

## Weakened Reporting? The Effect of Clawback Regime and Bonus Compensation on Fraud Reporting

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### Introduction

The Dodd-Frank Act of 2010 (DF) clawback provision expands the range of executives susceptible to forfeiture of incentive-based compensation in the event of a restatement. Under Section 304 of the Sarbanes-Oxley Act of 2002 (SOX), incentive compensation of only Chief Executive Officers (CEO) and Chief Financial Officers (CFO) is subject to clawback. DF Section 954 requires companies to recover excess incentive compensation from any executive officer, regardless of fault or cause of the restatement (e.g., due to error or intentional misconduct). The DF clawback provision is likely to be consequential because executive compensation packages are tilted toward incentive-based compensation in the form of bonus and equity compensation, with incentive-based pay increasing as a percentage of total pay in recent years (Gao and Li, 2015; Conyon, 2006; Leider, 2016; Shue and Townsend, 2017).

We study how the level of incentive-based compensation (i.e., bonus that has been received) combines with the relevant clawback regime to influence an observer's<sup>1</sup> likelihood to report fraud. Although the underlying motivation for the DF clawback provision is to improve the quality of financial statements, it may have the unintended consequence of decreasing fraud reporting among executive observers because their current incentive-based compensation is now susceptible to clawback under DF. Specifically, if an executive other than the CEO or CFO observes fraudulent behavior (i.e., Chief Accounting Officer), the likelihood that this executive reports the fraud likely varies between DF and SOX regimes because under the DF (SOX) regime the executive may lose (retain) incentive-based compensation.

We employ a 2×2 between-participants experimental design that manipulates the level of incentive-based compensation that may be subject to clawback in the form of a cash bonus (a low bonus versus a high bonus) and the SOX regime where an observer's incentive-based compensation is not subject to clawback (i.e., retain the bonus) versus the DF regime where an observer's incentive-based compensation is subject to clawback (i.e., lose the bonus). Participants were asked to indicate the likelihood that the observer, the Chief Accounting Officer, would report a financial fraud committed by the CFO through the two reporting outlets available at publicly traded companies (i.e., a company's internal hotline, which does not offer a financial reward to encourage fraud reporting, and the Securities and Exchange Commission (SEC) hotline, which offers a financial reward in the event of a successful enforcement).

The loss aversion principle of prospect theory (Kahneman and Tversky, 1979) postulates that individuals exhibit a stronger reaction to losses relative to gains; therefore, individuals tend to behave in a manner that seeks to avoid losses. We use this principle to develop predictions that an observer will be sensitive to the increased probability of forfeiting bonus compensation under the DF regime (subject to clawback), especially for a larger bonus. Specifically, we expect that an observer's likelihood of reporting fraud through a company's internal hotline decreases as the probability and magnitude of a loss of compensation increases (i.e., high versus low bonus). We next consider whether the level of bonus compensation and clawback regime have the same effect on an observer's fraud reporting likelihood through the SEC hotline, which offers the opportunity for a substantial monetary reward in the event of a successful tip that may offset the loss of bonus compensation.

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<sup>1</sup> For purposes of this study, an observer is defined as an individual who witnesses a wrongdoing and has not participated in the wrongdoing. We use observer and executive observer interchangeably throughout the manuscript.

We find that a fraud observer is less likely to report through a company's internal hotline when a high bonus is at stake relative to a low bonus under the DF regime, whereas the size of the bonus does not influence an observer's fraud reporting behavior under the SOX regime. This finding suggests that a higher level of compensation makes observers more sensitive to an increased probability of a clawback when assessing whether to report fraud through a company's internal hotline. With respect to an observer reporting fraud through the SEC hotline, we again find that observers are less likely to report when a high bonus is at stake under the DF regime but not under the SOX regime. Therefore, the likelihood of retaining a high level of bonus compensation appears to be more important to observers than reporting the fraud.

Our study makes several important contributions. First, our results indicate that a higher-level of incentive-based compensation subject to clawback under DF may weaken the effectiveness of a company's internal whistleblowing program as well as the SEC whistleblowing program. This finding is important because non-CEO and non-CFO executives are critical to internal fraud detection, given that they are likely to observe a fraud committed by the CEO, CFO or both. According to the SEC, 89 percent of uncovered fraud cases involve a CEO or CFO, whereas only 34 percent, 10 percent, and 38 percent of fraud cases involve the Controller, Chief Operating Officer, and vice presidents, respectively (Beasley *et al.*, 2010). Further, the Association of Certified Fraud Examiners reports that tips are the most common fraud detection method, likely because publicly traded companies have been required to have a fraud hotline to comply with SOX (ACFE, 2017).

Second, our findings suggest that compensation committees should consider a company's fraud reporting policies and the implication of the DF clawback provision along with any internal clawback policies when designing executive compensation packages. Specifically, an executive compensation package tilted towards incentive-based compensation may decrease the likelihood of internal fraud reporting by other executives and thus help compensation committees design more efficient contracts. Third, our finding that the DF clawback provision may discourage internal fraud reporting by other executives offers insight for audit firms and highlights that the effect of the DF clawback regime should be considered when designing an audit especially because purposely concealed fraud is less likely to be detected by auditors (AICPA, 2012).

Finally, we complement literature examining the effect of offering incentives to encourage whistleblowing. Our findings add to arguments that some situations, such as offering an incentive below a minimum threshold may decrease the likelihood that an observer will blow the whistle. Specifically, Berger, Perreault, and Wainberg (2015) find a lower incidence of reporting when economic incentives available to whistleblowers through a whistleblowing program are inadequate. We introduce evidence of a lower incidence of fraud reporting when whistleblowers are at risk of losing their compensation. It appears that under a DF regime an observer's focus shifts from doing the right thing and reporting fraud to not reporting fraud to avoid a loss of compensation. Our findings that underreporting may be an unintended consequence of including a broader range of executives in the DF Act relative to SOX should also be of interest to policy makers.

The remainder of the paper is organized as follows. In the next section, we discuss relevant literature and develop our hypotheses. We then explain our research method and present our results. Finally, we provide implications for practice, our study's limitations, and avenues for future research.

## **Literature Review and Hypotheses Development**

### ***Monetary Incentives for Whistleblowing***

Incentives for whistleblowing have gained significant attention since the advent of the SEC whistleblowing program in 2012. This program provides a reward for whistleblowing if the tip provides original information and successfully enables the SEC to order a sanction of at least \$1 million from the wrongdoer or the wrongdoer's organization. The whistleblower will then receive 10 percent to 30 percent of the sanction. Factors determining the amount of reward received include whether the whistleblower first reported to the company's internal hotline, the significance of the information provided, and the degree of assistance provided to the SEC during the investigation [SEC Rule 21 F-6(a)(1)-(4)].

Research conducted prior to the creation of the SEC whistleblowing program provides evidence that observers were internally motivated to blow the whistle to deter the wrongdoing. Specifically, the most important motivational factor considered prior to blowing the whistle is a sense of an ethical obligation to report wrongdoing, whereas financial incentives were less important in motivating whistleblowers (Miceli and Near, 1994; Miceli *et al.*, 2009). Research after the SEC whistleblowing program has examined incentives for whistleblowing and largely suggests that incentive effects are contingent on situational factors such as the strength of the evidence supporting the wrongdoing (Brink *et al.*, 2013),

perceived seriousness of the wrongdoing (Andon *et al.*, 2016), a close working relationship with the wrongdoer (Boo *et al.*, 2016), and the perceived threat of retaliation (Guthrie and Taylor, 2018). This line of research also suggests that offering an incentive below a prescribed minimum threshold may lead to less whistleblowing (Berger *et al.*, 2015).

Prior research on whistleblowing also explores whether observers are more likely to report internally as opposed to externally (Callahan and Collins, 1992; Kaplan *et al.*, 2009; Robertson *et al.*, 2011; Mansbach and Bachner, 2010). Despite monetary incentives offered for reporting externally, observers still prefer to report internally (Brink *et al.*, 2013).

### ***Compensation and Whistleblowing***

To appreciate the importance of the DF Act, it is critical to understand certain definitions applied therein. According to the SEC, an executive officer (other executive) includes: “the issuer’s president, principal financial officer, principal accounting officer (or controller), any vice president in charge of a principal business unit, division or function, and any other person who performs similar policy-making functions.” Therefore, other executive refers to an executive officer other than the CEO and CFO. Also, section 16 of the Securities Exchange Act of 1934 defines incentive-based compensation as “any compensation that is granted, earned, or vested based on a financial reporting measure.” Examples include: bonuses, restricted stock, stock options, stock appreciation rights, and proceeds received upon the sale of shares which were acquired or awarded after achieving a financial reporting performance benchmark.

Call *et al.* (2016) examine a sample of class action lawsuits resulting from fraudulent financial reporting convictions and find that compensating rank-and-file employees with stock option grants is associated with a lower incidence of whistleblowing allegations against the firm. Stock options may therefore deter employees from reporting observed financial statement fraud because revealing a fraud will likely lead to a drop in the firm’s stock price and therefore possibly reduce an observer’s future compensation. The sample period of Call *et al.* (2016) ended in 2011, which precedes the implementation of the SEC whistleblowing program and thus does not consider the potential to receive a reward from the SEC for a successful tip.

Rose *et al.* (2016) exploit the long-term focus of restricted stock and find that managers with restricted stock are more likely to blow the whistle relative to managers with unrestricted stock which tends to induce a short-term focus. However, because managers who receive restricted stock cannot immediately liquidate their holdings after blowing the whistle, but prior to the disclosure of the fraud to the public, their whistleblowing judgments are more sensitive to the opportunity to receive a large reward versus a small reward. Taken together, these findings suggest that observers analyze the trade-off prior to blowing the whistle—adverse consequences for reporting the fraud and the possibility of receiving a monetary reward for blowing the whistle (Rocha and Kleiner, 2005).

While the presence of a clawback provision may increase the reliability of financial statements *ex ante* by promoting higher financial reporting quality (Hodge and Winn, 2012; deHaan *et al.*, 2013), the presence of a clawback provision might deter executives’ willingness to restate financial statements upon the discovery of a material error (Pyzoha, 2015) or to report an observed fraud in order to avoid losing compensation. The work of Kahneman and Tversky (1979, 1984) and Tversky and Kahneman (1991) concerning the loss aversion principle of prospect theory explains this behavior. Specifically, prospect theory posits that an individual’s disutility from losses outweighs utility from gains, suggesting that aversion to losses has a stronger effect on behavior than opportunity for gains.

### ***Internal Fraud Reporting***

We first consider the combined effects of the level of bonus compensation (the amount of compensation) subject to clawback and the likelihood that the bonus compensation will be recouped (the probability of a loss) when an executive observer decides whether to report through a company’s internal hotline, which does not offer a financial incentive for blowing the whistle. Thus, the opportunity to receive a reward that may be perceived as a substitute for a loss of bonus compensation is not present. As a result, an observer faces the possibility of a monetary loss. Therefore, observers lose more utility from forfeiting a bonus (e.g., due to a clawback) than they earn from reporting the fraud and stopping the wrongdoing. Specifically, utility from the ability to retain compensation by not reporting a fraud is greater than the utility of doing the right thing and reporting the fraud which results in a loss of compensation (Feldman and Lobel, 2011; Frey, 1997; Frey and Jegen, 2001; Gneezy and Rustichini, 2000).

When assessing whether to report a fraud internally, we expect an observer to be sensitive to losing a larger amount of bonus compensation under the DF regime (where bonus is subject to loss) relative to the SOX regime (where bonus is

not subject to loss) because the loss of compensation is greater in magnitude and significantly more probable (i.e., the clawback of bonus compensation in the event of a restatement) under the DF regime. Thus, we predict an ordinal interaction between the relevant clawback regime and level of bonus compensation subject to clawback such that when the level of bonus compensation is high relative to low, an observer will be less likely to report fraud through a company's internal hotline in the DF clawback relative to the SOX clawback regime. This leads to our first hypothesis, which is depicted in Figure 1.

**H1:** The level of bonus compensation and the clawback regime will have an interactive effect on an observer's likelihood to report fraud through the company's internal hotline such that an observer will be less likely to report fraud when a high level of bonus is at stake under the DF regime relative to the SOX regime. [see Figure 1, pg 13]

### ***External Fraud Reporting and Incentives***

We also consider the effect of the clawback regime and level of bonus compensation subject to loss when an observer decides whether to report fraud through the SEC hotline that offers a reward in the event of a successful claim. Reporting to the SEC creates a more complex setting because there are financial upsides to reporting. However, as noted previously, both the amount of the reward and the likelihood of receiving a reward are uncertain when submitting a tip through the SEC hotline.

The possible loss of personal compensation due to blowing the whistle may lead an observer to weigh the uncertain potential for future compensation or the monetary *upside* when assessing whether to report through the SEC hotline. If an observer's fraud tip is successful (the original information leads the SEC to sanction more than \$1 million) the minimum upside is \$100,000 (10 percent of the \$1 million threshold).<sup>2</sup> However, the maximum amount of reward received for a successful tip may be much larger. In fiscal year 2016, the SEC awarded \$57 million to 13 whistleblowers resulting in an average award of \$4.4 million (SEC, 2017).

On the other hand, an observer who has more compensation to lose is also likely to consider the possibility of a monetary downside when reporting through the SEC hotline. Specifically, there exists the possibility that a tip may not lead to a successful sanction necessary for a reward or that the reward from the SEC is not large enough to offset the loss in compensation due the recoupment of one's bonus compensation. We argue that the level of bonus compensation and clawback regime will interact in predicting the likelihood of whistleblowing. An observer who has more to lose will place more weight on avoiding a loss relative to the possibility that a large gain from an SEC reward will offset the loss of compensation. Therefore, there exists an increased likelihood of loss under the DF regime (where bonus is subject to loss) which may lead to a lower likelihood of reporting fraud through the SEC hotline when a high bonus is at stake relative to a low bonus. We do not expect the level of bonus compensation to decrease an observer's likelihood of blowing the whistle in the SOX clawback regime because the observer's bonus is not subject to clawback in the event of a restatement. This leads to our second hypothesis, which is depicted in Figure 1:

**H2:** The level of bonus compensation and the clawback regime will have an interactive effect on an observer's likelihood to report fraud through the SEC hotline such that an observer will be less likely to report fraud when a high level of bonus is at stake under the DF regime relative to the SOX regime.

### **Experimental Design and Method**

We employ a 2×2 between-participants design to test our hypotheses. Our manipulated variables include bonus (low versus high) and clawback regime [bonus not subject to being recouped/lost under SOX (i.e., retain the bonus) versus bonus subject to being recouped/lost under DF (i.e., lose the bonus)]. A manual process was employed to ensure that participants were randomly assigned to one of four experimental conditions: bonus (low or high) and clawback regime (SOX or DF).

#### ***Participants***

A total of 96 part-time Master of Business Administration (MBA) students with professional work experience voluntarily participated in the study and were neither compensated for their participation nor students of the researchers. Within the sample of participants, 65.6 percent (63) are male and 34.4 percent (33) are female. On average, participants

<sup>2</sup> In our experiment, the amount of bonus compensation subject to clawback in the low (high) bonus condition is \$50,000 (\$350,000). Thus, the lowest end of the SEC reward threshold does (does not) exceed the low (high) bonus amount in our experiment.

report having approximately 15 years of professional work experience (standard deviation = 6 years). Descriptive statistics regarding participants' current employment position and compensation structure are reported in Table 1. [see Table 1, pg 14]

### ***Task***

Participants were presented with a fraudulent financial reporting scenario similar to that used in Brink *et al.* (2013, 2017) which is presented in Appendix. The scenario first introduced participants to Associated Materials Inc. (AMI), a publicly traded company listed on the New York Stock Exchange and a manufacturer of industrial consumable materials. Participants were told that AMI is required to file annual financial reports with the SEC and that AMI has yielded steady operating results for the past few years; however, these results are still just below those of key industry competitors.

Participants were next introduced to the two actors in the case: The observer, Casey Dalton, the Chief Accounting Officer (CAO), who is responsible for preparing the financial reports for AMI, and the wrongdoer, Jordan Miller, the Chief Financial Officer (CFO), who reviews and certifies the accuracy of financial reports filed with the SEC. Next, participants were told, "Dalton (CAO) is absolutely certain that Miller (CFO) intentionally and inappropriately engaged in fraudulent financial reporting, resulting in materially misstated financial reports." Participants were then presented with the independent variable manipulations and a brief description of the whistleblowing outlets available to the CAO, the Company's anonymous hotline required by SOX, and the SEC's hotline created under DF. After reading the case, participants responded to the fraud reporting likelihood (dependent variable) measures, manipulation check questions, a set of follow up questions, and demographic questions.

### ***Independent Variables***

#### **Bonus Compensation**

Bonus compensation was manipulated between participants at two levels: low and high. Participants were told that, "After AMI filed its reports with the SEC, Dalton (CAO) received a year-end bonus for meeting the firm's earnings per share target. Dalton's bonus was \$50,000 (10 percent of total salary) [or \$350,000 (70 percent of total salary)] in the low (high) conditions.

#### **Clawback Regime**

The clawback regime was also manipulated between subjects at two levels: SOX and DF. The SOX condition states:

"Dalton remembers that Section 304 of the Sarbanes-Oxley Act (SOX) requires companies to recover incentive-based compensation from only the CEO and CFO who erroneously receive such incentive-based compensation due to material noncompliance and misconduct, resulting in misstated financial statements that must be restated.

Under the SOX rule, Dalton's (CAO) bonus is not subject to the clawback provision and cannot be taken away due to the misstated financial statements filed by Miller (CFO).

The DF condition states:

"Dalton remembers that Section 954 of the Dodd-Frank Act (DF) requires companies to recover any excess incentive-based compensation from any current or former executive officer who erroneously received such incentive-based compensation due to misstated financial reports that must be restated.

Under the DF rule, Dalton's (CAO) bonus is subject to the clawback provision and can be taken away due to the misstated financial statements filed by Miller (CFO).

### ***Dependent Variable***

Consistent with existing whistleblowing research (e.g., see Dalton and Radtke, 2013; Schultz *et al.*, 1993; Curtis 2006; Wainberg and Perreault, 2016; Boo *et al.*, 2016, for a similar approach), we address a possible social desirability bias by measuring the dependent variable in the third person (our primary measure) and in the first person. To measure our dependent variable in the third person, we ask participants, "How likely do you think it is that Dalton (CAO) will report Miller's (CFO) wrongdoing through the Company's hotline (through the SEC's hotline)," with endpoints (1 = very unlikely and 7 = very likely). To measure our dependent variable in the first person, we ask participants, "How likely is it that you will self-report Miller's (CFO) behavior through the Company's hotline (SEC's hotline)," with endpoints (1 = very unlikely

and 7 = very likely). The third person captures participants' likelihood to report the observed fraud and is used to mitigate a social desirability bias in participants' responses. Mitigating a social desirability bias in an ethical decision-making task is important as individuals tend to represent themselves positively when making ethical decisions to promote their own self-image (Chung and Monroe, 2003; Zerbe and Paulhus, 1987), resulting in over-reporting "good behavior" or under-reporting "bad behavior."

Another approach to control for a social desirability bias is to create and include a covariate by subtracting the third person reporting likelihood from the first-person reporting likelihood (Cohen *et al.*, 2001; Kaplan *et al.* 2015; Chung and Monroe, 2003; Lowe *et al.*, 2015). The results of this approach are reported in the footnotes of Table 3 through Table 5.

## **Results**

### **Group Demographic Statistics**

We compare the demographic variables presented in Table 1 across the four experimental conditions and do not find a significant difference for years of professional work experience ( $F = 0.78$ ,  $p = 0.509$ ), gender ( $F = 0.84$ ,  $p = 0.478$ ), compensation type ( $F = 1.40$ ,  $p = 0.251$ ), and position title ( $F = 0.64$ ,  $p = 0.589$ ). In an untabulated analysis, these demographic variables were included as possible covariates in analyses presented in Table 3 and Table 4. None of these variables were significant covariates when included in an ANCOVA with either the internal hotline or the SEC hotline as the dependent variable (all  $p$ -values  $> 0.16$ ).

### **Manipulation Check**

To assess whether the clawback regime manipulated variable had the intended effect, we asked participants "How likely do you think it is that Dalton's bonus will be recouped if the fraud is reported?" with endpoints (1 = very unlikely and 7 = very likely). Consistent with expectations, participants predicted a higher likelihood of recoupment in the DF (i.e., lost the bonus) condition (mean = 5.27) relative to the SOX (i.e., retained the bonus) condition (mean = 4.60;  $t = 1.80$ ,  $p = 0.038$ , one-tailed).

We examined participants' responses to the question, "How would you describe the magnitude of the amount of bonus that Dalton received," with endpoints (1 = very small and 7 = very large) to determine whether the level of bonus manipulated variable had the intended effect. Consistent with expectations, participants perceived a higher magnitude under the high bonus condition (mean = 5.49) relative to the low bonus condition (mean = 4.31,  $t = 3.84$ ,  $p < 0.001$ , one-tailed).

### **Analysis of Correlations**

To understand the relationship between the independent variables, dependent variables, and participants' response to a set of follow-up questions, we examine the correlations in Table 2. We note that *Clawback* is negatively associated with the internal reporting likelihood ( $r = -0.25$ ,  $p = 0.016$ ) but not associated with the SEC reporting likelihood ( $r = -0.09$ ,  $p = 0.360$ ). We also note that *Bonus* is negatively associated with internal reporting likelihood ( $r = -0.28$ ,  $p = 0.006$ ) and SEC reporting likelihood ( $r = -0.22$ ,  $p = 0.033$ ). *Bonus* is also positively associated with loss of bonus importance when reporting internally ( $r = 0.36$ ,  $p < 0.001$ ) and to the SEC ( $r = 0.25$ ,  $p = 0.014$ ). These correlations offer some evidence of the effect of having more to lose (i.e., the size of the bonus) and clawback regime in observers' fraud reporting judgments.

We find that the perceived likelihood of claiming a reward when reporting to the SEC is positively associated with the SEC reporting likelihood ( $r = 0.37$ ,  $p < 0.001$ ). This correlation suggests that the ability to claim a reward from the SEC may have been an important factor in participants' SEC fraud reporting judgments and is included as a covariate in the statistical tests of H2.

## **Tests of Hypotheses**

### **Hypothesis 1**

The results of a general linear model analysis, specifically an ANOVA, cell means, and simple effects are presented in Table 3. Our first hypothesis predicts that an observer's likelihood to report fraud through a company's internal hotline under the DF clawback regime will be lower when a high level of bonus is at stake relative to a low level of bonus. As presented in Panel A, we first note a significant main effect of *Bonus* ( $F_{(1,92)} = 8.10$ ,  $p = 0.006$ ) which suggests that observers are less likely to report fraud through a company's internal hotline when a high level of bonus compensation (mean = 3.71)

is at stake relative to a low level of bonus compensation (mean = 4.67). We also find a significant *Bonus* × *Clawback* interaction ( $F_{(1,92)} = 2.88, p = 0.047$ ).

We examine the cell means and simple effects in Panel B of Table 3 to test H1 and Figure 2 to display the interaction. In the DF clawback condition, observers are significantly less likely to report internally through a company's hotline ( $F_{(1,92)} = 8.97, p = 0.002$ ) when a high bonus is at stake (mean = 3.04) relative to a low bonus (mean = 4.55). In the SOX clawback regime, there is not a significant difference ( $F_{(1,92)} = 0.24, p = 0.625$ ) between an observer's fraud reporting likelihood in the low bonus condition (mean = 4.78) relative to the high bonus condition (mean = 4.40). These results suggest that the effect of receiving a higher relative to lower level of bonus (i.e., a higher versus lower level of compensation is subject to loss) influences an observer's internal reporting likelihood only when the clawback of bonus compensation is more probable—the bonus compensation is at stake under the DF clawback regime versus the SOX regime. This result supports the argument that the enactment of the DF clawback regime may have an unintended consequence and cause an observer to view reporting a fraud as an extrinsically motivated action (i.e., an action that may result in a loss of compensation) as opposed to an intrinsically motivated action (i.e., doing the right thing). [see Table 3, pg 18] [see Figure 2, pg 13]

### Hypothesis 2

Our second hypothesis predicts that receipt of a high versus a low level of bonus compensation will decrease an observer's likelihood to report fraud through the SEC hotline under the DF clawback regime but not under the SOX regime. To test H2, we examine the results of a linear model analysis with cell means in Panel A of Table 4. Specifically, we estimate an ANCOVA with participants' response to the question, "How likely do you think it is that Dalton will claim an award in the event of a successful SEC enforcement resulting in a sanction exceeding \$1 million (the necessary threshold to receive an award from the SEC)? (endpoints: 1 = very unlikely and 7 = very likely)," as a covariate. The purpose of including the covariate is to control for the possibility that receiving a reward for reporting through the SEC hotline influences the observer's reporting decision. As noted previously, participants' likelihood of claiming a reward is positively associated with participants' likelihood of reporting through the SEC hotline and is not correlated with the independent variables, suggesting that it should be included as a covariate (Field, 2013).

The simple effects when the dependent variable is participants' likelihood of reporting through the SEC hotline are reported in Panel B of both Table 4 and Table 5. As presented in Table 4, we find a non-significant main effect of *Clawback* ( $F_{(1,92)} = 0.70, p = 0.405$ ), a significant main effect of *Bonus* ( $F_{(1,92)} = 4.56, p = 0.035$ ), and a non-significant *Bonus* × *Clawback* interaction ( $F_{(1,92)} = 0.71, p = 0.201$ ). We also find that the level of bonus compensation has a significant effect in the DF clawback regime ( $F_{(1,92)} = 4.43, p = 0.019$ ) but not in the SOX clawback regime ( $F_{(1,92)} = 0.84, p = 0.363$ ).

As shown in Panel A of Table 5, participants' likelihood of claiming a reward is a significant covariate in the ANCOVA ( $F_{(1,91)} = 14.34, p < 0.001$ ). We find a marginally significant main effect of *Bonus* ( $F_{(1,91)} = 3.32, p = 0.072$ ) and a non-significant main effect of *Clawback* ( $F_{(1,91)} = 2.58, p = 0.112$ ). The *Clawback* × *Bonus* interaction remains non-significant ( $F_{(1,91)} = 0.03, p = 0.219$ ). Panel B of Table 5 reveals that the simple effect of *Bonus* on participants' SEC reporting likelihood is marginally significant in the DF regime ( $F_{(1,91)} = 1.89, p = 0.086$ ) and non-significant in the SOX regime ( $F_{(1,91)} = 1.40, p = 0.240$ ). This result suggests that observers are less likely to report fraud through the SEC hotline when a high bonus relative to a low bonus has been received and is subject to clawback under DF but not under SOX.

### Conclusion

The Dodd-Frank Act of 2010 introduces a mechanism that seeks to improve the reliability of financial reports. Accountability for restatements has increased significantly under DF, as SOX limits clawback provisions to only CEOs and CFOs who intentionally manipulated financial statements leading to a restatement. DF extends the pool of individuals whose incentive compensation is subject to clawback provisions beyond just the CEO and CFO to all executive officers, regardless of their role or fault in a restatement. We examine whether the level of bonus subject to loss combined with the relevant clawback regime influences observers' fraud reporting behavior through their company's internal hotline, which does not offer a financial incentive, or through the SEC hotline, which does offer a financial incentive.

In support of our hypotheses, we find that the level of bonus compensation and the clawback regime combine to influence an observer's likelihood of reporting through a company's internal hotline. Specifically, we find that participants are less likely to report fraud internally through a company's hotline when a higher level of personal compensation is subject

to loss under a DF regime. Interestingly, an increased probability of a significant loss to compensation remains an important factor in participants' fraud reporting judgments even when a substantial reward from the SEC is potentially available.

Our study identifies sensitivity among fraud observers to situational factors that may induce some caution against blowing the whistle. Our findings suggest that fraud observers consider the effect of reporting the wrongdoing on their current compensation. In particular, when deciding whether to blow the whistle, observers consider the magnitude of a loss to personal compensation and the probability that the loss will occur. These key determinants and their interactive relationships reflect the complex environment of fraud reporting and thereby highlight the possibility of unintended consequences that may occur from well-intended regulations such as DF. For example, if a potential whistleblower is operating in a DF regime, a high bonus environment, and without probability of an external reward, the likelihood of reporting fraud may be low. Additionally, given the observed sensitivity to the presence of an uncertain reward from the SEC, firms may consider offering internal rewards for fraud reporting to remedy fraud before large-scale negative consequences can occur through external reporting channels.

These findings should be of interest to regulators and members of boards of directors, particularly members of the audit and compensation committees. Our analyses suggest that a lower probability of fraud reporting may be an unintended consequence of the DF clawback provision and that more consideration of the provision may be prudent given the findings of our study. For example, policy makers may consider a clawback exception for other executives (without fault) who report the need to correct misstated financial statements. In addition, audit committee oversight might benefit from alternative avenues to detect fraud especially because tips from inside an organization are the most common source of fraud detection (ACFE, 2017).

While our study makes several contributions to the public policy and whistleblowing literature, it is subject to limitations. The generalizability of the bonus effects may be limited because participants in our experiment did not "receive" the level of bonus compensation but read about receiving it in a case. While we examine the tendency to report one type of wrongdoing, observers' perceptions of other wrongful acts may differ and in turn influence the likelihood of reporting fraud (Kaplan *et al.*, 2015; Andon *et al.*, 2016).

The findings of our study suggest several avenues for future research. First, future research could examine factors that may mitigate the adverse effect of the DF clawback provision. Perhaps imposing an exemption that incentive-based compensation is not subject to clawback in the event of a restatement under certain conditions (i.e., reporting a fraud or an unintentional error) would mitigate the effect of the DF clawback regime. This exemption would of course need to be endorsed and upheld by the SEC, and observers would have to be confident that the exemption is certain to protect their decision to report. Future research could also examine whether the effect of the DF clawback provision is the same across different forms of incentive-based compensation such as stock options and restricted stock. Finally, our study omits the presence of financial pressure, which may decrease the likelihood of reporting a fraud as depicted in the fraud triangle. We leave the role of financial pressure in the presence of a financial clawback to future research.



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## **Appendix**

### **Experimental Case:**

#### **Associated Materials Inc. Overview**

Associated Materials Inc. (AMI) is a manufacturer of industrial consumable materials and employs approximately 2,200 workers in its plants. Formed in 1975, AMI specializes in the production of fiberglass substrates and manufactures a variety of chemical resins for the automotive industry. As a publicly traded company on the New York Stock Exchange, AMI is required to file annual financial reports with the Securities and Exchange Commission (SEC). AMI has yielded steady financial results for the past few years; however, these results are below those of key industry competitors.

Casey Dalton is the Chief Accounting Officer (CAO), responsible for preparing the financial reports for AMI. Prior to filing with the SEC, Jordan Miller, Chief Financial Officer (CFO), reviews and approves the financial reports prepared by Dalton. Federal law requires that the Chief Executive Officer (CEO) and CFO certify the accuracy of financial reports filed with the SEC.

#### **<Bonus Manipulations>**

##### **Low**

After AMI filed its reports with the SEC, Dalton (CAO) received a year-end bonus for meeting the firm's earnings per share target. Dalton's bonus was \$50,000 (10%) of total salary).

##### **High**

After AMI filed its reports with the SEC, Dalton (CAO) received a year-end bonus for meeting the firm's earnings per share target. Dalton's bonus was \$350,000 (70%) of total salary).

Dalton recalls that the financial reports he prepared showed that AMI had not met the firm's earnings per share target. These financial reports went to Miller (CFO) for review and approval prior to being filed with the SEC. Dalton later examined AMI's financial reports filed with the SEC and noticed that Miller had made changes to the accounting records that enabled AMI to meet its earnings per share target. Specifically, Miller understated expenses which overstated earnings per share and enabled both Dalton and Miller to earn a bonus. In the absence of the accounting manipulation in the financial reports, Miller and Dalton would not have received a bonus.

Dalton (CAO) is absolutely certain that Miller (CFO) intentionally and inappropriately engaged in fraudulent financial reporting, resulting in materially misstated financial reports.

#### **<Clawback Manipulations>**

##### **SOX**

Dalton remembers that Section 304 of the Sarbanes-Oxley Act (SOX) requires companies to recover incentive-based compensation from only the CEO and CFO who erroneously receive such incentive-based compensation due to material noncompliance and misconduct, resulting in misstated financial statements that must be restated.

Under the SOX rule, Dalton's (CAO) bonus is not subject to the clawback provision and cannot be taken away due to the misstated financial statements filed by Miller (CFO).

##### **DF**

Dalton remembers that Section 954 of the Dodd-Frank Act (DF) requires companies to recover any excess incentive-based compensation from any current or former executive officer who erroneously received such incentive-based compensation due to misstated financial reports that must be restated.

Under the DF rule, Dalton's (CAO) bonus is subject to the clawback provision and can be taken away due to the misstated financial statements filed by Miller (CFO).

#### **AMI's Whistleblowing Hotline**

Upon hire, Dalton was informed that AMI has an anonymous internal whistleblowing hotline ("the Company's hotline"). Individuals who observe wrongful behavior may confidentially submit tips to the company's anonymous hotline. All

complaints submitted to the hotline are documented and forwarded to the company's independent audit committee (a subset of the board of directors).

### **SEC Whistleblowing Hotline**

Upon hire, Dalton was informed about a SEC Whistleblower Program. Individuals who observe a securities law violation (e.g., fraudulent financial reporting) may confidentially submit tips to the SEC's anonymous hotline ("the SEC's hotline"). If the tip leads to a successful enforcement resulting in sanctions exceeding \$1 million, the whistleblower may apply for a reward to the Office of the Whistleblower within 90 days of disclosure of the enforcement action on the SEC website. The range for awards is between 10 percent and 30percent of the money collected by the SEC. Whistleblowers who choose to submit information anonymously must provide contact information of an attorney to be eligible for a reward.

Individuals are still eligible for a reward if they choose to also report the securities violation through the AMI Hotline as long as the they provide the same information to the SEC within 120 days of reporting internally.

Thus, employees may report to only a company's internal hotline, only to the SEC hotline, or to both the company's internal hotline and the SEC hotline.

Figure 1: Predicted Effect of Clawback and Bonus on Fraud Reporting through the Company's Internal Hotline (H1) and the SEC Hotline (H2)

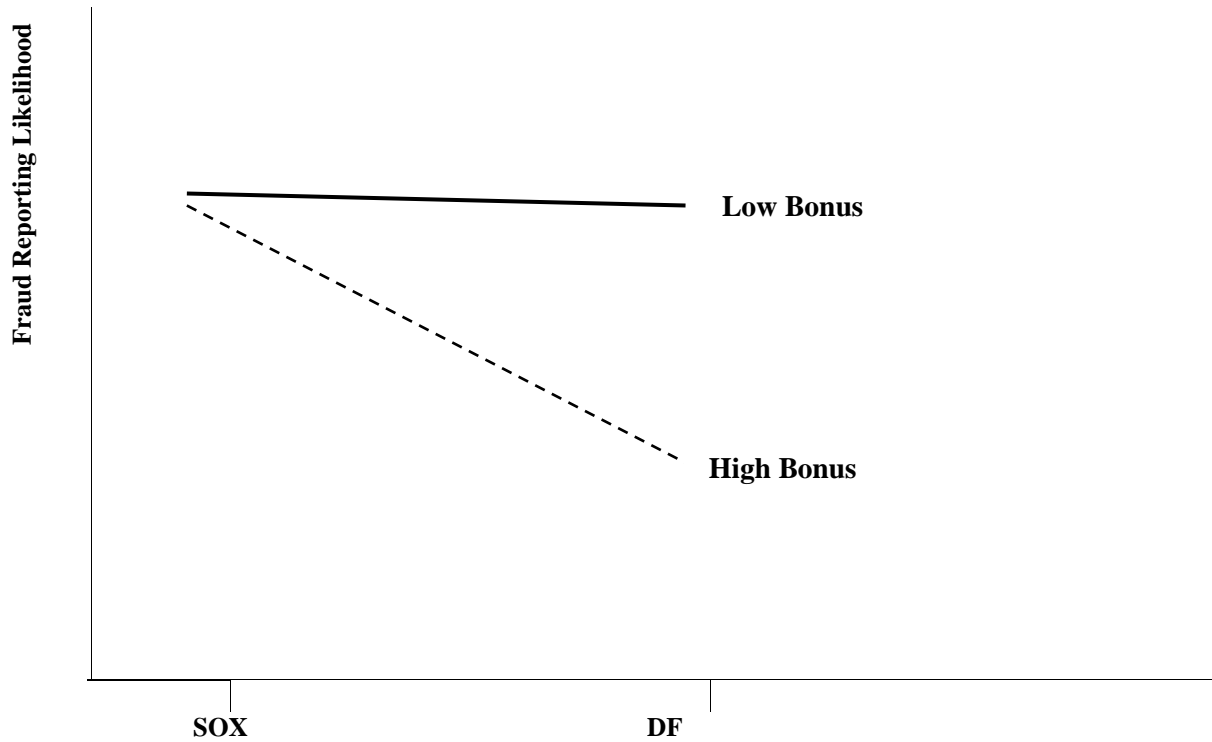


Figure 2: Results of the Effect of Clawback and Bonus on Fraud Reporting through the Company's Internal Hotline (H1)

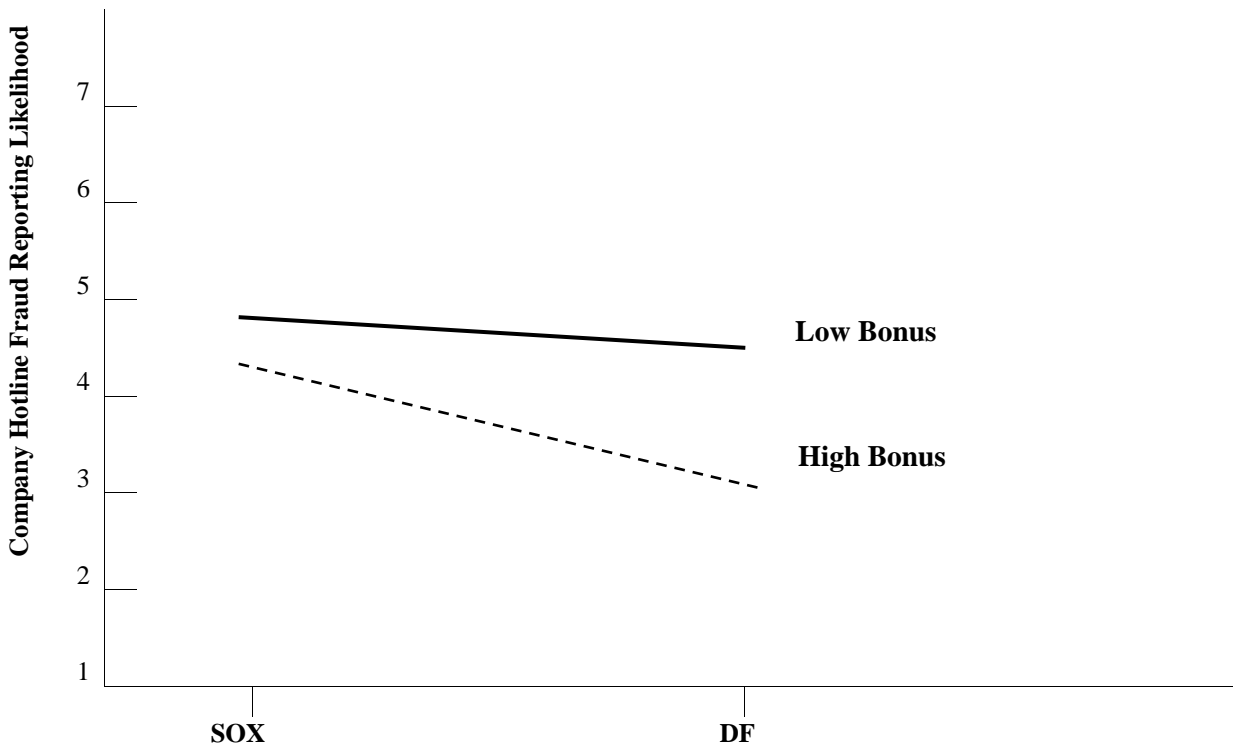


Figure 3: Results of the Effect of Clawback and Bonus on Fraud Reporting through the SEC Hotline (H2)

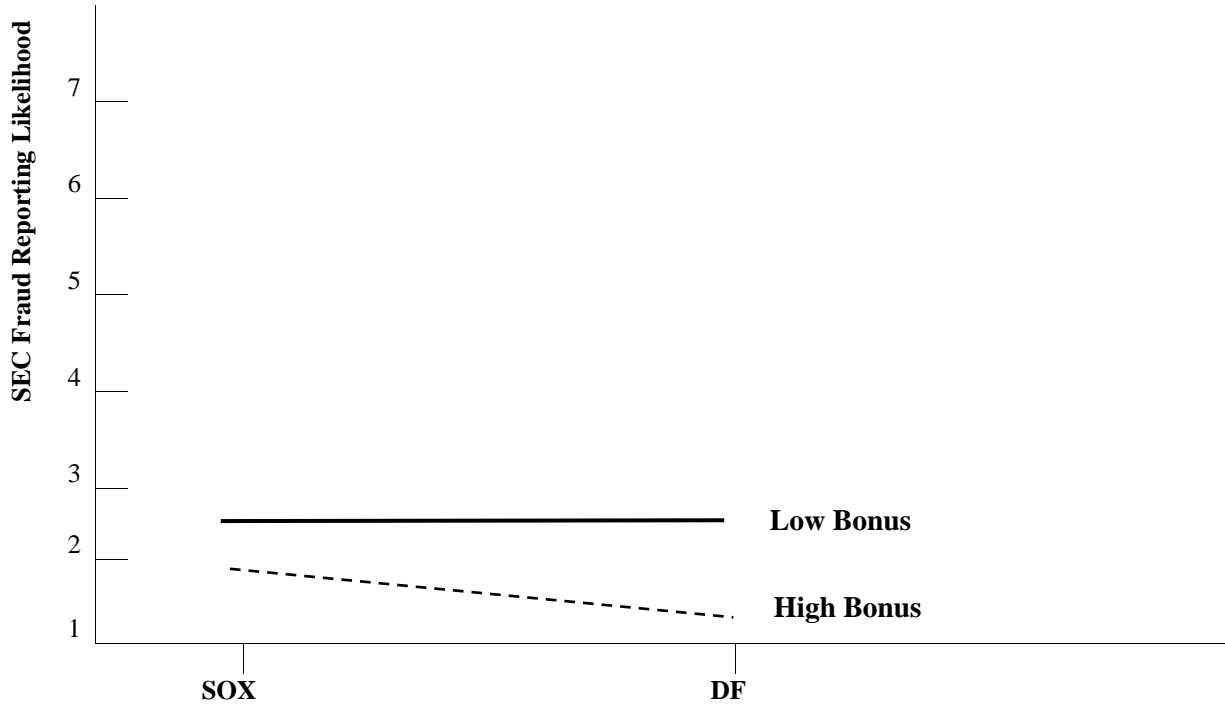


Table 1: Participants' Demographic Information (n = 96)

<b>Gender</b>	Male = 63 (65.6%)	Female = 33 (34.4%)
<b>Professional work experience</b>	Mean = 14.7 years	SD = 6.06 years
<b>Employment position</b>	Senior management	43 (44.8%)
	Management	23 (23.9%)
	Non-supervisory	19 (19.8%)
	Self-employed	6 (6.3%)
	Other	5 (5.2%)
<b>Compensation</b>	Fixed pay only	29 (30.2%)
	Variable pay only	2 (2.0%)
	Fixed and variable pay	59 (61.5%)
	Other	6 (6.3%)

**Table 2: Pearson Correlation Table**

	(1)	(2)	(3)	(4)	(5)	(6)
(1) Clawback	1					
(2) Bonus	0.02	1				
(3) Internal reporting likelihood	-0.25*	-0.28*	1			
(4) SEC reporting likelihood	-0.09	-0.22*	0.19	1		
(5) Likelihood of claiming bonus (SEC)	0.17	-0.11	-0.04	0.37*	1	
(6) Loss of bonus importance (Internal)	0.06	0.36*	-0.32*	-0.06	0.01	1
(7) Loss of bonus importance (SEC)	0.06	0.25*	-0.29*	-0.05	-0.05	0.74*

\*significant at the 5% level (two-tailed).

- (1) *Clawback* = observer's bonus is not subject to clawback under SOX (= 0) or is subject to clawback under DF (= 1).
- (2) *Bonus* = lower bonus received (\$50,000, 10% of salary) (= 0) or a higher bonus (\$350,000, 70% of salary) (=1) received by the observer.
- (3) *Internal reporting likelihood* = participant's response to the question, "How likely do you think it is that *Dalton* (CAO) will report Miller's (CFO) wrongdoing through the Company's hotline?" with endpoints (1 = very unlikely and 7 = very likely).
- (4) *SEC reporting likelihood* = How likely do you think it is that *Dalton* will report Miller's wrongdoing through the SEC's hotline? with endpoints (1 = very unlikely and 7 = very likely).
- (5) *Likelihood of claiming bonus* = How likely do you think it is that *Dalton* will claim an award in the event of a successful SEC enforcement resulting in a sanction exceeding \$1 million (the necessary threshold to receive an award from the SEC)? with endpoints (1 = very unlikely and 7 = very likely).
- (6) *Loss of bonus importance (Internal)* = Assuming that you are in Dalton's position, how important was the possibility of losing your bonus when deciding whether to report through the Company's hotline? with endpoints (1 = very unimportant and 7 = very important).
- (7) *Loss of bonus importance (SEC)* = Assuming that you are in Dalton's position, how important was the possibility of losing your bonus when deciding whether to report through the SEC's hotline? with endpoints (1 = very unimportant and 7 = very important).

Note: We do not include demographic variables in the correlation table given that the absence of a significant correlation between the all of the demographic variables and the variables currently reported in the correlation table.

**Table 3: Effect of Clawback and Bonus on Fraud Reporting through the Company's Internal Hotline**

**Panel A: General Linear Model (ANOVA)<sup>c</sup>**

Source	SS	df	MS	F-stat	p-value
Clawback	15.27	1	15.27	5.80	0.018
Bonus	21.33	1	21.33	8.10	0.006
Clawback × Bonus	7.55	1	7.55	2.88	0.047 <sup>†</sup>
Error	242.33	92	2.63		
Total	1947.00	96			

$R^2 = 0.160$  (Adj.  $R^2 = 0.133$ )

**Panel B: Cell Means (Standard Deviation)**

	SOX Regime	DF Regime	Totals	Simple Effects
<b>Low Bonus</b>	4.78 (1.68) n = 23	4.55 (1.63) n = 22	4.67 (1.64) n = 45	$F_{(1,92)} = 0.67$ (p = 0.417)
<b>High Bonus</b>	4.40 (1.89) n = 25	3.04 (1.25) n = 26	3.71 (1.73) n = 51	$F_{(1,92)} = 10.27$ (p = 0.002)
<b>Totals</b>	4.58 (1.78) n = 48	3.73 (1.61) n = 48	4.16 (1.74) n = 96	
<b>Simple Effects</b>	$F_{(1,92)} = 0.24$ (p = 0.625)	$F_{(1,92)} = 8.97$ (p = 0.002) <sup>†</sup>		

<sup>c</sup> This table presents the results of Hypothesis 1, which concerns the third person fraud reporting likelihood through the company's internal hotline. ANOVA results with the first person likelihood judgment with inclusion of a covariate to control for the social desirability bias provide similar inferences: *Clawback* ( $F_{(1,91)} = 6.14$ ,  $p = 0.015$ ), *Bonus* ( $F_{(1,91)} = 9.50$ ,  $p = 0.003$ ), *Bonus × Clawback*<sup>†</sup> ( $F_{(1,91)} = 2.96$ ,  $p = 0.045$ ), *SD Covariate* ( $F_{(1,91)} = 49.82$ ,  $p < 0.001$ ). <sup>†</sup> indicates a one-tailed given prediction, all other p-values are two-tailed. See Table 2 for variable definitions.



**Table 4: Effect of Clawback and Bonus on Fraud Reporting through the SEC Hotline**

**Panel A: General Linear Model (ANOVA)<sup>d</sup>**

Source	SS	df	MS	F-stat	p-value
Clawback	1.63	1	1.63	0.70	0.405
Bonus	10.62	1	10.62	4.56	0.035
Clawback × Bonus	1.66	1	1.66	0.71	0.201 <sup>†</sup>
Error	214.33	92	2.33		
Total	2338.00	96			

**Panel B: Cell Means (Standard Deviation)**

	SOX Regime	DF Regime	Totals	Simple Effects
<b>Low Bonus</b>	5.04 (1.82) n = 23	5.05 (1.65) n = 22	5.04 (1.72) n = 45	$F_{(1,92)} = 0.00$ (p = 0.004)
<b>High Bonus</b>	4.64 (1.35) n = 25	4.12 (1.28) n = 26	4.37 (1.33) n = 51	$F_{(1,92)} = 1.51$ (p = 0.223)
	4.83 (1.59) n = 48	4.54 (1.52) n = 48	4.59 (1.85) n = 96	
<b>Simple Effects</b>	$F_{(1,92)} = 0.84$ (p = 0.363)	$F_{(1,92)} = 4.43$ (p = 0.019) <sup>†</sup>		

<sup>d</sup> This table presents the results of the tests of Hypothesis 2, which concerns the third person fraud reporting likelihood through the SEC hotline. ANOVA results with the first person likelihood judgment with inclusion of a covariate to control for the social desirability bias provide similar inferences (*Clawback* ( $F_{(1,91)} = 1.66$ ,  $p = 0.201$ ), *Bonus* ( $F_{(1,91)} = 3.04$ ,  $p = 0.084$ ), *Bonus × Clawback*<sup>†</sup> ( $F_{(1,91)} = 01.10$ ,  $p = 0.149$ ), *SD Covariate* ( $F_{(1,91)} = 32.71$ ,  $p < 0.001$ ). <sup>†</sup> indicates a one-tailed given prediction, all other p-values are two-tailed. See Table 2 for variable definitions.

**Table 5: Effect of Clawback, Bonus, and Likelihood of Claiming a Bonus on Fraud Reporting through the SEC Hotline**

**Panel A: General Linear Model (ANCOVA)<sup>e</sup>**

Source	SS	df	MS	F-stat	p-value
Clawback	5.24	1	5.24	2.58	0.112
Bonus	6.76	1	6.76	3.32	0.072
Clawback × Bonus	0.05	1	0.05	0.03	0.438 <sup>†</sup>
Likelihood of claiming bonus	29.18	1	29.18	14.34	<0.001
Error	185.15	91	2.04		
Total	2338.00	96			

$R^2 = 0.190$  (Adj.  $R^2 = 0.155$ )

**Panel B: Estimated Marginal Means (Standard Errors)**

	SOX Regime	DF Regime	Totals	Simple Effects
<b>Low Bonus</b>	5.19 (0.30) n = 23	4.76 (0.31) n = 22	4.97 (0.22) n = 45	$F_{(1,91)} = 0.95$ $p = 0.331$
<b>High Bonus</b>	4.70 (0.29) n = 25	4.18 (0.28) n = 26	4.44 (0.20) n = 51	$F_{(1,91)} = 1.72$ $p = 0.193$
<b>Totals</b>	4.94 (0.21) n = 48	4.47 (0.21) n = 48	4.71 (0.15) n = 96	
<b>Simple Effects</b>	$F_{(1,91)} = 1.40$ $p = 0.240$	$F_{(1,91)} = 1.89$ $p = 0.086^{\dagger}$		

<sup>e</sup> This table presents the results of Hypothesis 2, which concerns the third person fraud reporting likelihood through the SEC's hotline. ANOVA results with the first person likelihood judgment with inclusion of a covariate to control for the social desirability bias provide similar inferences (*Clawback* ( $F_{(1,90)} = 3.27$ ,  $p = 0.074$ ), *Bonus*<sup>†</sup> ( $F_{(1,90)} = 3.04$ ,  $p = 0.026$ ), *Bonus* × *Clawback*<sup>†</sup> ( $F_{(1,90)} = 0.16$ ,  $p = 0.347$ ), *SD Covariate* ( $F_{(1,90)} = 35.73$ ,  $p < 0.001$ ), *Bonus Claim Likelihood* ( $F_{(1,90)} = 12.81$ ,  $p = 0.001$ )). <sup>†</sup> indicates a one-tailed given prediction, all other p-values are two-tailed. See Table 2 for variable definitions.