2006; Low 2004; Owosho et al. 2002; Taylor 2000). Additionally, extant archival research finds that when auditors are industry specialists at both the national and office level, they provide higher audit quality (Reichelt and Wang 2010). Knechel et al. (2007) find that the market prices the increase in audit quality, with positive abnormal returns, when a client switches to an

industry-specialist auditor. On the whole, the research indicates that an industry-specialist auditor makes for a more competent and expert auditor.

Companies acknowledge the benefits of a specialist, as 67% of Fortune 1000 companies surveyed believe that industry specialization or expertise is a very important factor in choosing an auditor (GAO 2008). Yet, not all companies are able to or are interested in contracting the services of a specialist auditor. I am interested in examining the potential impact that specialists may have on FRE behavior during the restatement process, as they may be influenced by the relative power dynamics that exist between them and the auditor. For example, Iyer and Rama (2004) find that management believes that they are able to persuade an auditor to agree with their position when the auditor has a shorter tenure with the client and also when retention is important to the auditor. To control for potential tenure effects, I use a moderately long audit firm tenure of six years in the experimental instrument. Further, in a study of actual CFO–auditor dyads, McCracken et al. (2008) find that CFOs determine the relationship existing between the parties. Two main relationships tend to exist between the parties: proactive and reactive interactions. CFOs in a proactive relationship rely on the auditors as “expert advisors” to ensure high quality financials. CFOs in a reactive relationship take ownership of the financials, actively question the auditor’s proposed adjustments, and challenge the validity of the auditor’s positions. Therefore, if an auditor is perceived as lacking expertise, the FRE may believe they hold a stronger power position in negotiation; this perceived asymmetry may in turn lead them to disagree with a recommended restatement.

After a misstatement is initially discovered, the process typically involves the auditor and FRE taking positions prior to getting additional parties involved (Chung and McCracken 2012). Therefore, the auditor’s expertise is an important contextual factor that FREs will likely consider

when taking their initial position. Further, in my experimental setting, there is ambiguity present in the proposed error restatement as relevant strict, authoritative guidance is not available. The ambiguity literature finds that auditors are more willing to side with the client in a situation of high ambiguity (Hackenbrack and Nelson 1996). Therefore, I predict that a FRE who does not rely on the auditors as an “expert advisor” will be more likely to utilize the ambiguity to resist the auditor’s proposed restatement.

Further, the restatement process may eventually involve the interactions of multiple parties, such as the CEO, external auditors, the audit committee, consultants, and regulators (Chung and McCracken 2012). A FRE with a non-industry specialist will be more likely to include the additional parties when the parties may support their position and therefore challenge the audit team’s position. For example, FREs may pursue a consultation with the auditor’s national office technical group. This request may be perceived as a direct challenge to the audit team’s expertise and could subsequently undermine the ability of the audit team to negotiate with management (McCracken et al. 2008). In addition, FREs may request that the audit committee should consider removing the current audit firm, as the proposed restatement may provide a visible indication that the auditor may not be able to appropriately monitor the financial reporting process now and going forward (Hennes et al. 2010). Thus, when there is a non-industry specialist, I predict that loss averse FREs will be more likely to challenge the expertise of the audit team by pursuing the involvement of the auditor’s national office technical group and by recommending the replacement of the auditor to the audit committee. I posit the following:

H2a: When the auditor is a non-industry specialist, FREs will be less likely to accept an auditor’s restatement recommendation that will lead to a clawback.

H2b: When the auditor is a non-industry specialist, FREs will be more likely to request the involvement of the external auditor's national office technical group when the auditor recommends a restatement that will lead to a clawback.

H2c: When the auditor is a non-industry specialist, FREs will be more likely to recommend that the audit committee considers replacing the external auditors when the auditor recommends a restatement that will lead to a clawback.

2.2.3 Executive Compensation Structure and Auditor Industry Specialization

As the psychology and accounting literatures have generally found robust results for the effects of loss aversion, other studies have extended those findings by investigating contextual factors that reduce or remove the predicted effects of prospect theory (Sawers et al. 2011; Moreno et al. 2002; Fagley and Miller 1987; Wang 1996). Moreno et al. (2002) find that managers who are making capital budgeting decisions are influenced by affective reactions, such that they become risk-averse in loss contexts instead of risk-taking. Sawers et al. (2011) find that risk-bearing in stock option compensation reduces the effects of loss aversion, as options move from at-the-money to in-the-money. In further extension of this research, I examine whether auditor industry specialization, an important contextual factor during financial reporting negotiations, reduces the effects of loss aversion on FRE behavior during the restatement process.

Prospect theory suggests that FREs, in general, will be averse to a loss of compensation based on a reference point of the status quo. The theory predicts that an individual will become even more loss averse as the magnitude of the loss gets farther from the reference point (Kahneman and Tversky 1979). Therefore, FREs that face a clawback of a higher percentage of incentives in their compensation mix will likely be more averse to the loss as compared to FREs

with a lower mix of incentives in their compensation. Yet, FREs who believe their specialist auditor possesses more expertise and power in the relationship will be less aggressive. In other words, a FRE will be more likely to accept a specialist auditor's recommendation regardless of higher or lower incentives. As discussed earlier, FREs with higher incentives are expected to act more aggressively, in general, by using the flexibility afforded to them in an ambiguous accounting situation. Yet, their behavior will be influenced less by their loss aversion when they are audited by an industry specialist. Taken together, when incentive compensation becomes a greater percentage of the compensation design and when there is a non-industry specialist auditor, FREs should become even less likely to agree with a proposed earnings restatement (see Figure 1 for the expected relationship). Further, FREs will be even more likely to undertake additional actions that will support their position of avoiding a restatement (see Figure 2 for the expected relationship). Thus, I posit the following interactions between executive compensation structure and auditor industry specialization:

H3a: Auditor industry specialization will mitigate the influence of loss aversion on FREs' decision-making since specialization should increase the likelihood that FREs will accept an auditor's restatement recommendation that will lead to a clawback (i.e., auditor industry specialization and executive compensation structure will interact).

H3b: Auditor industry specialization will mitigate the influence of loss aversion on FREs' decision-making since specialization should decrease the likelihood that FREs will request the involvement of the external auditor's national office technical group when the auditor recommends a restatement that will lead to a clawback (i.e., auditor industry specialization and executive compensation structure will interact).

H3c: Auditor industry specialization will mitigate the influence of loss aversion on FREs' decision-making since specialization should decrease the likelihood that FREs will recommend that the audit committee considers replacing the external auditors when the auditor recommends a restatement that will lead to a clawback (i.e., auditor industry specialization and executive compensation structure will interact).

CHAPTER THREE

RESEARCH METHODOLOGY

The research methodology chapter documents the approach used to test the hypotheses in this study. In the first section, I present the research design and the operationalization of the independent variables. Second, I describe the measures used for the dependent variables. Next, I detail the participants that were recruited for this study. Finally, I discuss the experimental instrument and the post-experiment questionnaire.

3.1 Research Design and Independent Variables

I test my hypotheses utilizing a 2x2 experimental design where the executive compensation structure (a higher percentage of total compensation based on incentives or a lower percentage of total compensation based on incentives) and auditor industry specialization (industry-specialist or non-industry specialist) are manipulated between-subjects. All participants make judgments with a clawback policy in their compensation contract, which will follow the framework provided in the Dodd-Frank Act. The policy covers accounting irregularities and accounting errors, and it does not require executive wrongdoing to trigger the clawback. The accounting scenario includes a proposed restatement of the previous year's financial statements from 2010, which would trigger the clawback policy. Executive compensation is manipulated through a higher or lower percentage mix of incentive compensation, while the total compensation is held constant. Participants are provided with the dollar amount of incentive compensation paid out in 2010 and their potential earnings in 2011. Auditor industry specialization is manipulated by indicating the extent of the audit team's (i.e., audit partner and senior managers) experience and training in the company's industry.

Plumlee and Yohn (2010) find during 2003–2006 that 37% of misstatements occurred

due to either a lack of clarity in an accounting standard or a judgment-related decision regarding an accounting standard. Therefore, I hold ambiguity constant by limiting the availability of precise authoritative guidance. The external auditors propose an impairment loss based on ASC 36-10 *Property, Plant, and Equipment Overall* (formerly FASB Statement No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*). The standard allows for multiple methods, including the traditional and probability-weighted approaches, to calculate the undiscounted cash flows during the recoverability test. Thus, estimating undiscounted cash flows is both an estimate that requires judgment and also one that lacks precise guidance regarding a specific method to use. The case materials indicate that the method used by management in 2010 found that no impairment loss was necessary, whereas the auditor's estimate calculated in 2011 will indicate otherwise.

Therefore, decision-making in an ambiguous environment is relevant for this study, such that the FREs need to rely on professional judgment to determine whether to restate the financial statements. When deciding the appropriate accounting treatment, an accountant utilizes the authoritative guidance provided by the various standard setters and regulatory bodies.

Accounting choices or treatment options become less limited when the authoritative guidance lacks precision. For example, Kennedy et al. (1997) find that when an auditor is determining the most appropriate accounting treatment, the auditor has a stronger justification for selecting an accounting treatment in situations with multiple options when the authoritative guidance is more precise. Alternatively, when the guidance is imprecise, the auditor justifies the more aggressive accounting treatment as allowed by the ambiguity (Hackenbrack and Nelson 1996).

Accounting restatements can occur for various reasons including internal company errors. However, extant research on earnings restatements has generally viewed restatements as the

result of aggressive, intentional managerial misreporting. During the years 2002–2005, 24% of restatements were due to intentional misstatements and 76% of restatements were due to errors (Hennes et al. 2008). I use a proposed restatement due to an error, as errors are the most common cause of a restatement. The accounting error is not due to a previous decision made by the CFO; instead the case materials indicate that it resulted from actions taken by a lower-level manager at a subsidiary. This approach is used to reduce the potential for participant concerns over future criminal charges or job loss after an earnings restatement. Lastly, audit committee quality is held constant at a moderate level. During a restatement process, the audit committee generally becomes involved after initial negotiations between the auditors and FRE (Chung and McCracken 2012). Therefore, I indicate that the audit committee is objective and it does not consistently take the side of either management or the auditors during audit committee meetings. This controls for any directional effects that the audit committee may have on the FREs' judgments.

3.2 Dependent Variables

Chung and McCracken (2012) find that when the auditors discover a potential restatement, the audit partners and senior managers present their documentation for the misstatement, including its materiality, to the FRE. The FRE then takes a position on the misstatement and reports it to the auditors, CEO, and audit committee. Therefore, the FRE participants' primary task in this study is to assess the likelihood they will agree with the external auditor's recommendation to restate the previously released financial statements. The FRE's initial position is important, as it would begin the process of a potential negotiation with the auditors. In the negotiation literature, there is evidence that audit committee members expect the

auditors and management to resolve disputes before engaging the committee (Gibbins et al. 2007; Gendron and Bedard 2006). I use this dependent variable to test H1a, H2a, and H3a.

In addition, based on whether or not the FREs are willing to accept the proposed restatement, they may take additional action to avoid restating the financial statements. Therefore, I ask the FRE participants to rate their likelihood of undertaking any of the following two courses of action: 1) requesting the involvement of the external auditor's national office technical group (H1b, H2b, and H3b) or 2) recommending that the audit committee considers replacing the external auditors (H1c, H2c, and H3c). I expect that FREs will respond to these additional dependent variables based on how likely they are to accept the restatement. As FREs become more risk-taking, I predict they will seek out additional actions that reduce the likelihood of making the restatement. I ask the three dependent variable questions on separate screens, so that the participants respond to each question independently of the others. The participants make their assessments on the three dependent variable questions on a 0%–100% scale (0% = No Likelihood, 50% = Moderate Likelihood, to 100% = Absolutely Certain).

Lastly, the participants are required to explain briefly the reasons why they took their position regarding the potential restatement for the primary dependent variable and for the dependent variable referring to consultation with the national office technical group. I do not request a short response for the last dependent variable due to the potential sensitivity of asking the participants to explain their reasoning for replacing or not replacing the audit firm. To test the free responses, I code the answers by assessing the total number of justifications provided by the participants to support their respective positions for the two dependent measures. In addition, the justifications are categorized based on key themes. The author and an independent coder analyze the free responses without knowledge of the experimental conditions. Further, I assess the inter-

rater reliability with Cohen's Kappa to ensure there is a high level of non-chance agreement between the coders (Cohen 1960; Landis and Koch 1977).

3.3 Participants

Sixty experienced financial reporting executives successfully completed my study.⁸ Fifty-four of the participants were recruited by a web-based research organization, Research Now (www.researchnow.com)⁹ and six participants were obtained through personal contacts at publicly-traded companies. As reported in Panel A of Table 1, the financial executives consisted of both CFOs (51%) and controllers/treasurers (48.3%) from publicly-traded companies.¹⁰ Consistent with prior accounting research, I use CFO, controller, and treasurer participants to represent management, as they should have experience as key members of financial reporting negotiations with the external auditors (Tan and Trotman 2010; Gibbins et al. 2007). Further, Section 954 of the Dodd-Frank Act indicates that "executive officers" will be covered in the upcoming clawback rules. Based on this terminology, 93.7% of Fortune 100 firms that have voluntarily adopted clawback policies included coverage for additional key members of management beyond just the CEO and CFO (Equilar 2012a). It is therefore reasonable to anticipate that these FREs will be directly impacted by the new clawback regulation. In addition,

⁸ One hundred and twelve participants completed the study and sixty participants (53.6%) correctly responded to the manipulation check questions and are therefore included in the final sample. The success rate of the manipulation check questions are discussed further in Section 4.1.

⁹ In the recent accounting literature, web-based research organizations have been used to recruit experimental subjects (e.g., Brazel et al. 2012; Brown-Liburd et al. 2012). Research Now provides online research solutions including the recruitment and use of research panels. Research Now currently maintains an active panel of approximately 8 million participants. Panel participants are recruited by invitation-only through a controlled member verification process. For this study, Research Now recruited participants from a sub-group consisting of CFOs, controllers, and treasurers. Participants in this sub-group indicated their respective job title during Research Now's member verification process. Thus, participant job information was collected before my study was initiated.

¹⁰ With the exception of years of experience as a CFO during their careers (8.10 years vs. 2.07 years) and percentage of participants with clawbacks (52% vs. 17%), I do not find any significant differences (all $p > 0.05$) between CFO and controller/treasurer participants for the remaining demographic variables. I consider all demographic variables as potential covariates in the analysis as part of hypothesis testing.

I find that 17% of the controller and treasurer participants in this study currently have a clawback policy in their personal compensation contract. This provides evidence that firms are beginning to include controllers and treasurers in their policies based on the Dodd-Frank Act provision.

To gain an understanding of the participants' experiences with clawback policies, Panel B of Table 1 reports clawback policy characteristics for the 21 participants (35%) that have a policy in their personal compensation contract.¹¹ The three most frequently noted characteristics are the following: 1) policy covers only key executives (71.4%), 2) requires misconduct (fraud) to be triggered (52.4%), and 3) policy covers cash bonuses (42.9%). The first two characteristics indicate that some firms' policies cover additional employees in their plans beyond key executives and that approximately half of the clawback policies also include triggers that do not rely simply on fraudulent activity. These findings provide some evidence that firms have begun enacting policies that reflect the pending requirements from the Dodd-Frank Act.

Panel C of Table 1 reports the participants in this study have significant professional business experience (21.7 years), substantial experience discussing audit adjustments with the external auditors (11.1 years), and some experience professionally as external auditors (2.7 years). Further, they have 5.2 years of experience working as CFO at a publicly-traded company and 9.3 years of professional experience working in the manufacturing industry. The mean approximate annual revenues for the participants' present companies are \$5.9 billion, which is comparable to firms in the Fortune 500 (CNN 2012). Panel D of Table 1 indicates that the average compensation structure for the participants is 68% base pay and 32% incentive pay. The participants also received a wide range of incentives in the most recent fiscal year, with the following types being the most common: 1) cash bonus (70%), 2) restricted shares (47%), and 3) stock options (40%).

¹¹ Participants with clawback policies consisted of 16 CFOs and five controllers/treasurers.

Last, I inquired about the participants' professional experience with specialist auditors and the perceived importance of utilizing an auditor with greater industry expertise. Panel E of Table 1 shows that 73% judge their current audit firms to be a "specialist" audit firm and 32% have requested that their company hire a specialist audit firm during their tenure as CFO. Last, I asked the participants to rate the extent to which they believe that specialists are important for achieving high quality financial reporting ("0 = Not At All Important," "5 = Somewhat Important," "10 = Extremely Important"). The participants indicated that having a specialist auditor is quite important with an average rating of 7.8.

With the exception of professional business experience, base pay and incentive pay as a percentage of total personal compensation, and whether their present company's auditor is a specialist, there were no statistically significant differences (all p-values > 0.05) between the experimental groups for the demographic variables. As part of hypothesis testing, I consider all demographic variables as potential covariates in the analysis.

3.4 Experimental Instrument

A link to the online instrument was sent to participants via email (see the experimental instrument in Appendix C). Participants began the study by reading a welcome page informing them that they will be assuming the role of CFO at a large hypothetical public company with multiple subsidiaries in the medical manufacturing industry. They then learned that the audit committee is objective and that there have been no significant disagreements between management and the auditors during their tenure as CFO. Lastly, they were able to review key financial statement amounts from 2010 and 2011.

Within the background section, I next manipulate the two factors. The incentive compensation manipulation was provided first to the participants. They were informed that the

company had been performing well during their six years as CFO and that it was on track to meet the consensus analyst EPS forecast in the current fiscal year of 2011. These factors are held constant, as the risk of turnover is higher for CFOs at small, distressed, and poorly performing firms (Hennes et al. 2008). The participants then read information regarding their compensation for 2010, and they learned that they signed a new contract in 2011. Information provided about the new contract included potential compensation, a new clawback policy, and notice that their perquisites have not changed. The new clawback policy covered financial statements starting in 2008.

For the executive compensation manipulation, I made use of 2011 survey data from S&P 500 CFOs and Section 954 of the Dodd-Frank Act (Equilar 2011). I identified a range of percentages (i.e., between the 10th and 90th percentiles) of total CFO compensation at health care and manufacturing firms in the S&P 500 for salary, bonus, and equity. I used the ends of each range to calculate the higher and lower incentive-based pay manipulations. In addition, I included a discretionary bonus in the compensation mix based on the CFO completing their fifth year of service at the Company.¹² Overall, each participant's total compensation was \$2.5 million, an amount within the range of medians for CFOs across all industries in the S&P 500 during 2010. Both manipulations used the same mix of equity (85%) and cash bonus (15%) for total incentives. Specifically, in the higher incentive manipulation, the CFO earned \$2.0 million in incentive-based pay, which consisted of a \$300,000 bonus and \$1.7 million in equity (i.e., stock option awards and stock awards). In the lower incentive manipulation, the CFO earned \$1.0 million in incentive-based pay, which consisted of a \$150,000 bonus and \$850,000 in equity. I let the participants know that the remaining compensation consisted of salary,

¹² Although the prevalence of discretionary bonus payouts has decreased somewhat in recent years, 20.4% of S&P 500 CFOs surveyed still received discretionary bonuses during 2010 (Equilar 2011). Further, 40% of the participants in this study earned a discretionary bonus in their personal compensation in 2011.

discretionary bonus, and perquisites. Lastly, participants in both manipulations are able to earn \$2.5 million in 2011 based on salary, bonuses, and equity compensation.

Next, I manipulated auditor industry specialization. I mentioned that their Big 4 external audit firm had been auditing the company for six years but a new audit team (i.e., partner and two senior managers) was brought on after the partner was required to roll off due to the audit partner rotation rules. A moderately long audit tenure of six years controls for tenure effects, as management believes they have more leverage in persuading an audit firm with a shorter tenure (Iyer and Rama 2004). To manipulate auditor industry specialization, the participants were provided with details regarding the experience and knowledge of the partner and two senior managers. According to extant research in auditing, an auditor's expertise, ability, and knowledge are gained through relevant experiences, education, and training (Moroney and Simnett 2009; Bedard and Chi 1993; Bedard 1989). Therefore, for the specialist manipulation, I indicated to the participants that the auditors had significant experience working on clients in the manufacturing industry throughout their careers, had attended industry-specific training in manufacturing during their careers, and had extensive experience leading engagements of large, public clients in the company's industry. For the non-specialist manipulation, the auditors were noted as having substantial experience as auditors and as having audited and led multiple audits of large public companies. Yet, the auditors were described as having some experience on clients in the manufacturing industry early in their careers, as having just attended their first industry-specific training in manufacturing to prepare for the audit, and as having had no experience leading engagements of large, public clients in the medical manufacturing industry.

The participants were then told that their external auditors have recommended a restatement of the previously issued 2010 financial statements. The restatement recommendation

was based on an estimate error for an impairment loss that was identified by the audit team in the 2010 financial statements. SFAS No. 154 requires material errors to be restated if identified in prior financial statements. Similar to the experimental methods used by Ng and Tan (2003), the error amount was quantitatively immaterial (less than 5% of pretax income), yet according to SEC Staff Accounting Bulletin No. 99 (SEC 1999) it was qualitatively material (EPS will fall below analyst forecast). Because the error amount causes EPS to fall below analyst forecast, the CFO had earned incentive-based compensation erroneously and will have to pay it back.

Ambiguity was held constant by informing participants that there is no precise guidance in the accounting standards for determining the best method of estimating the undiscounted cash flows during the recoverability test. The participants learned that the auditor's estimate of the undiscounted cash flows, which led to the proposed impairment loss, may be more conceptually sound than the one arrived at by management. This ensures that they are aware that the method being proposed by the auditor is more appropriate regardless of ambiguity. Yet, due to the lack of precise authoritative guidance and the fact that the error does not meet quantitative materiality thresholds, the participants had a basis for using professional judgment. Therefore, participants in this study had the latitude to accept the auditor's proposed restatement or not. Next, the participants were asked the dependent variable questions and the brief free-response questions. Manipulation check questions are used to verify participants' understanding of the incentive compensation, auditor industry specialization, and clawback policy.¹³

3.5 Post-Experiment Questionnaire

I obtained further insights and demographic information from the participants in a post-experiment questionnaire. I asked about the participants' most recent annual compensation

¹³ To ensure that the case materials, clawback policy, and proposed restatement were realistic, I developed the case with five audit partners from Big 4 firms, a corporate attorney with experience in writing and developing clawback policies for public companies, and a CFO at a Fortune 400 company.

consisting of base pay and incentives, the types of incentives that they received, and whether their current organizations have a clawback policy in place and if so, the various elements of the policy. I inquired whether the participants had gone through a restatement in their professional careers, as the process and consequences of the restatement will be salient. In addition, I inquired whether they have a specialist auditor, have any previous experiences with specialists, and have ever requested hiring a specialist at their companies.

Drawing on the concept of social projection, I also asked the participants to respond to a question regarding how they believe peer CFOs would respond to the same case study. A social projection question may be useful in this study due to the potential sensitivity of asking participants to indicate their likelihood to agree with an auditor regarding a restatement recommendation. Social projection theory indicates that an individual may project their own repressed unconscious or conscious beliefs on a hypothetical peer when prompted to reply to the same stimuli (Newman et al. 1997). By asking the social projection question, I attempt to remove any self-presentation bias by ascertaining whether the participants did or did not accurately indicate their true beliefs when initially responding.

Additionally, I asked if they felt responsible for the proposed restatement, one triggered by a lower-level manager. I next asked if they are likely to request the termination of the lower-level manager. Hodge and Winn (2012) find that conservative executives feel less responsible after enforcement of a clawback or holdback. Further, Cohen et al. (2007) find that the perception of fairness was a strong predictor of behavior when managers make aggressive accounting decisions to maximize earnings-based bonuses. I assessed whether concern for the shareholders and reputational losses was a consideration in their restatement judgments. I asked the participants to rate how knowledgeable they believed the auditors were in the case, as all

partners and senior managers should possess significant general domain knowledge (Bonner and Lewis 1990). I also asked their likelihood to involve other additional parties (i.e., CEO, audit committee, board of directors, or the company lawyer) in the restatement decision-making process, as these parties may be consulted to assist in resolving a proposed restatement (Chung and McCracken 2012). Lastly, I requested additional information from the participants including job title, total years of professional work experience, years as a CFO at a publicly-traded company, years in the manufacturing industry, total years of experience working with external auditors on audit adjustments, years of auditing experience (if any), and their company's approximate annual revenues.

CHAPTER FOUR

DATA ANALYSIS

4.1 Manipulation Checks

One hundred and twelve participants completed the study.¹⁴ However, only sixty participants correctly responded to the manipulation check questions.¹⁵ Participants were asked three manipulation check questions to ensure that they correctly identified the clawback policy and the two independent variables (see Figure 3 for a flow diagram of how the final sample was determined based on the manipulation checks). First, I asked the participants the following “Yes/No” question: “Was any of your incentive-based compensation subject to the company’s clawback policy?” Ninety-eight participants (87.5%) answered this question correctly. Next, I asked participants to recall the exact dollar amounts of their base pay and incentive pay from the experiment. Sixty-two participants (63.3%) provided the correct compensation amounts from their respective experimental group.¹⁶ Last, I asked the participants to rate the extent to which they believed the auditors were specialized in the company’s industry in the case (“0 = Not At All,” “5 = Somewhat,” and “10 = Highly Specialized”). Sixty participants (96.8%) correctly responded to the specialization manipulation check¹⁷ and are therefore included in the final

¹⁴ An additional twenty-seven participants started but did not successfully complete the study and are therefore not included in the sample.

¹⁵ The overall success rate for participants correctly answering the manipulation check questions of 53.6% is comparable to prior research that utilizes electronic survey methods (e.g., Brown-Liburd et al. 2012).

¹⁶ Thirty-six participants were excluded from the final sample, as they did not correctly recall their compensation amounts. Specifically, thirteen participants reversed their base pay and incentive pay amounts. Twenty-one participants recalled base pay and incentive pay amounts that both differed by greater than 25% of the manipulated amounts. Last, two participants recalled one of the compensation amounts correctly, yet their second amount recalled was more than 25% different. Further, I did not perform a sensitivity analysis with these participants due to the large discrepancies in their responses.

¹⁷ Two participants in the specialist auditor group answered “0 = Not At All” indicating that the specialist auditor was not specialized at all. Therefore, I removed the two participants from the sample, as they did not appropriately encode the manipulation. Inclusion of the participants does not qualitatively alter the interpretation of the results.

sample. As reported in Table 2, participants in the specialist auditor group viewed their auditors as significantly more specialized than participants in the non-specialist group (7.0 compared to 5.2; $F = 13.833$; $p = 0.000$). Further, I did not find a significant difference (all $p > 0.10$) between groups regarding their perceptions of how knowledgeable the audit team was in the case. In combination, these findings provide evidence that general audit domain knowledge was held constant between groups, yet the specialist group was incrementally more specialized in the medical manufacturing industry (Bonner and Lewis 1990).

4.2 Preliminary Analysis

I planned to utilize analysis of variance (ANOVA) models to test my hypotheses regarding the effects of executive compensation and auditor industry specialization on each of the dependent variables. My preliminary analysis tests whether the data meets the three basic assumptions of an ANOVA model – independent observations, normal distribution of the dependent variables, and homogeneity of variance (Keppel 1991, p. 97).

The first assumption, independent observations, was addressed in the experimental design by randomly assigning the participants to the experimental conditions. Next, I visually investigated the second assumption, normal distribution of the dependent variables, with boxplots and normal probability plots of the data. The visual investigation raised concerns regarding the normality of the data for each of the three dependent variables. Therefore, I next utilized the Shapiro-Wilk test, a statistical analysis of normality. I obtained 12 Shapiro-Wilk test statistics based on the three dependent variables and four experimental groups. The test indicated that 8 of the 12 groups fail to meet the second assumption. The four groups that did not violate the assumption were from the main dependent variable (i.e., likelihood to agree with the auditor's proposed restatement). Although ANOVA is robust to modest violations of this

assumption (Ferguson 1981, p. 245), the number of violations for the two secondary dependent variables (i.e., likelihood to request the involvement of the external auditor's national office technical group and likelihood to recommend that the audit committee considers replacing the external auditors) led me to supplement my analysis of these dependent variables with the Mann-Whitney two-sample rank-sum test. The Mann-Whitney is a nonparametric test that makes no assumptions regarding the distribution of the data (Mann and Whitney 1947; Wilcoxon 1945). Finally, I considered the third assumption, homogeneity of variance, by using Levene's statistic for the three dependent variables. I find evidence of equal variance (all $p > 0.10$) in the data and therefore the data do not violate the third assumption.

4.3 Hypotheses 1a, 2a, and 3a

H1a and H2a predict that FREs will be less likely to agree with a proposed restatement when they have higher incentives and when there is a non-specialist auditor, respectively. H3a predicts that auditor industry specialization will mitigate the influence of loss aversion on FREs' decision-making since specialization should increase their likelihood to agree. To test H1a, H2a, and H3a, I examine participants' responses to the primary dependent measure, the likelihood to agree with the proposed restatement.¹⁸ Panel A of Table 3 provides descriptive statistics for the likelihood to agree assessments and Panel B provides results from an analysis of covariance with awarded stock options¹⁹ and years of auditing experience as covariates.^{20,21} Consistent with H1a,

¹⁸ There was not a significant difference (all $p > 0.10$) between CFO participants and controller/treasurer participants for the main dependent variable.

¹⁹ Awarded stock options was assessed as a binary variable (0 = No or 1 = Yes) as to whether the participants were compensated with stock options in the most recent year.

²⁰ I find that awarded stock options and years of auditing experience are significant covariates ($p < 0.05$) in the testing of H1a, H2a, and H3a. Thus, I include these two covariates in the testing of my hypotheses. The remaining variables were found to be not significant covariates (all $p > 0.05$) in untabulated results and are therefore not included in the analysis.

²¹ In addition to the three basic ANOVA assumptions, ANCOVA requires that two additional assumptions are not violated: 1) linearity assumption (i.e., linear relationship exists between the dependent variable

I find a significant main effect for compensation structure ($F = 9.415$, $p = 0.002$, one-tailed), which indicates that FREs are less likely to agree with the proposed restatement when they have higher incentive compensation. Thus, the FREs are more loss averse resulting in more aggressive behavior. I do not find significant results for H2a ($F = 1.206$, $p = 0.139$, one-tailed), which indicates that there is no difference in the FREs' likelihood to agree with the proposed restatement when there is a specialist auditor as compared to a non-specialist auditor. Last, the results confirm the predicted interaction of compensation structure and auditor industry specialization in H3a ($F = 4.127$, $p = 0.024$, one-tailed).

I use planned contrasts with awarded stock options and years of auditing experience as covariates to test the nature of the interaction in H3a (see Figure 4). I utilize 1, -3, 1, 1 contrast coding to test the H3a prediction, where the -3 code represents the participants' likelihood to agree assessment in the higher incentives-non-specialist auditor condition. Consistent with H3a, the overall contrast test is significant ($F = 12.598$, $p < 0.001$, one-tailed – untabulated).²² In addition, as reported in Panel C of Table 3, I find that FREs' likelihood assessments are greater in the specialist auditor condition (35.00%) as compared to the non-specialist auditor condition (19.95%) when there are higher incentives ($F = 4.892$, $p = 0.016$, one-tailed). When there is a non-specialist, FREs' likelihood assessments are greater when there are lower incentives (44.63%) as compared to higher incentives (19.95%) ($F = 13.178$, $p = 0.001$, one-tailed). Further, I find no significant differences for FREs' likelihood assessments in the specialist auditor condition when there are higher incentives (35.00%) as compared to the lower incentives

and covariates) and 2) homogeneity of slopes assumption (i.e., interactive relationships between the covariates and independent variables do not exist). I find evidence that both the assumption of linearity (all $p < .05$) and the assumption of homogeneity of slopes (all $p > .10$) are not violated. Thus, it is appropriate to proceed with the ANCOVA analysis.

²² In addition, I performed a residual between-subject variance test and find that the remaining unexplained between-groups residual explains a non-significant part of the variance ($p > .10$).

(40.12%) ($F = 0.554$, $p = 0.230$, one-tailed). Last, there are no differences for FREs' likelihood assessments in the lower incentives condition when there is a specialist (40.12%) as compared to a non-specialist (44.63%) ($F = 0.441$, $p = 0.255$, one-tailed). Taken as a whole, the significant interaction effect and the contrast results indicate that the key contextual factor of auditor industry specialization effectively mitigates the impact of loss aversion on FRE decision-making, consistent with H3a.

4.3.1 Free Response Analysis

In addition to hypothesis testing for the main dependent variable, I examine the participants' answers to several free response questions. The participants were asked to briefly explain the reasons why they took their respective position regarding the proposed restatement. I code the responses based on the number of justifications that they provided to support their position. To count the number of justifications, I read through the responses for key themes and established categories based on whether the FREs' justifications agreed or disagreed with the proposed restatement. An independent coder reviewed the responses, reached consensus with the author on the categories, and separately counted the number of justifications. The coders agreed with each other on 90.0% of the agreeing justifications (Kappa coefficient = 0.81) and 95.0% of the disagreeing justifications (Kappa coefficient = 0.85). The Kappa coefficients indicate substantial agreement between the two coders (both significant at $p = 0.000$) (Cohen 1960; Landis and Koch 1977). All differences were resolved by mutual agreement between the coders.

Panel A of Table 4 shows the justifications provided by the FREs that disagreed with the proposed restatement. The most common responses included the following: 1) methodology is subjective (both methods are acceptable within GAAP) (51.7% of participants) (e.g., "since both methods are acceptable under GAAP, it is not clear that the proposed new method is superior")

and “both methods of valuation are relatively subjective and either one being acceptable”), 2) offered no reasons to disagree with the proposed restatement (23.3%), 3) issue needs further analysis (16.7%) (e.g., “this would need further discussion to understand the auditor's calculations” and “I would look further into other companies in the industry to see what valuation methods were used at their companies”) 4) proposed impairment is a current year issue (15.0%) (e.g., “I would take adjustment in current year as necessary” and “current year impairment, current year conditions”), and 5) analysis was done in good faith with best professional judgment (15.0%) (e.g., “estimate was made in good faith, using best known information at the time of prior earnings release” and “our approach was not aggressive or done for the purpose of manipulating numbers”). Based on the most commonly provided justification for not restating, the accounting scenario appeared to be sufficiently ambiguous based on the subjective accounting standard.

Panel B of Table 4 shows the justifications provided by the FREs that agreed with the restatement. The most common responses included the following: 1) offered no reasons to agree with the proposed restatement (83.3% of participants), 2) agree with the audit team’s recommendation (11.7%) (e.g., “agree with the impairment analysis” and “any adverse effect from their new numbers is a fair and impartial (however unfortunate) result”), 3) likely to agree but issue needs to be reviewed by an additional party (5.0%) (e.g., “more discussion and review with the audit committee would be required” and “still would like it verified with specialist auditing area”), and 4) restating is the most conservative approach (5.0%) (e.g., “it is a more conservative approach” and “try to be conservative, aligned with external auditor view”).

To test the FREs’ free responses for the number of justifications disagreeing with the proposed restatement (see Panel A of Table 5 for descriptive statistics), I perform analysis of

covariance with awarded stock options, years of auditing experience, and impact of a restatement on shareholders as covariates.²³ Based on the theory utilized to develop the first set of hypotheses in this dissertation, I expect that FREs will provide more justifications against restating as they become less likely to restate. As reported in Panel B of Table 5, I find a marginally significant main effect for compensation structure ($F = 3.888$, $p = 0.054$, two-tailed), as FREs documented more justifications for not restating when they had a higher percentage of incentives. This finding is directionally consistent with the results for H1a, as FREs attempt to avoid a restatement with higher incentives. I do not find significant results ($F = 1.167$, $p = 0.285$, two-tailed) for the number of disagreeing justifications based on the specialization of the auditor. The results show a marginally significant interaction of compensation structure and auditor industry specialization ($F = 3.602$, $p = 0.063$, two-tailed).

I use planned contrasts with awarded stock options, years of auditing experience, and impact of a restatement on shareholders as covariates (see Panel C of Table 5) with 1, -3, 1, 1 contrast coding to further test the interaction (see Figure 5). The -3 code represents the participants' number of disagreeing justifications in the higher incentives-non-specialist auditor condition. The overall contrast test is directionally consistent with hypothesis testing, but is not significant at conventional levels ($F = 2.291$, $p = 0.136$, two-tailed – untabulated). Further, I do not find any significant differences for the number of disagreeing justifications in the specialist auditor condition (1.43) as compared to the non-specialist auditor condition (1.61) when there are higher incentives ($F = 0.270$, $p = 0.606$, two-tailed). When there is a non-specialist, the number of FRE justifications is greater when there are higher incentives (1.61) as compared to

²³ The variables awarded stock options, years of auditing experience, and impact of a restatement on shareholders are significant covariates ($p < 0.05$) and are therefore included in the analysis. The remaining variables were found to be not significant covariates (all $p > 0.05$) in untabulated results and are therefore not included in the analysis.

lower incentives (0.69) ($F = 7.564$, $p = 0.008$, two-tailed). I find no significant differences in the specialist auditor condition when there are higher incentives (1.43) as compared to the lower incentives (1.39) ($F = 0.013$, $p = 0.911$, two-tailed). Last, FREs offer significantly more disagreeing justifications in the lower incentives condition when there is a specialist (1.39) as compared to a non-specialist (0.69) ($F = 4.380$, $p = 0.041$, two-tailed).

Next, I perform an analysis of covariance on the number of supporting justifications for restating the financials (see descriptive statistics in Panel A of Table 6) with awarded stock options as a covariate (see Panel B of Table 6 for analysis).²⁴ I find a significant main effect for compensation structure ($F = 6.287$, $p = 0.015$, two-tailed), as FREs provided more justifications for restating when they had a lower percentage of incentives. This result indicates that a FRE may be more willing to justify a proposed restatement when they have less to lose. Additionally, I find a significant main effect for auditor industry specialization ($F = 4.403$, $p = 0.040$, two-tailed), where FREs offer more justifications in support of a restatement when there is a non-specialist auditor. This finding may indicate that a FRE believes greater justification is necessary to support a restatement when the auditor lacks expertise in the industry. Last, I find a marginally significant interaction of compensation structure and auditor industry specialization ($F = 3.105$, $p = 0.084$, two-tailed) (see Figure 6).

To further test the interaction (see Figure 5), I use planned contrasts with awarded stock options as a covariate (see Panel C of Table 6) with 1, 1, 1, -3 contrast coding. The -3 code represents the participants' number of agreeing justifications in the lower incentives-non-specialist auditor condition. The overall contrast test is significant ($F = 13.952$, $p = 0.000$, two-

²⁴ The variable awarded stock options is a significant covariate ($p < 0.05$) and is therefore included in the analysis. The remaining variables were found to be not significant covariates (all $p > 0.05$) in untabulated results and are therefore not included in the analysis.

tailed – untabulated).²⁵ In addition, there are no significant differences for the number of agreeing justifications in the specialist auditor condition (0.05) as compared to the non-specialist auditor condition (0.09) when there are higher incentives ($F = 0.054$, $p = 0.817$, two-tailed). When there is a non-specialist, the number of FRE justifications is greater when there are lower incentives (0.61) as compared to higher incentives (0.09) ($F = 9.315$, $p = 0.003$, two-tailed). I find no significant differences in the specialist auditor condition when there are higher incentives (0.05) as compared to the lower incentives (0.15) ($F = 0.279$, $p = 0.600$, two-tailed). Last, FREs offer significantly more agreeing justifications in the lower incentives condition when there is a non-specialist (0.61) as compared to a specialist (0.15) ($F = 7.415$, $p = 0.009$, two-tailed).

4.4 Hypotheses 1b, 2b, and 3b

I predict that FREs will be more likely to request the involvement of the external auditor's national office technical group when they have higher incentives (H1b) and when there is a non-specialist auditor (H2b). Further, H3b predicts that auditor industry specialization will mitigate the influence of loss aversion on FREs' decision-making since specialization should decrease their likelihood to request the involvement of the national office. To test H1b, H2b, and H3b, I examine the FREs' likelihood to request involvement of the auditor's national office technical group during the restatement process (see Table 7 for results and Figure 7 for observed effects).²⁶ Using analysis of variance, I do not find significant results for H1b ($F = 1.609$, $p = 0.210$, two-tailed). This indicates that there is no difference in the FREs' likelihood to request involvement of the national office technical team when they have higher incentives as compared to lower incentives. I do not find significant results for H2b ($F = 0.177$, $p = 0.676$,

²⁵ Utilizing a residual between-subject variance test, I find that the remaining unexplained between-groups residual explains a non-significant part of the variance ($p > .10$).

²⁶ There was not a significant difference (all $p > 0.10$) between CFO participants and controller/treasurer participants for the national office dependent variable.

two-tailed), which indicates that there is no difference in the FREs' likelihood to request involvement of the national office technical team when there is a specialist auditor as compared to a non-specialist auditor. Last, I do not find significant results for the predicted interaction in H3b ($F = 0.004$, $p = 0.948$, two-tailed).^{27, 28}

Overall, the results indicate that FREs are very likely to request the involvement of the national office technical team (72.83%). In a survey of FREs, Gibbins et al. (2005) find that the national office technical group was involved in 50% of the participants' negotiation examples of auditor-client disagreements. Yet, when the resolution of a disagreement or complex issue is based on an accounting standard that requires choices to be made, the national office technical group will generally be relied upon to assist in the negotiation (Salterio and Denham 1997). The restatement decision in this study was based on an ambiguous standard, which may have led the FREs to prefer the involvement of the auditor's national office across all groups. Further, in a post-SOX environment, it is reasonable to expect that firm-wide consultations with the national office are more commonplace especially during an ambiguous restatement process.

4.4.1 Free Response Analysis

Next, I examine the participants' answers to the free response question related to requesting the involvement of the national office technical group. The participants were asked to briefly explain the reasons for why they took their respective position regarding consultation with the technical team. I read through the responses for key themes and established categories

²⁷ As the normality assumption was violated for this dependent measure, I supplemented my analysis with the non-parametric Mann-Whitney U Test. The non-parametric tests provide similar results as the ANOVAs for H1b ($U = 374$, $p = 0.250$, two-tailed -untabulated) and for H2b ($U = 427$, $p = 0.733$, two-tailed -untabulated).

²⁸ The variables responsibility for lower manager's misstatement, likelihood to request audit committee involvement, and likelihood to request board of director's involvement are significant covariates ($p < 0.05$). The inclusion of these variables does not qualitatively impact the interpretation of the results and are therefore not included in the analysis. The remaining variables were found to be not significant covariates (all $p > 0.05$) in untabulated results and are therefore not included in the analysis.

based on whether the FREs' justifications supported or did not support consulting with the national office. The participants' free responses are coded based on the number of justifications that they provided. An independent coder also examined the free responses, reached consensus with the author on the categories, and counted the number of justifications. The two coders agreed with each other on 93% of the participants for the number of supporting justifications (Kappa coefficient = 0.87) and 98% of the participants for the number of justifications that disagreed with the national office consultation (Kappa coefficient = 0.95). The Kappa coefficients indicate substantial agreement between the two coders (both significant at $p = 0.000$) (Cohen 1960; Landis and Koch 1977). All differences were resolved by mutual agreement between the coders.

Panel A of Table 8 provides results for the FREs that provided reasons why the national office should be contacted. The most common responses provided included the following: 1) proposed restatement is a subjective issue that requires further analysis (28.3% of participants) (e.g., "provide another opinion and opportunity to gain consensus on subjective approaches" and "I want a thorough justification of a subjective event"), 2) offered no reasons to request the national office (28.3%), 3) need their greater technical expertise and industry knowledge (18.3%) (e.g., "this is a technical matter so the national office's perspective would be helpful" and "I think it would be relevant to have industry experts that can speak to what they have seen industry wide"), and 4) restatements are significant decisions with great implications and costs (15.0%) (e.g., "before we make a restatement of that magnitude I want to be sure" and "I would like a third opinion as this will have a significant impact on our results as well as a large impact due to the costs involved"). The most commonly provided justification for contacting the national office

confirms that I created an accounting scenario that was ambiguous based on a subjective accounting standard.

Panel B of Table 8 provides results for the FREs that offered justifications where they disagree with involving the national office. The most common reasons included the following: 1) offered no reasons to not request the national office (78.3% of participants), 2) national office's opinion will not differ from the local audit team (5.0%) (e.g., "consulting with the national office technical group is far more likely to result in consensus with the regional office" and "the national group would always take the position of the local office for write-offs") and 3) will discuss the proposed restatement further with local audit team first (5.0%) (e.g., "since the situation does not show any discussion with the current auditors, that would be the first place to start before the situation is elevated" and "would work with the auditors before calling them in").

To test the free responses, I perform analysis of variance on the number of FRE justifications in support of requesting the involvement of the national office and the number of FRE explanations against requesting its involvement. As reported in Table 9, I do not find any significant differences (all $p > 0.10$) between groups for the number of supporting justifications. Thus, FREs do not provide a different number of supporting justifications based on the incentive compensation or the specialization of the auditor (see Figure 8 for observed effects). Likewise, I do not find any significant differences (all $p > 0.10$) between groups for the number of justifications provided by FREs in opposition to involving the national office (see Table 9 for results and Figure 9 for observed effects). These findings are consistent with the hypothesis testing for the national office dependent measure, as FREs did not differ in their likelihood assessments or written responses regarding an intervention by the national office.

4.5 Hypotheses 1c, 2c, and 3c

To test H1c, H2c, and H3c, I examine the results for my last dependent variable, which considers the FREs' likelihood to recommend that the audit committee considers replacing the external auditors (see Table 11 for results and Figure 10 for observed effects).²⁹ H1c and H2c predict that FREs will be more likely to recommend that the auditors be replaced when they have higher incentives and when there is a non-specialist auditor, respectively. H3c predicts that auditor industry specialization will mitigate the influence of loss aversion on FREs' decision-making since specialization should decrease their likelihood to request the termination of the auditors. Using analysis of variance, I do not find significant results for H1c ($F = 0.101$, $p = 0.752$, two-tailed), which indicates there is no difference in the FREs' likelihood to request replacing the external auditors when there are higher incentives as compared to lower incentives. I do not find significant results for H2c ($F = 0.048$, $p = 0.827$, two-tailed), which indicates that there is no difference in the FREs' likelihood to request replacing the external auditors when there is a specialist auditor as compared to a non-specialist auditor. Last, I do not find significant results for the predicted interaction in H3c ($F = 0.109$, $p = 0.742$, two-tailed).^{30, 31}

These findings indicate that FREs are unlikely to request that the audit committee should consider replacing the auditors (27.83%). Hennes et al. (2010) note that switching costs incurred by dismissing an auditor may outweigh the potential benefits of an increase in reporting

²⁹ There was not a significant difference (all $p > 0.10$) between CFO participants and controller/treasurer participants for the likelihood to replace the external auditors dependent variable.

³⁰ Due to the violation of the normality assumption for this dependent measure, I complement the analysis with the Mann-Whitney U Test, which also fails to find significant results for H1c ($U = 436$, $p = 0.834$, two-tailed -untabulated) and H2c ($U = 445$, $p = 0.952$, two-tailed -untabulated).

³¹ The variables peers likelihood to agree with proposed restatement and likelihood to request termination of lower level manager are significant covariates ($p < 0.05$). The inclusion of these variables does not qualitatively impact the interpretation of the results and are therefore not included in the analysis. The remaining variables were found to be not significant covariates (all $p > 0.05$) in untabulated results and are therefore not included in the analysis.

credibility that would come from replacing the auditors. This concern may have led FREs to be less likely to consider taking the aggressive action of initiating a request to terminate the auditors during a restatement process.

4.6 Supplemental Analysis

4.6.1 Post-Experiment Questionnaire Responses

In addition to hypothesis testing, I perform supplemental analyses to further examine the results by investigating the responses from the post-experiment questionnaire (see Table 12 for full results). First, I asked the participants to rate the extent to which they believed a peer CFO would be likely to agree with the proposed restatement (“0% = No Likelihood,” “50% = Moderate Likelihood,” and “100% = Absolutely Certain”). The question was developed based on the concept of social projection, which attempts to mitigate self-presentation bias (Newman et al. 1997). I find that the results of the question are not consistent with the pattern of the main dependent measure, as there are no statistical differences between groups (all $p > 0.10$). Further, a t-test indicates that participants believed their peers (40.5%) would be marginally more likely to agree with the restatement as compared to themselves (35.0%) ($t = -1.946$, $p = 0.056$ two-tailed). Social projection questions may be useful when a participant believes a question is too sensitive and therefore will not present their true intentions when prompted (Newman et al. 1997). Yet, I interestingly find that the FREs indicated they would be less likely to agree with the proposed restatement as compared to their expectations for a hypothetical peer. As a result, I conclude the participants’ responses were not influenced by self-presentation bias. Similarly, Hodge and Winn (2012) find that their executive participants did not become more conservative with revenue recognition decisions after adopting a holdback or clawback; however, the executives expected peer executives to make more conservative revenue recognition decisions.

Next, I inquired about the participants' likelihood to involve additional parties in the decision-making process ("0% = No Likelihood," "50% = Moderate Likelihood," and "100% = Absolutely Certain"). I find that FREs are marginally more likely to request the involvement of the CEO when there is a non-specialist auditor (91.0%) as compared to a specialist auditor (79.3%) ($F = 3.525$, $p = 0.066$ two-tailed), which may indicate that FREs are looking for the support of the CEO to contest the restatement when there is a non-specialist. I do not find any significant differences (all $p > 0.10$) between groups for the FRE participants' likelihood to involve the audit committee, the board of directors, and the company attorney. Overall, FREs were 82.83% likely to involve the audit committee, 66.83% likely to engage the board of directors, and 82.13% likely to contact the attorney.

FREs responded to questions regarding the impact the restatement would have on their personal reputation and also on the shareholders ("−5 = Very Negatively," "0 = No Impact," and "10 = Very Positively"). I find that FREs believe the impact of a restatement will have a marginally more negative effect on their personal reputation when they have higher incentives (−1.77) as compared to lower incentives (−0.60) ($F = 3.799$, $p = 0.056$ two-tailed). This finding may indicate that FREs believe their reputation will be more negatively impacted after they pay back a greater percentage of incentive compensation that was earned off of erroneously stated financials. In other words, FREs may believe outside parties will be more likely to suspect they aggressively reported the financial statements when they had a higher incentive payout. I find that FREs believe the impact on the shareholders will be marginally more negative when they have higher incentives (−2.30) as compared to lower incentives (−1.27) ($F = 3.919$, $p = 0.053$ two-tailed) and significantly more negative when there is a non-specialist auditor (−2.45) as compared to a specialist (−1.07) ($F = 6.747$, $p = 0.012$ two-tailed). These findings indicate that FREs

believe the market will react more negatively after they have a greater amount of incentive compensation clawed back and also because the current auditors may be unable to appropriately monitor the firms' financial reporting (Hennes et al. 2010).

Participants were next asked to rate the extent to which they would feel responsible for a restatement caused by a lower-level manager ("0 = Not Responsible," "5 = Somewhat Responsible," and "10 = Very Responsible") and also their likelihood to terminate the lower-level manager in the case ("0% = No Likelihood," "50% = Moderate Likelihood," and "100% = Absolutely Certain"). I do not find any significant differences (all $p > 0.10$) between groups for their extent of responsibility and their likelihood to request termination of the lower-level manager. Overall, the participants believed *they* would feel responsible (6.98) for the restatement and they were unlikely to terminate the manager (28.67%).

Finally, I inquired about the participants' experience with restatements during their professional careers. As reported in Panel C of Table 1, 21 participants (35%) had experienced a restatement. The participants experienced the restatements in a wide range of positions, including CFO (8.3%), controller/treasurer (16.7%), accounting manager (5.0%), vice president of finance (3.3), and audit manager (3.3%). The circumstances surrounding the participants' experiences also varied widely, including having no prominent role in resolving the restatement, being involved in discussions during the process with various parties (i.e., the SEC, external auditors, audit committee, other executives, and legal counsel), and taking oversight responsibility for the restatement process. Participants also described processes that did and did not result in a restatement and examples that ended with a current year adjustment instead. Consistent with this study, Chung and McCracken (2012) find that their interviewees experienced a similar variety of

restatement processes, including interactions with internal and external parties and the nature of the process outcomes.

CHAPTER FIVE

DISCUSSION, CONTRIBUTIONS, AND LIMITATIONS

5.1 Discussion and Contributions

This dissertation examines FREs' judgments and decision-making when the external auditors propose a restatement that will lead to a clawback. Clawback policies are utilized to recoup incentive compensation that an executive erroneously earned based on previously misstated financial statements. Clawbacks were first introduced in SOX and subsequently restructured in the Dodd-Frank Act in an attempt to improve corporate governance through an increased focus on executive compensation and earnings restatements. Since the passage of the Dodd-Frank Act, clawback policies have become increasingly common at publicly-traded firms as the firms prepare for the SEC to finalize and mandate clawback rules in the near future (Equilar 2012a; SEC 2012). To date, the extant research has studied the implications for firms that voluntarily adopt a clawback policy and executives' behaviors after a clawback has been triggered. To my knowledge, this is the first study that investigates executives' behaviors *during* a restatement process. Thus, my study is a timely one that provides important insights to regulators, public companies, and academics regarding FREs' behaviors in a clawback environment.

I perform an experiment in which FREs considered a proposed restatement by the external auditors that would trigger a clawback and therefore a loss of previously earned incentive compensation. I find that FREs are more averse to paying back previously earned incentives when their incentive-based pay makes up a higher percentage of their total compensation as compared to a lower percentage. Further, FREs' behaviors are influenced by the specialization of the external auditor when they have a higher percentage of incentives, whereas

specialization does not affect behaviors when incentive compensation represents a smaller percentage of total compensation. Specifically, when a specialist auditor proposes the restatement as opposed to a non-specialist auditor, FREs' loss aversion is mitigated and they are less likely to disagree with the restatement. As a result, FREs exhibit the most aggressive financial reporting behavior when there is a non-specialist auditor and their compensation consists of a higher percentage of incentives.

The study's findings are informative to regulators, as the results provide evidence of an unintended negative consequence of passing clawback regulation. Luis Aguilar (2010), SEC Commissioner, indicated that clawback provisions should create a financial reporting culture of enhanced honesty and integrity leading to fewer future restatements. The archival literature does report a decrease in restatements after the voluntary adoption of a clawback policy (deHaan et al. 2013; Chan et al. 2012). Yet, deHaan et al. (2013) note their findings should be viewed with caution, as managers may now be incentivized to not amend the financial statements. Therefore, a reduction in restatements should not necessarily be construed as an increase in financial reporting quality in a clawback environment. Thus, my findings confirm the concerns of deHaan et al. (2013), as the results indicate that FREs will make more aggressive reporting decisions to avoid restating the financial statements when they are confronted with a clawback of a significant percentage of their previously earned compensation. Thus, their behavior may drive a reduction in restatements due to a desire to retain their compensation, which is counter to the goal of the regulation. In other words, the intention of the clawback provisions was to increase FREs' financial reporting integrity while preparing the financial statements. However, it may have also created an environment that motivates more aggressive FRE behaviors during restatement negotiations leading to a potential reduction in financial statement quality.

Organizations may also find the results of my study to be informative as they consider how to structure their executive compensation in a clawback setting. For example, results indicate that firms may need to structure compensation with higher base salaries as a percentage of total compensation to deter aggressive behavior in response to clawback policies. Early evidence suggests that voluntary adopters of clawback policies have increased their CEOs' compensation. The increase was mainly driven by an increase in base salary, which is typically not vulnerable to a clawback (deHaan et al. 2013). In addition, firms may need to consider utilizing more incentives linked to non-financial performance targets, such that a clawback cannot recoup the compensation. Equilar (2012b) finds that 38.5% of CEOs at S&P 1500 firms were awarded a portion of their incentives in the years 2008-2010 based on metrics tied to non-financial strategic objectives, such as quality or safety. In a clawback setting, the use of incentives driven by similar non-financial metrics may need to increase.

This study contributes to the auditor industry specialization and negotiation literatures. Brown-Liburd et al. (2012) note that the extant literature is limited regarding the factors that influence managerial behavior during financial reporting negotiations. I extend this research by finding that auditor industry specialization is a key contextual factor during the onset of a restatement negotiation process in a clawback setting. Specifically, specialization causes FREs to be less aggressive when faced with the clawback of a higher percentage of their incentives. FREs may have perceived the specialist auditors as having more power in the relationship and therefore they were more reluctant to challenge the restatement recommendation despite the loss of significant incentives. Audit committees selectively hire specialist auditors for the purpose of having a more knowledgeable monitor of their financial reporting process, which is evidenced by the committees' willingness to pay the specialists an audit fee premium (Fung et al. 2012). Thus,

it is reasonable to expect that a specialist may carry more clout during a financial reporting negotiation, as the audit committee handpicked the auditors for their industry expertise. Auditor industry specialization has been shown in the accounting literature to have significant benefits (e.g., Moroney and Simnett 2009; Solomon et al. 1999) and this study further contributes to the research by showing specialists can be an effective monitoring mechanism during a restatement negotiation in the clawback context.

Through its methodology and design, this study also contributes to the earnings restatements literature, as archival techniques are unable to examine an environment where there is a *potential* restatement. In general, the research on restatements has been mainly investigated through the use of archival techniques. Yet, archival data do not exist for potential restatements, as they are not disclosed. Using an experimental design, I am able to identify several specific motivations and factors that may influence FREs to make decisions during the restatement process when they are faced with having to repay previously earned incentives.

5.2 Limitations and Future Research

This study may suffer from some limitations due to choices made in the experimental design. In general, an experiment suffers from threats to external validity, as it may not completely replicate what may happen in a real setting. Gibbins et al. (2007) find that the negotiation process over financial reporting decisions among management, the external auditor, and the audit committee is a complex process that requires research and analysis by the parties that are involved. The main dependent variable in my study obtained the FREs' initial position regarding agreement or disagreement with the restatement recommendation from the auditors. This initial position begins the process that eventually leads to negotiations with the auditor and

the audit committee. Future academic research could explore the subsequent negotiation that ensues among the three parties during a restatement with a clawback.

Further, the behavior of the participants in this study may not be representative of all CFOs, controllers, and treasurers at public companies. As with any experiment, the use of a small sample of participants may be a threat to the external validity of a study. Due to the significant difficulty of recruiting financial reporting executives, I employed Research Now to obtain the majority of my sample. Participants came from a wide range of firm sizes with mean annual revenues consistent with Fortune 500 firms (CNN 2012). In comparison to prior accounting literature that used similar subjects, the FREs in this study were employed at larger firms on average and had a comparable number of years of professional experience (Gibbins et al. 2007; Gibbins et al. 2005). Last, the participants in this study had a wide range of experiences with compensation types and structures. However, it is unknown if the results of this study are specific only to individuals who participate in experiments with Research Now.

In addition, there may be limitations related to the manipulation of the executive compensation structure and FRE participants' experiences with clawbacks and restatements. First, executive compensation structures can be complex in practice, as there may be many different mixes of salary and incentives. For example, the demographic results in this study showed that the participants earned a wide range of incentive-types in their personal compensation. I chose the compensation design for this study based on actual survey data from S&P 500 CFOs and on the specific types of incentives that Section 954 outlines as being covered by the upcoming clawback regulation. The survey data utilized may not generalize to the compensation structures of all public company CFOs. Future studies could examine more complex compensation structures and the effects they have on FRE behavior in a clawback

setting. Next, the FREs had diverse experiences with clawback policies. Yet, performing the study before Section 954-related regulations are finalized by the SEC provides some insight regarding the potential impact of clawback policies. Future research could investigate the impact of clawback policies after they have been fully implemented, at a time when FREs can generally be assumed to have had some direct experience with clawbacks. Finally, the FRE participants had limited experiences with restatements. This was not unexpected given the relatively limited number of restatements in practice. As a result, there are only a few studies that explore managerial decision-making *during* restatement processes. Future research could further explore this area, as restatements are significant financial reporting events.

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FIGURES

Figure 1

Predicted Effects of Auditor Industry Specialization and Executive Compensation Structure on FREs' Likelihood to Agree with a Restatement that will lead to a Clawback

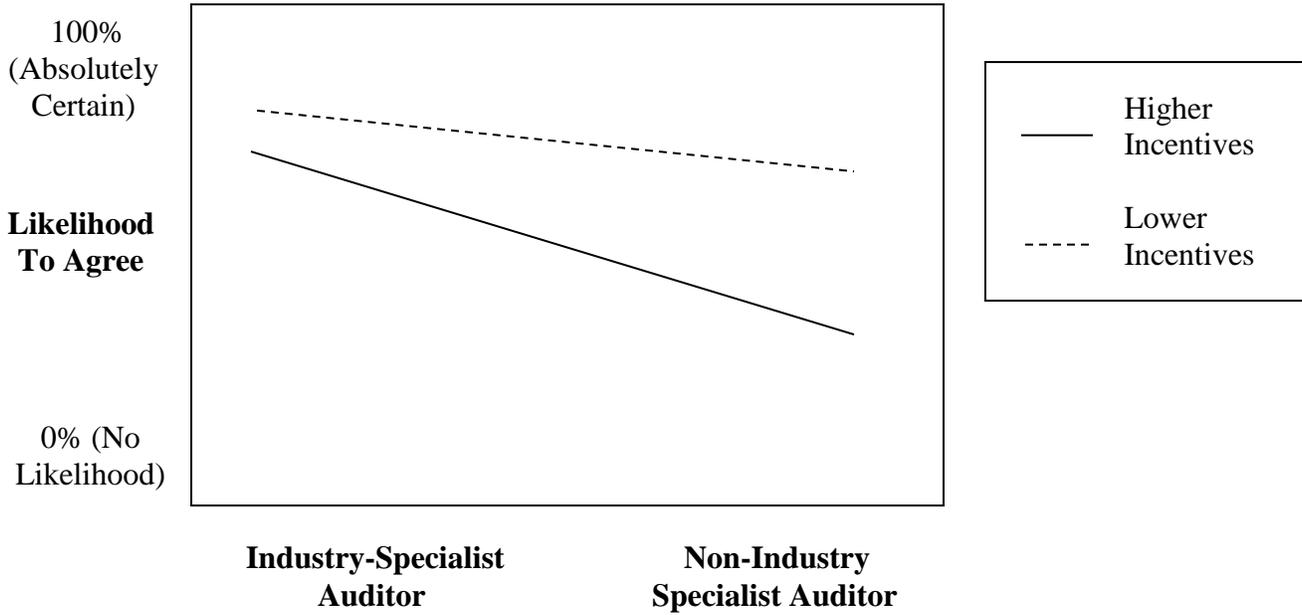
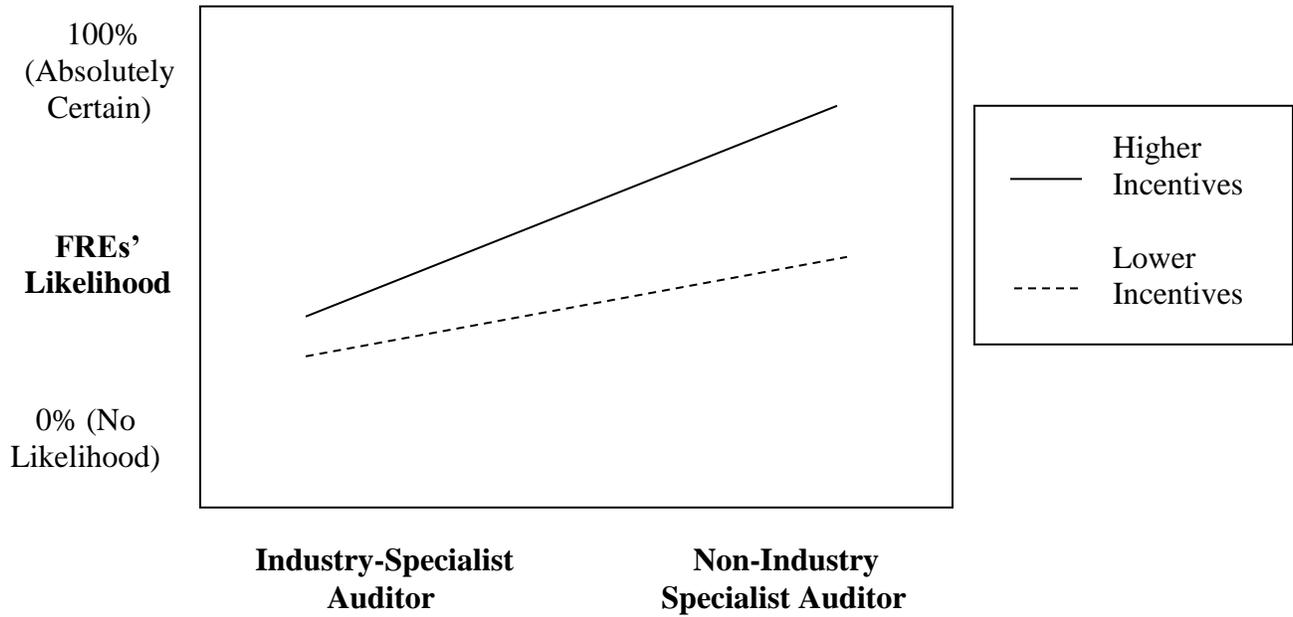


Figure 2

Predicted Effects of Auditor Industry Specialization and Executive Compensation Structure on FREs' Likelihood to take Additional Action to Avoid a Restatement that will lead to a Clawback³²



³² Additional action includes requesting the involvement of the auditor's national office technical group and recommending to the audit committee that it should consider replacing the auditor.

Figure 3

Flow Diagram for Determination of Final Sample based on the Manipulation Check Questions

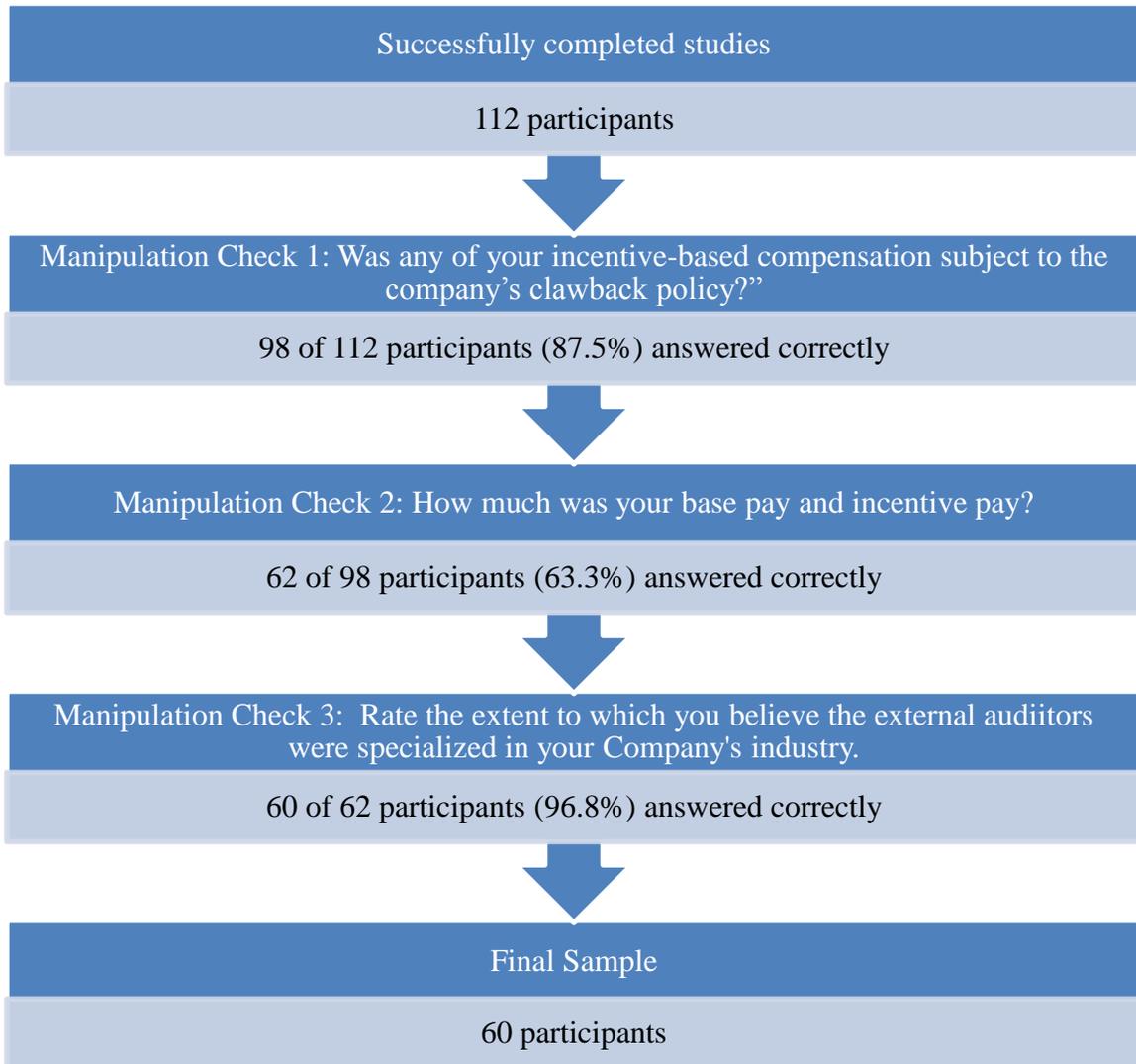
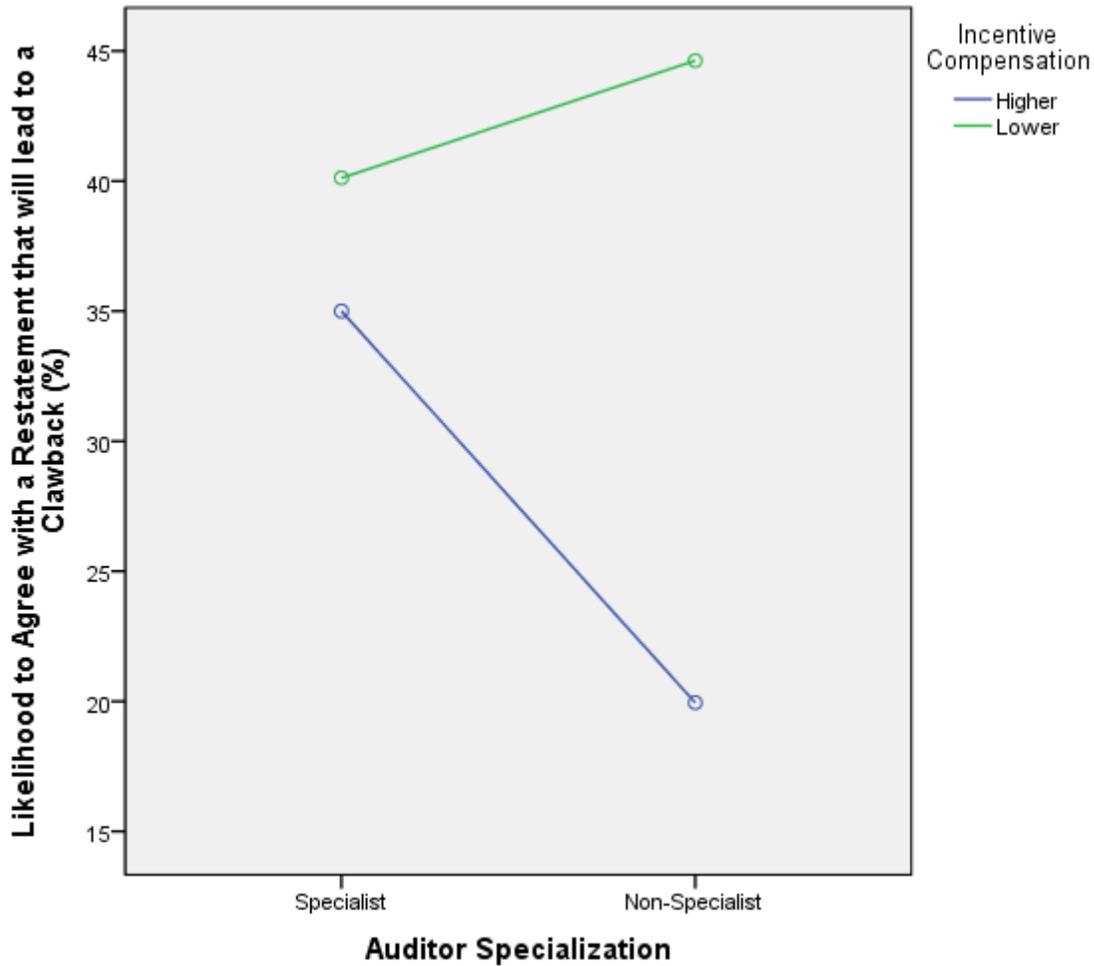


Figure 4

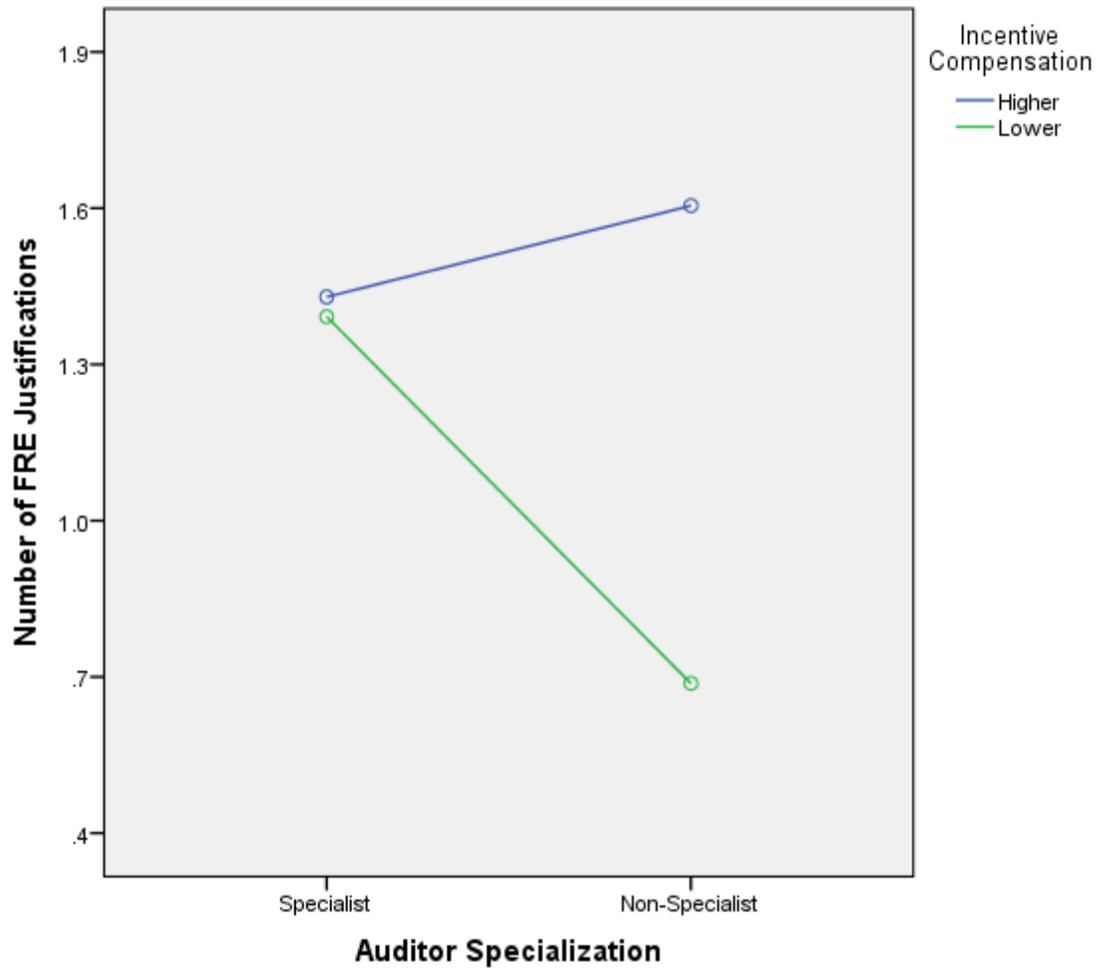
Observed Effects of Auditor Industry Specialization and Executive Compensation Structure on FROs' Likelihood to Agree with a Restatement that will lead to a Clawback³³



³³ Graph presents the interaction of Executive Compensation Structure and Auditor Industry Specialization on CFOs' likelihood to agree with a restatement that will lead to a clawback using estimated marginal means from analysis of covariance (ANCOVA) with awarded stock options and years of auditing experience as covariates.

Figure 5

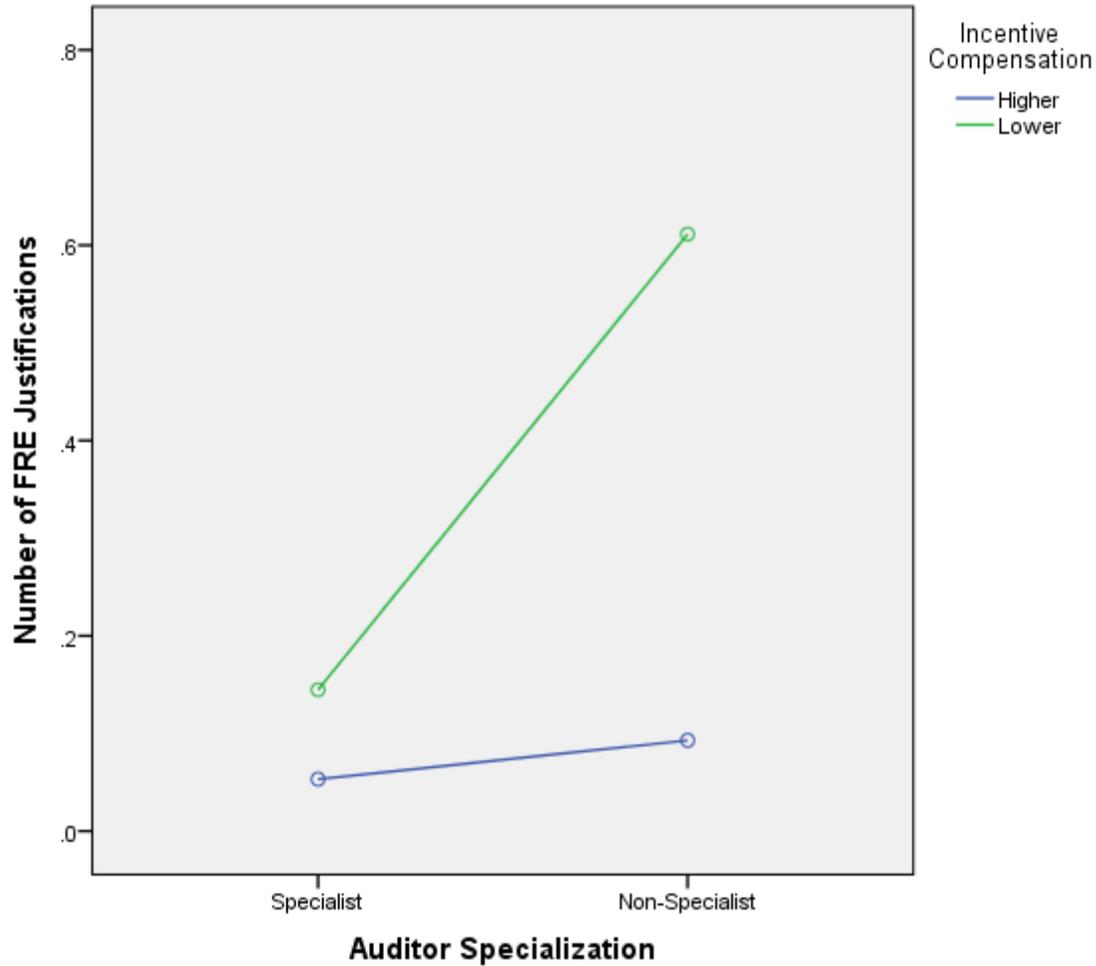
Observed Effects of Auditor Industry Specialization and Executive Compensation Structure on FREs' Justifications for Disagreeing with the Proposed Restatement³⁴



³⁴ Graph presents the interaction of Executive Compensation Structure and Auditor Industry Specialization on CFOs' justifications for disagreeing with the proposed restatement using estimated marginal means from analysis of covariance (ANCOVA) with awarded stock options, years of auditing experience, and impact of a restatement on shareholders as covariates.

Figure 6

Observed Effects of Auditor Industry Specialization and Executive Compensation Structure on FREs' Justifications for Agreeing with the Proposed Restatement³⁵



³⁵ Graph presents the interaction of Executive Compensation Structure and Auditor Industry Specialization on CFOs' justifications for agreeing with the proposed restatement using estimated marginal means from analysis of covariance (ANCOVA) with awarded stock options as covariate.

Figure 7

Observed Effects of Auditor Industry Specialization and Executive Compensation Structure on FREs' Likelihood to Request the Involvement of the External Auditor's National Office Technical Group

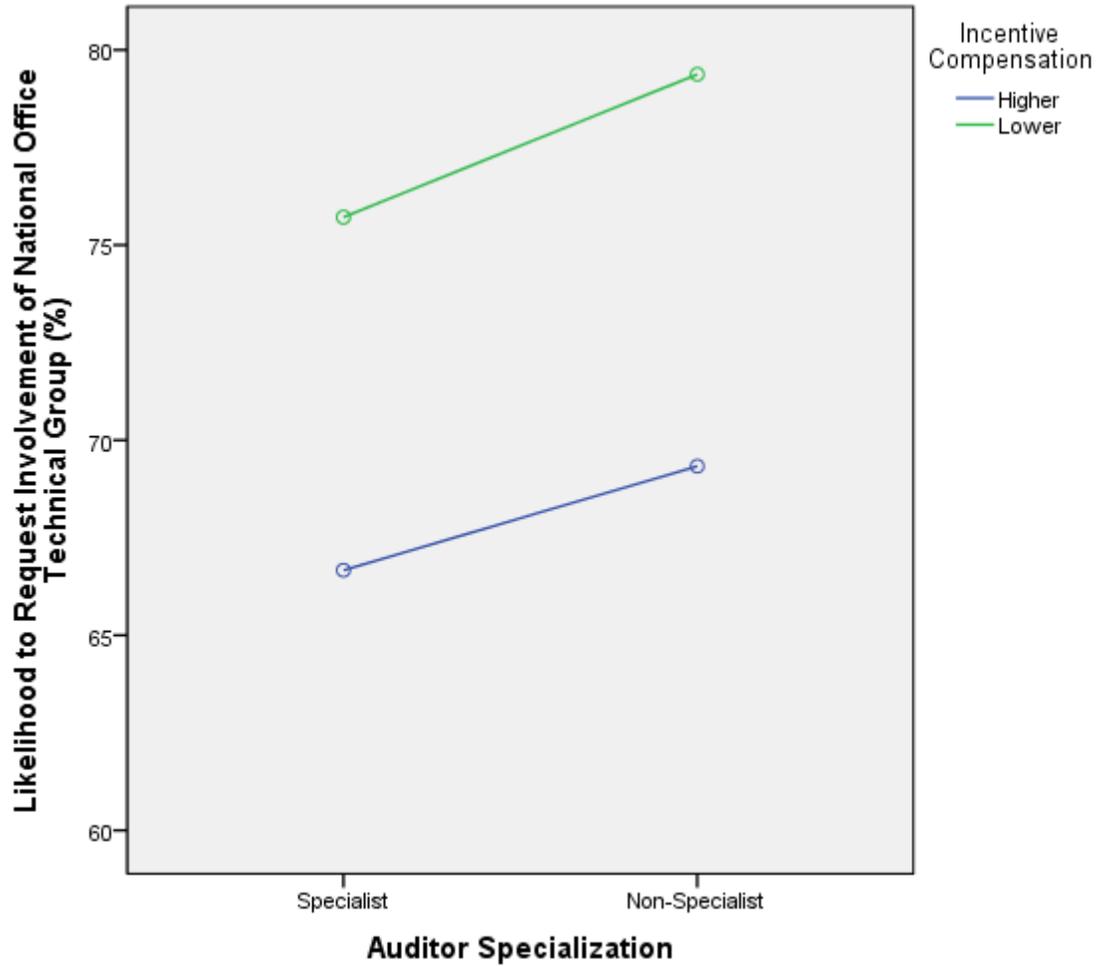


Figure 8

Observed Effects of Auditor Industry Specialization and Executive Compensation Structure on FREs' Justifications for Requesting the External Auditor's National Office

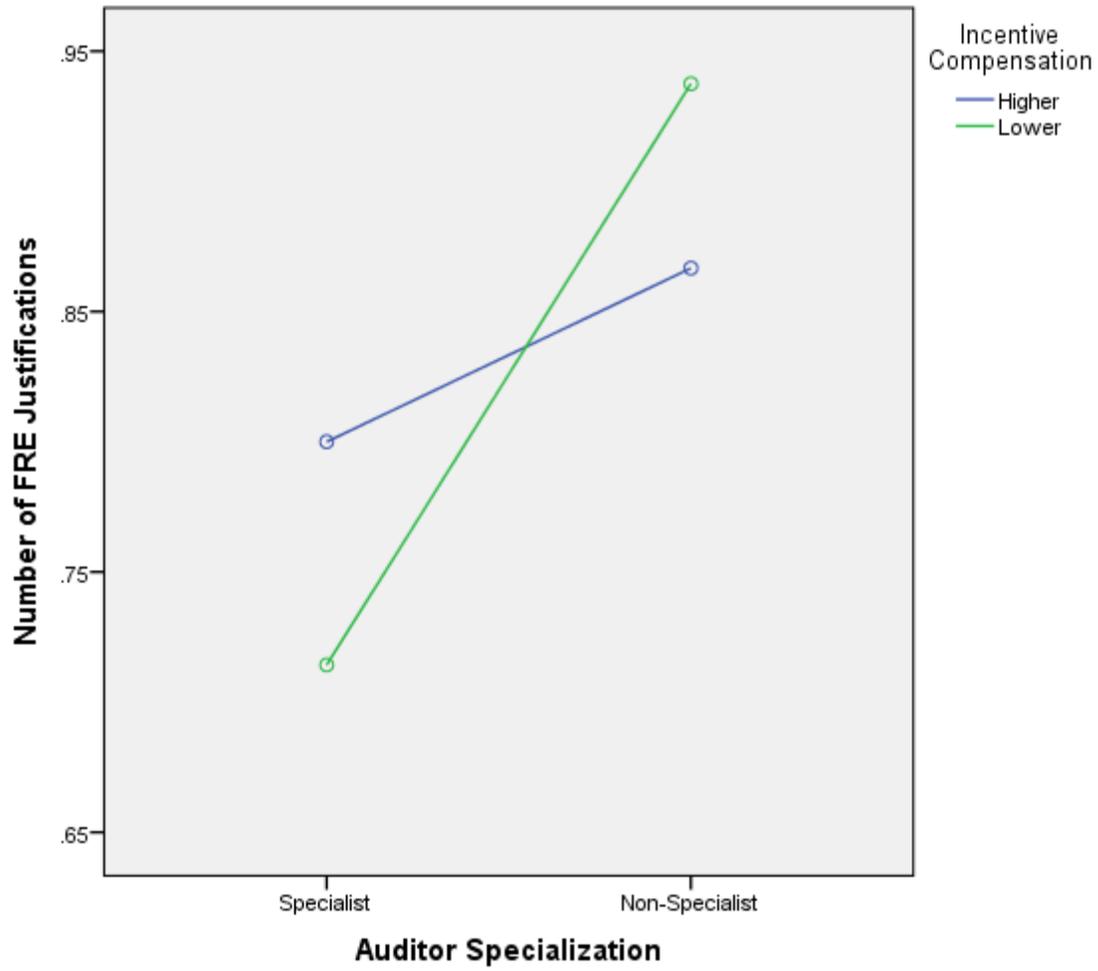


Figure 9

Observed Effects of Auditor Industry Specialization and Executive Compensation Structure on FREs' Justifications for Not Requesting the External Auditor's National Office

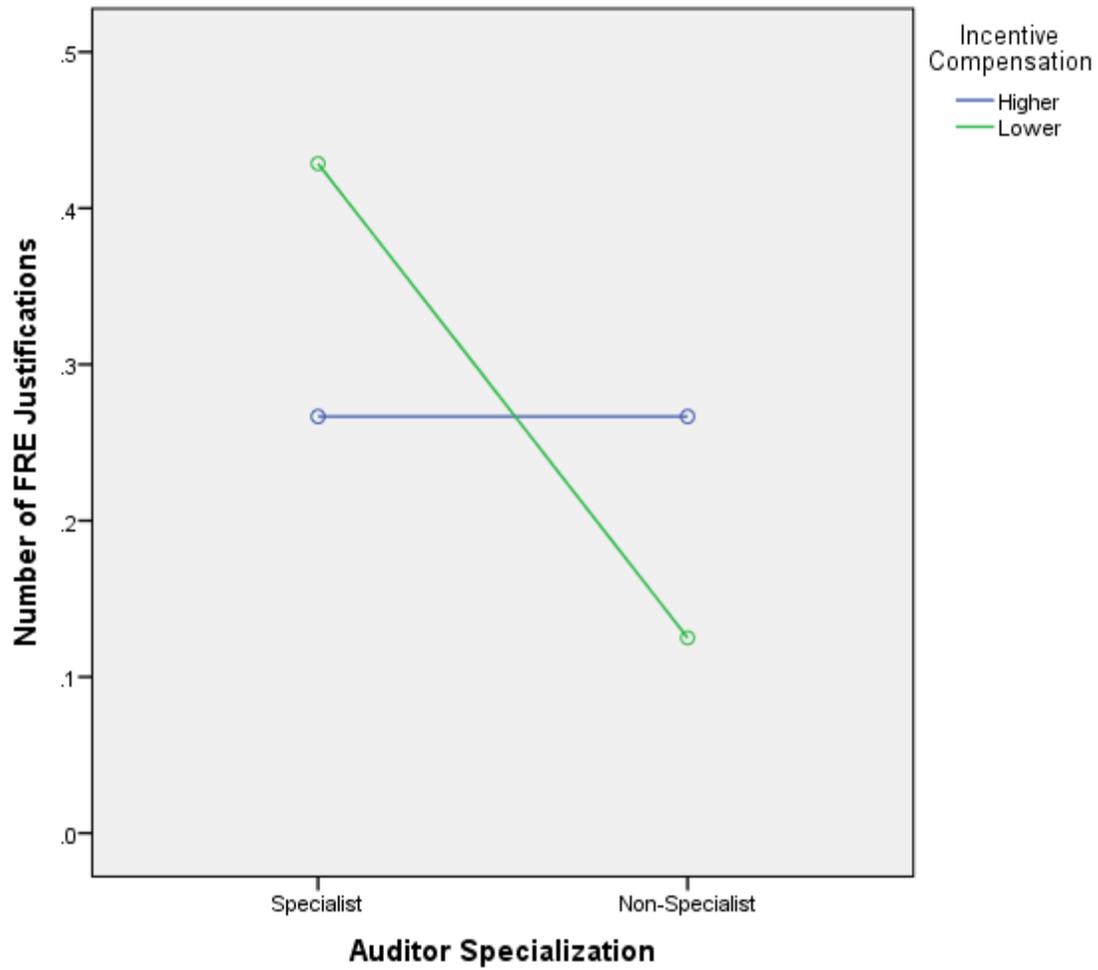
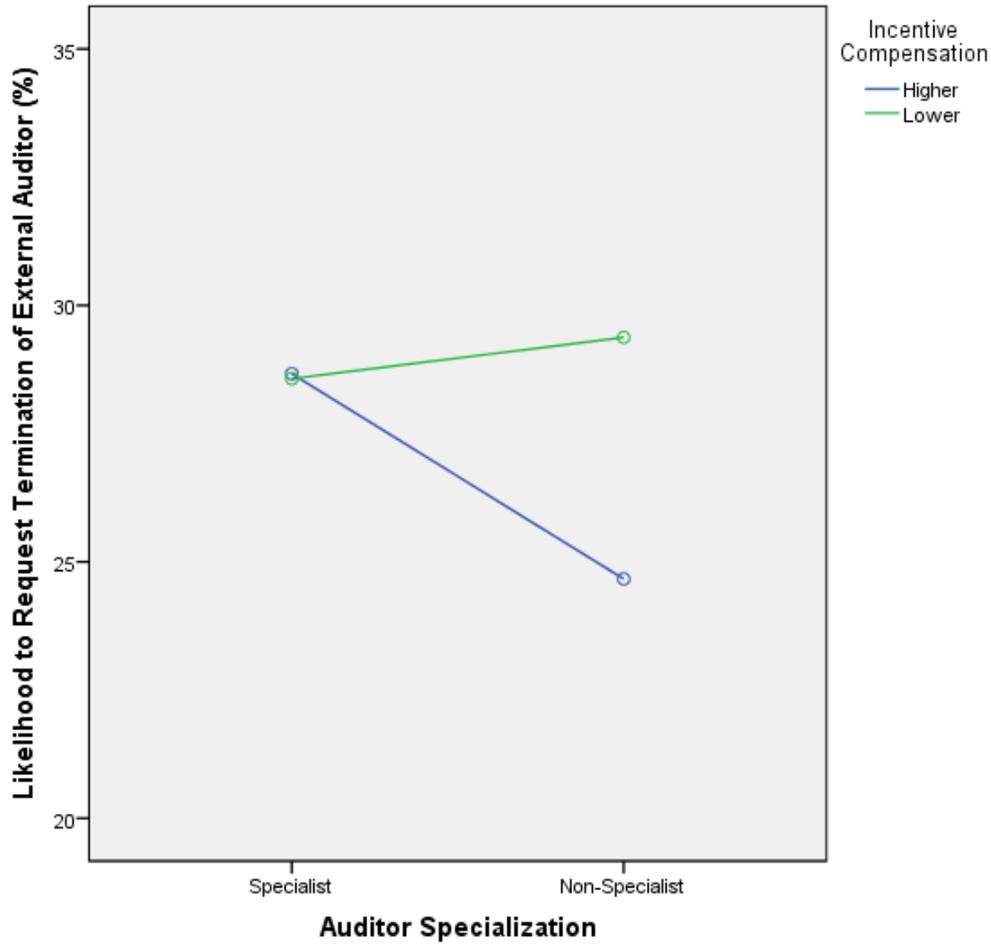


Figure 10

Observed Effects of Auditor Industry Specialization and Executive Compensation Structure on FREs' Likelihood to Recommend that the Audit Committee Considers Replacing the External Auditors



TABLES

**Table 1
Demographics**

Panel A: FRE Job Responsibility: Percentages

	<i>n = 60</i>	Percent
FRE's present job responsibility		
CFO	31	51.7
Controller / Treasurer	29	48.3
FRE's present company is publicly-traded	60	100.0

Panel B: FRE Clawback Policy Characteristics: Percentages

	<i>n = 21</i>	Percent
FRE's clawback policy characteristics		
Requires misconduct (fraud) to be triggered	11	52.4
Requires executive fault to be triggered	6	28.6
Policy covers all employees	3	14.3
Policy covers only key executives	15	71.4
Board has discretion on using the policy	6	28.6
Policy covers stock sale profits	6	28.6
Policy covers restricted shares	7	33.3
Policy covers stock awards	4	19.0
Policy covers cash bonuses	9	42.9
Policy covers stock option awards	8	38.1

Table 1 (continued)

Panel C: FRE Professional Experience: Means (Standard Deviations) and ANOVA

Variables	Means (n=60)	Higher Incentives		Lower Incentives		ANOVA-F Ratio (p values) ¹		
		Specialist Auditor (n=15)	Non-Specialist Auditor (n=15)	Specialist Auditor (n=14)	Non-Specialist Auditor (n=16)	Compensation Structure	Auditor Industry Specialization	Compensation Structure X Auditor Industry Specialization
Years of professional business experience	21.68 (7.39)	26.93 (4.77)	19.27 (6.30)	20.57 (8.25)	20.00 (7.73)	2.500 (0.119)	5.355 (0.024)	3.973 (0.051)
Years of experience as a CFO at a publicly-traded company	5.18 (5.86)	5.47 (6.89)	6.60 (6.21)	5.14 (6.41)	3.63 (3.81)	1.166 (0.285)	0.016 (0.900)	0.753 (0.389)
Years of professional industry experience in manufacturing	9.32 (9.59)	11.33 (12.59)	9.27 (7.36)	9.14 (10.81)	7.62 (7.39)	0.579 (0.450)	0.506 (0.480)	0.012 (0.914)
Years of experience discussing audit adjustments with auditors	11.10 (7.78)	12.00 (8.19)	10.93 (8.41)	10.93 (9.43)	10.56 (5.57)	0.123 (0.727)	0.121 (0.729)	0.029 (0.865)
Years of experience as an auditor	2.71 (3.14)	2.80 (2.98)	1.73 (2.52)	3.11 (3.34)	3.19 (3.69)	1.155 (0.287)	0.362 (0.550)	0.490 (0.487)
Approximate annual revenues of present company (\$millions)	5,872 (1,447)	4,095 (7,858)	5,191 (8,525)	4,821 (9,006)	9,097 (24,730)	0.371 (0.545)	0.499 (0.483)	0.175 (0.677)
Experience with a restatement (0 = No or 1 = Yes)	0.35 (.48)	0.33 (0.49)	0.47 (0.52)	0.21 (0.43)	0.37 (0.50)	0.706 (0.404)	1.375 (0.246)	0.012 (0.913)

1. F Ratio (p values) in bold are significant at $p < 0.05$.

Table 1 (continued)

Panel D: FRE Compensation: Means (Standard Deviations) and ANOVA

Variables	Means (n=60)	Higher Incentives		Lower Incentives		ANOVA-F Ratio (p values) ¹		
		Specialist Auditor (n=15)	Non-Specialist Auditor (n=15)	Specialist Auditor (n=14)	Non-Specialist Auditor (n=16)	Compensation Structure	Auditor Industry specialization	Compensation Structure X Auditor Industry specialization
Base pay as percentage of total compensation (%)	67.98 (17.04)	58.79 (19.53)	70.38 (15.03)	74.50 (14.64)	68.38 (16.22)	2.449 (0.124)	0.391 (0.535)	4.096 (0.048)
Incentive pay as percentage of total compensation (%)	32.02 (17.04)	41.21 (19.53)	29.62 (15.03)	25.50 (14.64)	31.62 (16.22)	2.449 (0.124)	0.391 (0.535)	4.096 (0.048)
Awarded restricted shares (0 = No or 1 = Yes)	0.47 (0.50)	0.53 (0.52)	0.27 (0.46)	0.50 (0.52)	0.56 (0.51)	1.024 (0.316)	0.619 (0.435)	1.610 (0.210)
Awarded stock options (0 = No or 1 = Yes)	0.43 (0.50)	0.47 (0.52)	0.53 (0.52)	0.43 (0.51)	0.31 (0.48)	0.980 (0.326)	0.036 (0.851)	0.488 (0.488)
Awarded stock (0 = No or 1 = Yes)	0.25 (0.44)	0.13 (0.35)	0.33 (0.49)	0.21 (0.43)	0.31 (0.48)	0.070 (0.793)	1.716 (0.196)	0.200 (0.657)
Awarded discretionary bonus (0 = No or 1 = Yes)	0.40 (0.49)	0.27 (0.46)	0.40 (0.51)	0.50 (0.52)	0.44 (0.51)	1.100 (0.299)	0.075 (0.785)	0.575 (0.451)
Awarded cash bonus (0 = No or 1 = Yes)	0.70 (0.46)	0.67 (0.49)	0.80 (0.41)	0.64 (0.50)	0.69 (0.48)	0.314 (0.577)	0.536 (0.467)	0.133 (0.717)
Awarded stock appreciation rights (0 = No or 1 = Yes)	0.07 (0.45)	0.07 (0.26)	0.07 (0.26)	0.00 (0.00)	0.13 (0.34)	0.004 (0.950)	0.905 (0.345)	0.905 (0.345)

1. F Ratio (p values) in bold are significant at $p < 0.05$.

Table 1 (continued)

Panel E: FRE External Auditor Experience: Means (Standard Deviations) and ANOVA

Variables	Means (n=60)	Higher Incentives		Lower Incentives		ANOVA-F Ratio (p values) ¹		
		Specialist Auditor (n=15)	Non-Specialist Auditor (n=15)	Specialist Auditor (n=14)	Non-Specialist Auditor (n=16)	Compensation Structure	Auditor Industry specialization	Compensation Structure X Auditor Industry specialization
Present company's auditor is a specialist (0 = No or 1 = Yes)	0.73 (0.45)	0.47 (0.52)	0.80 (0.41)	0.71 (0.47)	0.94 (0.25)	3.130 (0.082)	6.537 (0.013)	0.256 (0.615)
Have requested specialist auditor (0 = No or 1 = Yes)	0.32 (0.47)	0.20 (0.41)	0.47 (0.52)	0.36 (0.50)	0.25 (0.45)	0.060 (0.807)	0.432 (0.514)	2.371 (0.129)
Importance of specialist (0 = Not at All to 10 = Extremely)	7.75 (1.83)	7.33 (1.54)	7.87 (1.60)	7.29 (2.20)	8.44 (1.86)	0.312 (0.579)	3.236 (0.077)	0.436 (0.512)

1. F Ratio (p values) in bold are significant at $p < 0.05$.

Table 2
Manipulation Check Variables:
Means (Standard Deviations) and ANOVA

Variables ¹	Means (n=60)	Higher Incentives		Lower Incentives		ANOVA-F Ratio (p values) ²		
		Specialist Auditor (n=15)	Non-Specialist Auditor (n=15)	Specialist Auditor (n=14)	Non-Specialist Auditor (n=16)	Compensation Structure	Auditor Industry specialization	Compensation Structure X Auditor Industry specialization
Auditor industry specialization ³	6.03 (2.12)	6.80 (1.70)	4.53 (2.26)	7.14 (1.83)	5.75 (1.77)	2.512 (0.119)	13.833 (0.000)	0.789 (0.378)
Auditor knowledge ⁴	5.92 (2.10)	6.33 (1.45)	4.93 (2.46)	6.36 (2.17)	6.06 (1.98)	1.188 (0.280)	2.567 (0.115)	1.092 (0.300)

1. ANOVA analysis was performed on these variables to assess whether the auditor industry specialization manipulation was appropriately encoded by the participants.
2. F Ratio (p values) in bold are significant at $p < 0.05$.
3. Assessed on the scale: (“0 = Not At All,” “5 = Somewhat,” and “10 = Highly Specialized”).
4. Assessed on the scale: (“0 = Not Knowledgeable,” “5 = Somewhat Knowledgeable,” and “10 = Very Knowledgeable”).

Table 3
Results for FREs' Likelihood to Agree with the Restatement (H1a, H2a, and H3a)

Panel A: Estimated Marginal Means (Standard Errors)

	Specialist Auditor	Non-Specialist Auditor	Totals
Lower Incentives	40.12 (4.95) n = 14	44.63 (4.86) n = 16	42.38 (3.41) n = 30
Higher Incentives	35.00 (4.78) n = 15	19.95 (4.85) n = 15	27.47 (3.40) n = 30
Totals	37.56 (3.44) n = 29	32.29 (3.33) n = 31	34.93 (2.39) n = 60

Panel B: Analysis of Covariance¹

Variable	SS	Df	F ratio	P Value (two-tailed)
Compensation Structure ²	3,220.35	1	9.415	0.003
Auditor Industry Specialization ³	412.52	1	1.206	0.277
Compensation Structure * Auditor Industry Specialization	1,411.51	1	4.127	0.047
Covariates:				
Awarded Stock Options ⁴	3,206.20	1	9.374	0.004
Years of Auditing Experience	1,981.15	1	5.792	0.020

1. ANCOVA was performed with the dependent variable Likelihood to Agree with the Restatement (assessed on the scale: "0 = No Likelihood," "5 = Moderate Likelihood," and "10 = Absolutely Certain").
2. Compensation Structure variable: higher incentives or lower incentives.
3. Auditor Industry Specialization variable: specialist auditor or non-specialist auditor.
4. Assessed as to whether the participants were awarded stock options during the most recent fiscal year (0 = No or 1 = Yes).

Table 3 (continued)

Panel C: Tests of Contrasts

Comparison	F Ratio	P Value (two-tailed)
Higher Incentives Specialist Auditor vs. Higher Incentives Non-Specialist Auditor	4.892	0.031
Higher Incentives Specialist Auditor vs. Lower Incentives Specialist Auditor	0.554	0.460
Higher Incentives Non-Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	13.178	0.001
Lower Incentives Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	0.441	0.509

Notes: Tests of Contrasts were used to analyze differences between the groups.

Table 4
Free Response Analysis: FREs' Justifications
for Agreeing or Disagreeing with the Proposed Restatement

Panel A: FREs' Justifications that Disagreed with the Proposed Restatement: Percentages

	<i>n = 60</i>	Percent
Methodology is subjective (both methods are acceptable within GAAP)	31	51.7
Offered no reasons to disagree with the proposed restatement	14	23.3
Issue needs further analysis	10	16.7
Proposed impairment is a current year issue	9	15.0
Analysis was done in good faith with best professional judgment	9	15.0
Previous audit team gave a clean opinion	5	8.3
Proposed impairment is not material	4	6.7
Do not want to pay back my compensation	2	3.3
New audit team lacks knowledge about the company's business	2	3.3
Amount is an estimate (i.e., not 100% accurate)	2	3.3
Auditor did not provide facts to support impairment	1	1.7
Restatement will cause a decrease in shareholder value	1	1.7

Notes: This table summarizes FRE participants' answers to a free response question requesting them to provide reasons supporting their position taken for the main dependent variable Likelihood to Agree with the Restatement (see Table 3). The categories and the number of disagreeing justifications provided above are summarized based on all sixty FRE participants' written responses.

Table 4 (continued)

Panel B: FRES' Justifications that Agreed with the Proposed Restatement: Percentages

	<i>n = 60</i>	Percent
Offered no reasons to agree with the proposed restatement	50	83.3
Agree with the audit team's recommendation	7	11.7
Likely to agree but issue needs to be reviewed by an additional party	3	5.0
Restating is the most conservative approach	3	5.0
Big 4 audit firm made the recommendation	1	1.7
Audit team has appropriate expertise	1	1.7
Audit team was recently trained on the subject matter	1	1.7

Notes: This table summarizes FRE participants' answers to a free response question requesting them to provide reasons supporting their position taken for the main dependent variable Likelihood to Agree with the Restatement (see Table 3). The categories and the number of agreeing justifications provided above are summarized based on all sixty FRE participants' written responses.

Table 5
Results for FREs' Justifications for Disagreeing with the Proposed Restatement

Panel A: Estimated Marginal Means (Standard Errors)

	Specialist Auditor	Non-Specialist Auditor	Totals
Lower Incentives	1.39 (0.25) n = 14	0.69 (0.23) n = 16	1.04 (0.17) n = 30
Higher Incentives	1.43 (0.23) n = 15	1.61 (0.24) n = 15	1.52 (0.17) n = 30
Totals	1.41 (0.17) n = 29	1.15 (0.17) n = 31	1.28 (0.12) n = 60

Panel B: Analysis of Covariance¹

Variable	SS	Df	F ratio	P Value (two-tailed)
Compensation Structure ²	3.079	1	3.888	0.054
Auditor Industry Specialization ³	0.924	1	1.167	0.285
Compensation Structure * Auditor Industry Specialization	2.853	1	3.602	0.063
Covariates:				
Awarded Stock Options ⁴	3.737	1	4.720	0.034
Years of Auditing Experience	4.704	1	5.940	0.018
Impact of a Restatement on Shareholders ⁵	3.197	1	4.037	0.050

1. ANCOVA was performed with the dependent variable Number of Disagreeing Justifications.
2. Compensation Structure variable: higher incentives or lower incentives.
3. Auditor Industry Specialization variable: specialist auditor or non-specialist auditor.
4. Assessed as to whether the participants were awarded stock options during the most recent fiscal year (0 = No or 1 = Yes).
5. Assessed on the scale: (“-5 = Very Negatively,” “0 = No Impact,” and “10 = Very Positively”).

Table 5 (continued)

Panel C: Tests of Contrasts

Comparison	F Ratio	P Value (two-tailed)
Higher Incentives Specialist Auditor vs. Higher Incentives Non-Specialist Auditor	0.270	0.606
Higher Incentives Specialist Auditor vs. Lower Incentives Specialist Auditor	0.013	0.911
Higher Incentives Non-Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	7.564	0.008
Lower Incentives Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	4.380	0.041

Notes: Tests of Contrasts were used to analyze differences between the groups.

Table 6
Results for FREs' Justifications for Agreeing with the Proposed Restatement

Panel A: Estimated Marginal Means (Standard Errors)

	Specialist Auditor	Non-Specialist Auditor	Totals
Lower Incentives	0.15 (0.13) n = 14	0.61 (0.12) n = 16	0.38 (0.09) n = 30
Higher Incentives	0.05 (0.12) n = 15	0.09 (0.12) n = 15	0.07 (0.09) n = 30
Totals	0.10 (0.09) n = 29	0.35 (0.08) n = 31	0.23 (0.06) n = 60

Panel B: Analysis of Covariance¹

Variable	SS	Df	F ratio	P Value (two-tailed)
Compensation Structure ²	1.37	1	6.287	0.015
Auditor Industry Specialization ³	0.96	1	4.403	0.040
Compensation Structure * Auditor Industry Specialization	0.68	1	3.105	0.084
Covariates:				
Awarded Stock Options ⁴	2.35	1	10.707	0.002

1. ANCOVA was performed with the dependent variable Number of Agreeing Justifications.
2. Compensation Structure variable: higher incentives or lower incentives.
3. Auditor Industry Specialization variable: specialist auditor or non-specialist auditor.
4. Assessed as to whether the participants were awarded stock options during the most recent fiscal year (0 = No or 1 = Yes).

Table 6 (continued)

Panel C: Tests of Contrasts

Comparison	F Ratio	P Value (two-tailed)
Higher Incentives Specialist Auditor vs. Higher Incentives Non-Specialist Auditor	0.054	0.817
Higher Incentives Specialist Auditor vs. Lower Incentives Specialist Auditor	0.279	0.600
Higher Incentives Non-Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	9.315	0.003
Lower Incentives Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	7.415	0.009

Notes: Tests of Contrasts were used to analyze differences between the groups.

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Table 7
Results for FREs' Likelihood to Request External Auditor's
National Office Involvement (H1b, H2b, and H3b)

Panel A: Means (Standard Errors)

	Specialist Auditor	Non-Specialist Auditor	Totals
Lower Incentives	75.71 (7.24) n = 14	79.38 (6.02) n = 16	77.67 (4.59) n = 30
Higher Incentives	66.67 (8.77) n = 15	69.33 (7.90) n = 15	68.00 (5.80) n = 30
Totals	71.03 (5.69) n = 29	74.52 (4.93) n = 31	72.83 (3.72) n = 60

Panel B: Analysis of Variance¹

Variable	SS	Df	F ratio	P Value (two-tailed)
Compensation Structure ²	1,363.46	1	1.609	0.210
Auditor Industry Specialization ³	149.80	1	0.177	0.676
Compensation Structure * Auditor Industry Specialization	3.70	1	0.004	0.948

-
1. ANOVA was performed with the dependent variable Likelihood to Involve the External Auditor's National Office (assessed on the scale: "0 = No Likelihood," "5 = Moderate Likelihood," and "10 = Absolutely Certain").
 2. Compensation Structure variable: higher incentives or lower incentives.
 3. Auditor Industry Specialization variable: specialist auditor or non-specialist auditor.

Table 7 (continued)

Panel C: Tests of Contrasts

Comparison	F Ratio	P Value (two-tailed)
Higher Incentives Specialist Auditor vs. Higher Incentives Non-Specialist Auditor	0.051	0.823
Higher Incentives Specialist Auditor vs. Lower Incentives Specialist Auditor	0.623	0.437
Higher Incentives Non-Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	1.039	0.316
Lower Incentives Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	0.154	0.698

Notes: Tests of Contrasts were used to analyze differences between the groups.

Table 8
Free Response Analysis: FREs' Justifications for
Requesting or Not Requesting the External Auditor's National Office

Panel A: Justifications for FREs to Request the External Auditor's National Office:
Percentages

	<i>n = 60</i>	Percent
Proposed restatement is a subjective issue that requires further analysis	17	28.3
Offered no reasons to request the national office	17	28.3
Need their greater technical expertise and industry knowledge	11	18.3
Restatements are significant decisions with great implications and costs	9	15.0
National office is always involved in restatement decisions	5	8.3
If the local audit team will not change their restatement recommendation	2	3.3
The local audit team is new	2	3.3
Previous audit team gave a clean opinion	1	1.7
Need a fourth party's opinion as well (i.e., not the national office)	1	1.7
Proposed impairment is not material	1	1.7
Do not want to pay back my compensation	1	1.7

Notes: This table summarizes FRE participants' answers to a free response question requesting them to provide reasons supporting their position taken for the dependent variable Likelihood to Request the Involvement of the External Auditor's National Office (see Table 7). The categories and the number of justifications to request the national office provided above are summarized based on all sixty FRE participants' written responses.

Table 8 (continued)**Panel B: Justifications for FREs to Not Request the External Auditor's National Office:
Percentages**

	<i>n = 60</i>	Percent
Offered no reasons to not request the national office	47	78.3
National office's opinion will not differ from the local audit team	3	5.0
Will discuss the proposed restatement further with local audit team first	3	5.0
Local audit team has appropriate expertise	2	3.3
It is a subjective, professional judgment within the accounting standards	2	3.3
Proposed impairment is a current year issue	1	1.7
Review it first with the company's accounting standards department	1	1.7
Review the proposed restatement for errors first	1	1.7
Agree with the local audit team's recommendation	1	1.7
Disclose it as an unadjusted audit difference to the board of directors	1	1.7
Document it as an unadjusted audit difference in the workpapers	1	1.7

Notes: This table summarizes FRE participants' answers to a free response question requesting them to provide reasons supporting their position taken for the dependent variable Likelihood to Request the Involvement of the External Auditor's National Office (see Table 7). The categories and the number of justifications to not request the national office provided above are summarized based on all sixty FRE participants' written responses.

Table 9
Results for FREs' Justifications for Requesting the External Auditor's National Office

Panel A: Means (Standard Errors)

	Specialist Auditor	Non-Specialist Auditor	Totals
Lower Incentives	0.71 (0.16) n = 14	0.94 (0.14) n = 16	0.83 (0.12) n = 30
Higher Incentives	0.80 (0.15) n = 15	0.87 (0.22) n = 15	0.83 (0.12) n = 30
Totals	0.76 (0.12) n = 29	0.90 (0.12) n = 31	0.83 (0.08) n = 60

Panel B: Analysis of Variance¹

Variable	SS	Df	F ratio	P Value (two-tailed)
Compensation Structure ²	0.00	1	0.002	0.965
Auditor Industry Specialization ³	0.74	1	0.736	0.395
Compensation Structure * Auditor Industry Specialization	0.22	1	0.215	0.645

1. ANOVA was performed with the dependent variable Number of Justifications for Requesting the External Auditor's National Office.
2. Compensation Structure variable: higher incentives or lower incentives.
3. Auditor Industry Specialization variable: specialist auditor or non-specialist auditor.

Table 9 (continued)

Panel C: Tests of Contrasts

Comparison	F Ratio	P Value (two-tailed)
Higher Incentives Specialist Auditor vs. Higher Incentives Non-Specialist Auditor	0.066	0.799
Higher Incentives Specialist Auditor vs. Lower Incentives Specialist Auditor	0.155	0.697
Higher Incentives Non-Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	0.077	0.784
Lower Incentives Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	1.064	0.311

Notes: Tests of Contrasts were used to analyze differences between the groups.

Table 10
Results for FREs' Justifications for Not Requesting the External Auditor's National Office

Panel A: Means (Standard Errors)

	Specialist Auditor	Non-Specialist Auditor	Totals
Lower Incentives	0.43 (1.09) n = 14	0.13 (0.34) n = 16	0.27 (0.14) n = 30
Higher Incentives	0.27 (0.46) n = 15	0.27 (0.46) n = 15	0.27 (0.08) n = 30
Totals	0.34 (0.15) n = 29	0.19 (0.07) n = 31	0.27 (0.08) n = 60

Panel B: Analysis of Variance¹

Variable	SS	Df	F ratio	P Value (two-tailed)
Compensation Structure ²	0.00	1	0.004	0.952
Auditor Industry Specialization ³	0.35	1	0.838	0.364
Compensation Structure * Auditor Industry Specialization	0.35	1	0.838	0.364

1. ANOVA was performed with the dependent variable Number of Justifications for Not Requesting the External Auditor's National Office.
2. Compensation Structure variable: higher incentives or lower incentives.
3. Auditor Industry Specialization variable: specialist auditor or non-specialist auditor.

Table 10 (continued)

Panel C: Tests of Contrasts

Comparison	F Ratio	P Value (two-tailed)
Higher Incentives Specialist Auditor vs. Higher Incentives Non-Specialist Auditor	0.000	1.000
Higher Incentives Specialist Auditor vs. Lower Incentives Specialist Auditor	0.279	0.602
Higher Incentives Non-Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	0.962	0.335
Lower Incentives Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	1.122	0.299

Notes: Tests of Contrasts were used to analyze differences between the groups.

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Table 11
Results for FREs' Likelihood to Request that the Audit Committee Considers Replacing the External Audit Firm (H1c, H2c, and H3c)

Panel A: Means (Standard Errors)

	Specialist Auditor	Non-Specialist Auditor	Totals
Lower Incentives	28.57 (8.11) n = 14	29.38 (6.86) n = 16	29.00 (5.17) n = 30
Higher Incentives	28.67 (7.92) n = 15	24.67 (6.08) n = 15	26.67 (4.92) n = 30
Totals	28.62 (5.57) n = 29	27.10 (4.55) n = 31	27.83 (3.54) n = 60

Panel B: Analysis of Variance¹

Variable	SS	Df	F ratio	P Value (two-tailed)
Compensation Structure ²	79.63	1	0.101	0.752
Auditor Industry Specialization ³	38.30	1	0.048	0.827
Compensation Structure * Auditor Industry Specialization	86.34	1	0.109	0.742

1. ANOVA was performed with the dependent variable Likelihood to Request that the Audit Committee Considers Replacing the External Audit Firm (assessed on the scale: "0 = No Likelihood," "5 = Moderate Likelihood," and "10 = Absolutely Certain").
2. Compensation Structure variable: higher incentives or lower incentives.
3. Auditor Industry Specialization variable: specialist auditor or non-specialist auditor.

Table 11 (continued)

Panel C: Tests of Contrasts

Comparison	F Ratio	P Value (two-tailed)
Higher Incentives Specialist Auditor vs. Higher Incentives Non-Specialist Auditor	0.160	0.692
Higher Incentives Specialist Auditor vs. Lower Incentives Specialist Auditor	0.000	0.993
Higher Incentives Non-Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	0.151	0.701
Lower Incentives Specialist Auditor vs. Lower Incentives Non-Specialist Auditor	0.006	0.940

Notes: Tests of Contrasts were used to analyze differences between the groups.

Table 12
Supplemental Analysis:
Means (Standard Deviations) and ANOVA

Variables ¹	Higher Incentives		Lower Incentives		ANOVA-F Ratio (p values) ¹			
	Means (n=60)	Specialist Auditor (n=15)	Non- Specialist Auditor (n=15)	Specialist Auditor (n=14)	Non- Specialist Auditor (n=16)	Compensation Structure	Auditor Industry specialization	Compensation Structure X Auditor Industry specialization
Peer's likelihood to agree with proposed restatement ²	40.50 (23.03)	38.00 (16.99)	38.00 (29.33)	39.29 (16.85)	46.25 (26.80)	0.624 (0.433)	0.333 (0.566)	0.333 (0.566)
Likelihood to request CEO involvement ²	85.33 (25.14)	86.67 (19.52)	89.33 (23.75)	71.43 (35.70)	92.50 (15.71)	0.911 (0.344)	3.525 (0.066)	2.119 (0.151)
Likelihood to request audit committee involvement ²	82.83 (27.19)	80.67 (27.64)	89.33 (18.70)	76.43 (32.72)	84.38 (29.21)	0.419 (0.520)	1.367 (0.247)	0.003 (0.960)
Likelihood to request board of directors involvement ²	66.83 (32.50)	63.33 (37.16)	74.00 (28.49)	57.14 (34.74)	71.88 (29.71)	0.243 (0.624)	2.267 (0.138)	0.058 (0.810)
Likelihood to request company attorney involvement ²	82.17 (25.98)	76.00 (30.70)	88.00 (25.13)	78.57 (25.68)	85.63 (22.79)	0.000 (0.988)	1.983 (0.165)	0.134 (0.716)
Impact of a restatement on personal reputation ³	-1.18 (2.33)	-1.53 (2.07)	-2.00 (1.65)	-0.71 (2.13)	-0.50 (3.06)	3.799 (0.056)	0.045 (0.833)	0.328 (0.569)
Impact of a restatement on shareholders ³	-1.78 (2.24)	-1.60 (1.92)	-3.00 (1.93)	-0.50 (2.68)	-1.94 (1.88)	3.919 (0.053)	6.747 (0.012)	0.001 (0.973)

(The table is continued on the next page.)

Table 12 (continued)

Variables ¹	Means (n=60)	Higher Incentives		Lower Incentives		ANOVA-F Ratio (p values) ¹		
		Specialist Auditor (n=15)	Non-Specialist Auditor (n=15)	Specialist Auditor (n=14)	Non-Specialist Auditor (n=16)	Compensation Structure	Auditor Industry specialization	Compensation Structure X Auditor Industry specialization
Responsibility for lower manager's misstatement ⁴	6.98 (2.41)	7.00 (2.51)	6.40 (2.69)	7.14 (1.51)	7.38 (2.78)	0.781 (0.380)	0.085 (0.772)	0.433 (0.513)
Likelihood to request termination of lower manager ²	28.67 (23.47)	2.27 (1.83)	2.53 (2.23)	2.86 (2.60)	3.75 (2.60)	2.241 (0.140)	0.923 (0.341)	0.269 (0.606)

1. F Ratio (p values) in bold are significant at $p < 0.05$.
2. Question was assessed by the participants on the following scale: 0% = No Likelihood to 100% = Absolutely Certain.
3. Question was assessed by the participants on the following scale: -5 = Very Negatively to 5 = Very Positively.
4. Question was assessed by the participants on the following scale: 0 = Not Responsible to 10 = Very Responsible.

APPENDICES

Appendix A: The Dodd-Frank Act: Section 954

(from <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>)

SEC. 954. RECOVERY OF ERRONEOUSLY AWARDED COMPENSATION

The Securities Exchange Act of 1934 is amended by inserting after section 10C, as added by section 952, the following:

SEC. 10D. RECOVERY OF ERRONEOUSLY AWARDED COMPENSATION POLICY.

(a) LISTING STANDARDS.—The Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not comply with the requirements of this section.

(b) RECOVERY OF FUNDS.—The rules of the Commission under subsection (a) shall require each issuer to develop and implement a policy providing—

(1) for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws; and

(2) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.

Appendix B: Example Clawback Policy: Starbucks Corporation³⁶:

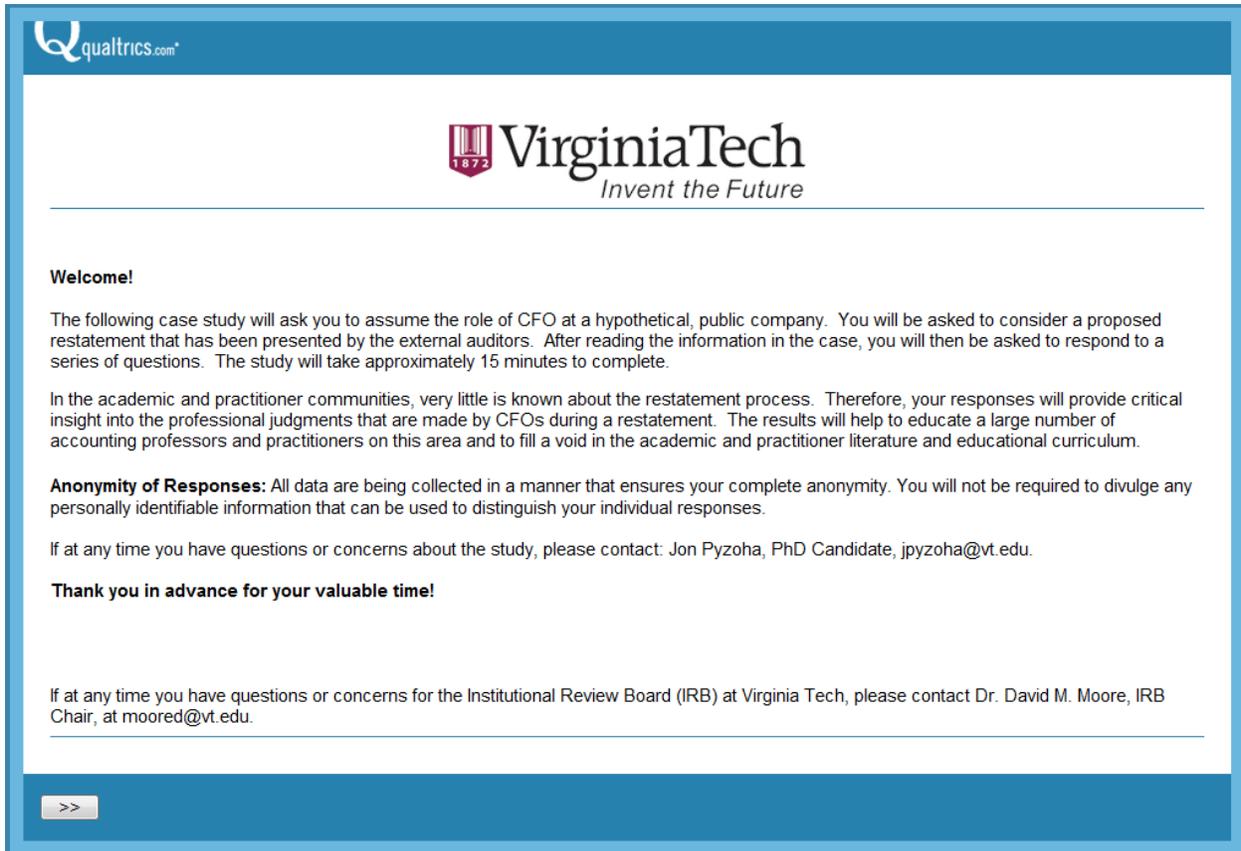
Recovery of Incentive Compensation Policy

During its November 2009 meeting, the board of directors, upon the recommendation of the Compensation Committee, approved the Recovery of Incentive Compensation Policy. The policy allows the Company to seek reimbursement with respect to incentive compensation paid or awarded to executive officers (as designated by the board) where (i) the payment of a bonus or equity award (or the vesting of such award) was predicated upon the achievement of financial results that were the product of fraudulent activity or that were subsequently the subject of a material negative restatement and (ii) a lower bonus payment or equity award would have been made to executive officers (or lesser or no vesting would have occurred with respect to such award) based on the restated financial results or the financial results that would have pertained absent such fraudulent activity. The Compensation Committee believes that the Recovery of Incentive Compensation Policy is in the best interests of the Company. The policy is effective, with respect to equity awards, beginning with awards granted in fiscal 2010 and, with respect to annual incentive bonuses, beginning with bonuses earned for fiscal 2010.

³⁶ Obtained from Starbucks Corporation's Proxy Statement dated January 28, 2011 available at <http://www.sec.gov/Archives/edgar/data/829224/000119312511017426/ddef14a.htm>

Appendix C: Experimental Instrument

Exhibit 1: Welcome Screen



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 **VirginiaTech**
Invent the Future

Welcome!

The following case study will ask you to assume the role of CFO at a hypothetical, public company. You will be asked to consider a proposed restatement that has been presented by the external auditors. After reading the information in the case, you will then be asked to respond to a series of questions. The study will take approximately 15 minutes to complete.

In the academic and practitioner communities, very little is known about the restatement process. Therefore, your responses will provide critical insight into the professional judgments that are made by CFOs during a restatement. The results will help to educate a large number of accounting professors and practitioners on this area and to fill a void in the academic and practitioner literature and educational curriculum.

Anonymity of Responses: All data are being collected in a manner that ensures your complete anonymity. You will not be required to divulge any personally identifiable information that can be used to distinguish your individual responses.

If at any time you have questions or concerns about the study, please contact: Jon Pyzoha, PhD Candidate, jpyzoha@vt.edu.

Thank you in advance for your valuable time!

If at any time you have questions or concerns for the Institutional Review Board (IRB) at Virginia Tech, please contact Dr. David M. Moore, IRB Chair, at moored@vt.edu.

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Exhibit 2: Company Background Screen



Please Note: Please do not use the back arrow in your Internet browser during this study. You will be able to review all of the information presented (i.e., the background information and the audit issue) without using the back arrow in your browser.

Medical Marvels Company Background

Medical Marvels, Inc. (the Company) is a large publicly-traded company in the manufacturing industry with operations throughout the mid-Atlantic region of the U.S. The Company produces and sells medical equipment and has multiple subsidiaries. The Company is subject to the normal reporting requirements of a publicly-owned company. During your six-year tenure as CFO, the Company has made no significant accounting policy changes, has reported no extraordinary items, and has had no other unusual non-operating activities.

No significant disagreements between management and the auditor have reached the audit committee or board of directors during your time as the CFO. In general, during discussions at audit committee meetings, the audit committee members are objective and consider all of the facts presented before determining their position. They do not immediately take the side of management or the auditor.

Financial Statements

Currently, the financial statements for the fiscal year ended December 31, 2011 are being audited. Selected financial results for 2011 and the audited results for 2010 are provided below:

(In \$ thousands)	For the Year Ended	
	Dec. 31, 2011 (unaudited)	Dec. 31, 2010 (audited)
OPERATING SUMMARY		
Net Sales	\$ 6,375,629	\$ 6,118,646
Income Before Taxes	1,418,761	1,365,775
Net Income	975,330	942,386
Earnings Per Share (EPS)	2.72	2.61
FINANCIAL POSITION		
Inventory	\$ 1,087,740	\$ 1,041,838
Total Assets	8,808,169	8,455,842
Total Liabilities	4,544,348	4,351,122

Please turn the page to read some background information about your current role as CFO at Medical Marvels.



Exhibit 3: CFO Background Screen – Higher Incentive Manipulation



Please Note: Please do not use the back arrow in your Internet browser during this study. To review any previously provided information, please scroll to the bottom of the screen and click on the respective image.

CFO Background and Compensation

You have been the CFO at Medical Marvels for six years. During your tenure, the Company has seen consistent growth in pre-tax income (4-6% each year) and the Company is currently on target to meet the consensus analyst forecast in the current year. Last year (2010) you earned total compensation of \$2.5 million, which included \$2.0 million in incentive-based pay that you received for beating the consensus analyst EPS forecast.

The \$2.0 million included a mixture of equity-based compensation (85%) (i.e., stock option awards and stock awards) and a cash bonus (15%). The remaining compensation consisted of base salary, a discretionary bonus, and perquisites. The discretionary bonus was awarded for completing your fifth year of service at the Company. Here is a summary of your compensation:

Compensation	Amount
Base Pay	\$500,000
Incentive Pay	\$2,000,000
Total Pay	\$2,500,000

In the current year (2011), you signed a new compensation contract with the following highlights:

- In the current year, if you meet all performance targets, you can earn \$2.5 million in compensation. Your incentive-based pay will include the same mixture of equity-based compensation and cash bonus as 2010. The remaining compensation will consist of base salary.
- In your new contract, the Company included a clawback policy, in accordance with the Dodd-Frank Act. In the event of any restatement due to either an error or misconduct, you will be required to pay back or return any incentive-based compensation (i.e., stock option awards, stock awards, and bonuses) that you earned based on the misstated financials. The policy will be triggered regardless of your personal responsibility for the misstatement. It covers financial statements starting in 2008.
- In your new contract, you also noted that there have been no changes to your health insurance coverage, retirement benefits, and perquisites such as car usage and financial planning.

Please turn the page to read some background information about Medical Marvel's external auditors.

Page 2 of 14

To review any of the previously provided information, please click on the respective image below:



Exhibit 4: CFO Background Screen – Lower Incentive Manipulation



Please Note: Please do not use the back arrow in your Internet browser during this study. To review any previously provided information, please scroll to the bottom of the screen and click on the respective image.

CFO Background and Compensation

You have been the CFO at Medical Marvels for six years. During your tenure, the Company has seen consistent growth in pre-tax income (4-6% each year) and the Company is currently on target to meet the consensus analyst forecast in the current year. Last year (2010) you earned total compensation of \$2.5 million, which included \$1 million in incentive-based pay that you received for beating the consensus analyst EPS forecast.

The \$1 million included a mixture of equity-based compensation (85%) (i.e., stock option awards and stock awards) and a cash bonus (15%). The remaining compensation consisted of base salary, a discretionary bonus, and perquisites. The discretionary bonus was awarded for completing your fifth year of service at the Company. Here is a summary of your compensation:

Compensation	Amount
Base Pay	\$1,500,000
Incentive Pay	\$1,000,000
Total Pay	\$2,500,000

In the current year (2011), you signed a new compensation contract with the following highlights:

- In the current year, if you meet all performance targets, you can earn \$2.5 million in compensation. Your incentive-based pay will include the same mixture of equity-based compensation and cash bonus as 2010. The remaining compensation will consist of base salary.
- In your new contract, the Company included a clawback policy, in accordance with the Dodd-Frank Act. In the event of any restatement due to either an error or misconduct, you will be required to pay back or return any incentive-based compensation (i.e., stock option awards, stock awards, and bonuses) that you earned based on the misstated financials. The policy will be triggered regardless of your personal responsibility for the misstatement. It covers financial statements starting in 2008.
- In your new contract, you also noted that there have been no changes to your health insurance coverage, retirement benefits, and perquisites such as car usage and financial planning.

Please turn the page to read some background information about Medical Marvel's external auditors.

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To review any of the previously provided information, please click on the respective image below:



Exhibit 5: Auditor Background Screen – Industry Specialist Manipulation



Please Note: Please do not use the back arrow in your Internet browser during this study. To review any previously provided information, please scroll to the bottom of the screen and click on the respective image.

External Auditor Background

The Company has been audited by the same Big 4 firm for the past six years. A new audit team started in the current year, as the previous partner rotated off after spending five years on the audit. The new audit team is led by one audit partner and two senior managers that have substantial experience as auditors, as well as, significant experience gained by working on clients in your Company's industry throughout their careers. Their focus on manufacturing and specifically medical manufacturing clients has also included attending industry-specific training during their careers. Lastly, they have extensive experience working on and leading multiple audits of large public companies in your industry.

During the audit firm's tenure, all quarterly financial information has been reviewed on a timely basis and the auditors have issued unqualified audit reports every year.

Please turn the page to read about an audit issue that the external auditors have discovered.

Page 3 of 14

To review any of the previously provided information, please click on the respective image below:



Exhibit 6: Auditor Background Screen – Non-Industry Specialist Manipulation



Please Note: Please do not use the back arrow in your Internet browser during this study. To review any previously provided information, please scroll to the bottom of the screen and click on the respective image.

External Auditor Background

The Company has been audited by the same Big 4 firm for the past six years. A new audit team started in the current year, as the previous partner rotated off after spending five years on the audit. The new audit team is led by one audit partner and two senior managers that have substantial experience as auditors, as well as, some experience working on clients in your Company's industry early in their careers. In preparation for this audit, they each attended their first industry-specific training in manufacturing. Lastly, they have extensive experience working on and leading multiple audits of large public companies. This is the first time they will lead the audit of a medical manufacturing client.

During the audit firm's tenure, all quarterly financial information has been reviewed on a timely basis and the auditors have issued unqualified audit reports every year.

Please turn the page to read about an audit issue that the external auditors have discovered.

Page 3 of 14

To review any of the previously provided information, please click on the respective image below:



Exhibit 7: Audit Issue Screen



Please Note: Please do not use the back arrow in your Internet browser during this study. To review any previously provided information, please scroll to the bottom of the screen and click on the respective image.

Audit Issue

In 2010, a manager at one of Medical Marvels' subsidiaries determined that an impairment analysis was necessary for a group of five machines at their manufacturing facility. Due to recent improvements and developments in technology for this type of machine, the manager thought that they may require impairment. The manager performed the analysis based on ASC 360-10 *Property, Plant, and Equipment: Overall* (formally FASB Statement No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*).

In Step 1 of the analysis, the manager performed the recoverability test and found that the carrying value of the machines, \$143.5 million, was less than the undiscounted future cash flows, \$153.5 million, using the traditional, best-estimate approach. The manager concluded, in accordance with the standard, that the carrying value of the machines is recoverable and therefore the subsidiary would not be required to recognize an impairment loss. The manager documented that the market price for the machines was \$100.0 million.

Due to changes in the economic conditions in the industry in recent years, the new audit team was concerned about potential impairment losses on Medical Marvels' machines and equipment. In 2011, the new audit partner and senior managers concluded that the manager's estimate of undiscounted cash flows for the machines in 2010 was developed in good faith, yet they believe that the estimate was too aggressive. The auditors favor an alternative, more conservative method of estimating the undiscounted cash flows, which is the probability-weighted approach. The auditor's approach calculated an undiscounted cash flow amount of \$133.5 million for the machines in 2010. Therefore, the carrying value is greater than the undiscounted cash flows and not recoverable. Step 2 finds that an impairment is required, as the carrying value is more than the fair value by \$43.5 million.

Here is a summary of the amounts discussed above:

Building Values	12/31/10	Auditor Proposed Impairment
Carrying Value	\$143.5 million	\$143.5 million
Undiscounted Cash Flows	\$153.5 million	\$133.5 million
Fair Value	\$100.0 million	\$100.0 million
Impairment Loss	\$0	\$43.5 million

Proposed Restatement

The auditors concluded that an error restatement of the 2010 financial statements is necessary due to the impairment loss of \$43.5 million. The auditor-proposed restatement amount for 2010 falls below the auditor's quantitative materiality threshold from the 2010 financial statements. Yet, the auditor-proposed restatement amount is qualitatively material, as the restatement will cause the 2010 pretax EPS to decrease from \$2.61 to \$2.53, which is now below the consensus analyst forecast for pretax EPS, which was \$2.57 in 2010. In addition, the incentive compensation that you earned by previously beating the consensus analyst forecast EPS will be subject to the company's new clawback policy.

As the undiscounted cash flow estimate is determined in a subjective analysis, the manager at the subsidiary has strong reservations about the proposed restatement because the authoritative guidance allows for both methods to be used in the recoverability test. Yet, there are some understandable reasons why the method proposed by the audit team may be encouraged, as it is generally considered to be more conceptually sound relative to the method used by management.

Please turn the page to answer some questions regarding the proposed restatement.

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To review any of the previously provided information, please click on the respective image below:



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Exhibit 8: Dependent Variables Screen 1



Please Note: Please do not use the back arrow in your Internet browser during this study. To review any previously provided information, please scroll to the bottom of the screen and click on the respective image.

1. How likely is it that you would agree with the auditor's proposed restatement of the 2010 financial statements for the \$43.5 million impairment loss?

No Likelihood					Moderate Likelihood					Absolutely Certain
0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
<input type="radio"/>										

2. Please briefly explain the reasons for why you took this position regarding the proposed restatement.

Page 5 of 14

To review any of the previously provided information, please click on the respective image below:



Company Background



CFO Background



Auditor Background



Proposed Restatement

[>>](#)

Exhibit 10: Dependent Variables Screen 3

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5. How likely is it that you would request the audit committee to consider replacing the external audit firm?

No Likelihood	Moderate Likelihood						Absolutely Certain			
0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
<input type="radio"/>										

Please turn the page to answer some debriefing questions.

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To review any of the previously provided information, please click on the respective image below:

 Company Background	 CFO Background	 Auditor Background	 Proposed Restatement
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Exhibit 11: Manipulation Checks Screen

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Please Note: Please do not use the back arrow in your Internet browser during this study.

Debriefing Questions: Please answer the following questions based on the information provided in the case.

1. In the case, how much was your base pay and incentive pay?

Base Pay (\$)	<input type="text" value="0"/>
Incentive Pay (\$)	<input type="text" value="0"/>
Total	<input type="text" value="0"/>

2. Please rate the extent to which you believe the external auditors in this case were specialized in your Company's industry.

Not At All	Somewhat								Highly Specialized	
0	1	2	3	4	5	6	7	8	9	10
<input type="radio"/>										

3. Was any of your incentive-based compensation subject to the company's clawback policy?

Yes

No

Please turn the page to continue answering debriefing questions.

Page 8 of 14

Exhibit 12: Follow-Up Questions Screen #1



Please Note: Please do not use the back arrow in your Internet browser during this study.

Debriefing Questions: Please answer the following questions based on the information provided in the case.

1. Please rate the extent to which you believe your peers (i.e., other CFOs) would be likely to agree with the auditor's proposed restatement of the 2010 financial statements.

No Likelihood	Moderate Likelihood						Absolutely Certain			
0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
<input type="radio"/>										

2. Please rate the extent to which you believe the audit team was knowledgeable?

Not Knowledgeable	Somewhat Knowledgeable						Very Knowledgeable			
0	1	2	3	4	5	6	7	8	9	10
<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

3. During the restatement decision-making process, how likely is it that you would request the involvement of the following parties?

	No Likelihood			Moderate Likelihood						Absolutely Certain	
	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
CEO	<input type="radio"/>										
Audit Committee	<input type="radio"/>										
Board of Directors	<input type="radio"/>										
Company Attorney	<input type="radio"/>										

Please turn the page to continue answering some debriefing questions.



Exhibit 13: Follow-Up Questions Screen #2



Please Note: Please do not use the back arrow in your Internet browser during this study.

Debriefing Questions: Please answer the following questions based on the information provided in the case.

4. Please rate the extent to which you believe your reputation will be affected if there is a restatement.

Very Negatively		No Impact						Very Positively		
-5	-4	-3	-2	-1	0	1	2	3	4	5
<input type="radio"/>										

5. Please rate the extent to which you believe the shareholders will be affected if there is a restatement.

Very Negatively		No Impact						Very Positively		
-5	-4	-3	-2	-1	0	1	2	3	4	5
<input type="radio"/>										

Please turn the page to continue answering some debriefing questions.

Page 10 of 14



Exhibit 14: Follow-Up Questions Screen #3



Please Note: Please do not use the back arrow in your Internet browser during this study.

Debriefing Questions: Please answer the following questions based on the information provided in the case.

6. Please rate the extent to which you would feel responsible for a restatement caused by a lower-level manager.

Not Responsible		Somewhat Responsible						Very Responsible		
0	1	2	3	4	5	6	7	8	9	10
<input type="radio"/>										

7. How likely is it that you would request termination of the lower-level manager at the subsidiary?

No Likelihood		Moderate Likelihood						Absolutely Certain		
0%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
<input type="radio"/>										

Please turn the page to answer some demographic questions based on your professional work experience.

Page 11 of 14



Exhibit 15: Demographics Screen 1

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Please Note: Please do not use the back arrow in your Internet browser during this study.

Demographic Questions: Please answer the following demographic questions based on your professional work experience.

1. What is your current position or job title?

2. How many years of professional business experience do you have in general?

3. How many years of professional business experience do you have as a CFO at a publicly-traded company?

4. How many years of professional business experience do you have in the manufacturing industry?

5. How many years of professional business experience do you have in discussing audit adjustments with the external auditors?

6. Please indicate how many years, if any, that you worked as an external auditor for a public accounting firm.

7. Is your current company publicly-traded?

Yes

No

8. What are the approximate annual revenues of your company?

Please turn the page to continue answering questions related to your professional experience.

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Exhibit 16: Demographics Screen 2

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Please Note: Please do not use the back arrow in your Internet browser during this study.

Demographic Questions: Please answer the following questions based on your professional experience.

1. In the most recent fiscal year, please indicate approximately what percentage of your total compensation consisted of base pay and incentive pay from your current company (please note this question is optional):

Base Pay (% of total compensation)	<input type="text" value="0"/>
Incentive Pay (% of total compensation)	<input type="text" value="0"/>
Total	<input type="text" value="0"/>

2. In the most recent fiscal year, please indicate which of the following incentives you received from your current company (please note this question is optional):

<input type="checkbox"/> Restricted shares	<input type="checkbox"/> Stock option awards
<input type="checkbox"/> Stock awards	<input type="checkbox"/> Discretionary bonus
<input type="checkbox"/> Cash (bonus) incentives	<input type="checkbox"/> Stock appreciation rights (SARs)

3. Does your current company have a clawback policy?

Yes
 No

Exhibit 17: Demographics Screen 3a

(If “Yes” to Question #3 from Exhibit 16)

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3a. Please select all of the following options that apply to your company's clawback policy:

<input type="checkbox"/> Requires misconduct (fraud) to be triggered	<input type="checkbox"/> Covers stock sale profits
<input type="checkbox"/> Requires executive fault	<input type="checkbox"/> Covers restricted shares
<input type="checkbox"/> Covers all employees	<input type="checkbox"/> Covers stock awards
<input type="checkbox"/> Covers only key executives	<input type="checkbox"/> Covers cash (bonus) incentives
<input type="checkbox"/> The Board of Directors has discretion on using the clawback	<input type="checkbox"/> Covers stock option awards

4. Have you ever gone through a restatement decision-making process during your professional career?

Yes
 No

4a. If so, what was your job title at the time (Please Note: If you have had experiences with more than one restatement process, please indicate your title during the most recent one)?

4b. If so, also please briefly explain your role in the discussion and resolution of the restatement decision:

5. Does your current company have an industry-specialist external auditor?

Yes
 No

6. Have you ever requested that your company hire an industry-specialist external auditor during your career as a CFO?

Yes
 No

7. In general, please rate the extent to which you believe having an industry-specialist auditor is important to achieving high quality financial reporting.

Not At All					Somewhat						Extremely Important
0	1	2	3	4	5	6	7	8	9	10	
<input type="radio"/>											

Please turn the page to finish the study.

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Exhibit 18: Demographics Screen 3b

(If “No” to Question #3 from Exhibit 16)

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4. Have you ever gone through a restatement decision-making process during your professional career?

Yes
 No

4a. If so, what was your job title at the time (Please Note: If you have had experiences with more than one restatement process, please indicate your title during the most recent one)?

4b. If so, also please briefly explain your role in the discussion and resolution of the restatement decision:

5. Does your current company have an industry-specialist external auditor?

Yes
 No

6. Have you ever requested that your company hire an industry-specialist external auditor during your career as a CFO?

Yes
 No

7. In general, please rate the extent to which you believe having an industry-specialist auditor is important to achieving high quality financial reporting.

Not At All	Somewhat								Extremely Important	
0	1	2	3	4	5	6	7	8	9	10
<input type="radio"/>										

Please turn the page to finish the study.

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