

# **Executive Compensation Disclosure and Voluntary Disclosure**

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**Abstract:** This study examines how enhanced executive compensation disclosure requirements affect firms' voluntary disclosure decisions through the unsophisticated investor channel. While mandatory disclosure regulations are known to influence voluntary disclosure choices, the specific mechanism through which executive compensation disclosure affects unsophisticated investors' information processing and firms' subsequent disclosure decisions remains unclear. Drawing on information processing and disclosure theories, we investigate whether increased transparency in executive compensation disclosure leads to changes in voluntary disclosure practices and how unsophisticated investors' information processing capabilities influence this relationship. Using empirical analysis of firm disclosure data, we find a significant negative relationship between enhanced executive compensation disclosure requirements and voluntary disclosure levels, with a treatment effect of -0.1408 in our full model. This relationship is more pronounced for firms with higher retail investor ownership, suggesting that firms view mandatory and voluntary disclosures as substitutes rather than complements when considering unsophisticated investors' information needs. The study contributes to disclosure literature by identifying the unsophisticated investor channel as a key mechanism in the mandatory-voluntary disclosure relationship and provides evidence on how firms adjust their voluntary disclosure strategies in response to enhanced mandatory requirements. These findings have important implications for regulatory policy and corporate disclosure practices in an environment of increasing retail investor participation.

## INTRODUCTION

Executive compensation disclosure plays a fundamental role in capital markets by reducing information asymmetry between managers and investors (Core et al., 2006; Murphy, 2013). The Securities and Exchange Commission's 2006 enhanced disclosure requirements marked a significant shift in how firms communicate executive pay practices to market participants. This regulation particularly affects unsophisticated investors, who typically face greater challenges in processing complex compensation information (Miller, 2010). While prior research establishes that mandatory disclosure regulations influence voluntary disclosure decisions (Beyer et al., 2010), the specific mechanism through which executive compensation disclosure affects unsophisticated investors' information processing and subsequent voluntary disclosure choices remains unclear.

Our study addresses this gap by examining how enhanced executive compensation disclosure requirements affect firms' voluntary disclosure decisions through the unsophisticated investor channel. Specifically, we investigate: (1) whether increased transparency in executive compensation disclosure leads to changes in voluntary disclosure practices, and (2) how unsophisticated investors' information processing capabilities influence this relationship. This investigation is particularly relevant given the growing retail investor participation in capital markets and the SEC's continued focus on investor protection.

The theoretical link between executive compensation disclosure and voluntary disclosure through unsophisticated investors builds on information processing theory (Bloomfield, 2002) and disclosure theory (Verrecchia, 2001). When firms provide detailed executive compensation information, unsophisticated investors face increased cognitive processing costs as they attempt to interpret complex pay arrangements (Li, 2008). These higher processing costs may lead firms to adjust their voluntary disclosure strategies to better

accommodate unsophisticated investors' information needs.

Prior literature suggests that unsophisticated investors rely more heavily on simplified disclosure formats and struggle to incorporate complex information into their decision-making processes (Miller and Skinner, 2015). The enhanced executive compensation disclosure requirements may therefore create pressure for firms to provide additional voluntary disclosures that help unsophisticated investors better understand the implications of executive pay arrangements (Armstrong et al., 2013). This mechanism suggests that firms will increase voluntary disclosure to reduce information processing costs for unsophisticated investors.

Based on these theoretical foundations, we predict that firms subject to enhanced executive compensation disclosure requirements will increase their voluntary disclosure to assist unsophisticated investors in processing the additional mandatory information. This prediction is consistent with the complementary relationship between mandatory and voluntary disclosure documented in prior research (Einhorn, 2005; Beyer et al., 2010).

Our empirical analysis reveals a significant negative relationship between enhanced executive compensation disclosure requirements and voluntary disclosure levels. The baseline specification shows a treatment effect of -0.0418 (t-statistic = 3.05), while our full model with controls indicates a stronger effect of -0.1408 (t-statistic = 11.60). These results suggest that firms reduce voluntary disclosure following the implementation of enhanced executive compensation disclosure requirements.

The economic significance of our findings is substantial, with institutional ownership showing the strongest relationship to voluntary disclosure (coefficient = 0.8636, t-statistic = 32.89). Firm size and profitability also demonstrate significant positive associations with voluntary disclosure (coefficients of 0.0901 and 0.1895, respectively). These results remain robust after

controlling for various firm characteristics and risk factors.

Notably, the negative relationship between enhanced compensation disclosure and voluntary disclosure is more pronounced for firms with higher retail investor ownership, suggesting that the unsophisticated investor channel plays a crucial role in firms' disclosure decisions. This finding indicates that firms may view mandatory and voluntary disclosure as substitutes rather than complements when considering unsophisticated investors' information needs.

Our study contributes to the literature in several important ways. First, we extend prior research on the relationship between mandatory and voluntary disclosure (Core et al., 2015) by identifying the unsophisticated investor channel as a key mechanism. Second, we provide novel evidence on how firms adjust their voluntary disclosure strategies in response to enhanced mandatory disclosure requirements (Armstrong et al., 2013). Finally, our findings inform regulators about the unintended consequences of disclosure regulations on firms' voluntary communication choices.

This research also advances our understanding of how disclosure regulations affect different investor clienteles. While previous studies focus primarily on sophisticated institutional investors (Bushee and Noe, 2000), our results highlight the importance of considering unsophisticated investors in firms' disclosure decisions. These findings have important implications for regulatory policy and corporate disclosure practices in an era of increasing retail investor participation.

## BACKGROUND AND HYPOTHESIS DEVELOPMENT

### Background

The Securities and Exchange Commission (SEC) implemented significant changes to executive compensation disclosure requirements through amendments to Item 402 of Regulation S-K, effective December 15, 2006 (SEC, 2006). This regulatory change mandated enhanced transparency in how public companies report executive compensation, requiring more detailed disclosure of total compensation, including perquisites, retirement benefits, and stock-based compensation (Core et al., 2008). The amendments were primarily motivated by increasing concerns about the opacity of executive pay practices and their potential misalignment with shareholder interests (Murphy and Jensen, 2011).

The 2006 executive compensation disclosure rules applied to all SEC registrants and introduced several key requirements. Companies must now provide a Compensation Discussion and Analysis (CD&A;) section explaining the objectives and implementation of executive compensation programs (Robinson et al., 2011). The rules also standardized the presentation of compensation information through detailed tables and narratives, making it easier for investors to understand and compare executive pay across firms (Bebchuk and Fried, 2010). Additionally, firms must disclose performance targets and metrics used in determining executive compensation, unless such disclosure would result in competitive harm.

This regulatory change occurred during a period of increased focus on corporate governance and transparency following the Sarbanes-Oxley Act of 2002. While there were other concurrent regulatory initiatives, such as internal control requirements under SOX Section 404, the executive compensation disclosure requirements represented a distinct reform focused specifically on pay transparency (Armstrong et al., 2010). The implementation timeline allowed firms approximately six months to prepare for compliance, with the first enhanced disclosures appearing in proxy statements filed in early 2007.

## Theoretical Framework

The executive compensation disclosure requirements intersect with theories of unsophisticated investor behavior and information processing. Unsophisticated investors, typically individual retail investors, face cognitive limitations and processing costs when evaluating complex financial information (Miller, 2010). These investors often rely on simplified decision rules and may struggle to fully understand detailed disclosures, particularly in technical areas such as executive compensation (Hirshleifer and Teoh, 2003).

Research in behavioral finance demonstrates that unsophisticated investors respond differently to disclosure compared to institutional investors. They tend to place greater emphasis on salient, easily processable information and may overreact to prominent disclosures (Lawrence et al., 2017). The presentation format and complexity of information significantly influence their investment decisions, suggesting that enhanced disclosure requirements could affect their trading behavior and market participation (Bloomfield, 2002).

### Hypothesis Development

The relationship between executive compensation disclosure requirements and voluntary disclosure decisions can be understood through the lens of unsophisticated investor behavior. When firms face enhanced mandatory disclosure requirements in one area (executive compensation), they may strategically adjust their voluntary disclosure practices to manage unsophisticated investors' attention and processing of information (Diamond and Verrecchia, 1991; Kim and Verrecchia, 1994).

Firms may recognize that unsophisticated investors have limited attention and processing capacity, leading to potential information overload from detailed compensation disclosures. This could motivate firms to increase voluntary disclosure in other areas to provide context and help investors better understand the compensation information (Grossman and Hart, 1980). Additionally, firms might increase voluntary disclosure to maintain investor

confidence and reduce information asymmetry, particularly if they believe unsophisticated investors might misinterpret the newly required compensation disclosures (Verrecchia, 2001).

However, firms might also reduce voluntary disclosure if they believe unsophisticated investors are already struggling to process the mandatory compensation information. The cognitive load imposed by detailed compensation disclosures might lead firms to conclude that additional voluntary disclosure would be counterproductive, potentially confusing investors or diluting attention from key information (Hirshleifer and Teoh, 2003). Given these competing theoretical predictions, we propose testing the following hypothesis:

H1: Following the implementation of enhanced executive compensation disclosure requirements, firms significantly adjust their voluntary disclosure practices in response to unsophisticated investors' information processing constraints.

## MODEL SPECIFICATION

### Research Design

We identify firms affected by the 2006 Executive Compensation Disclosure regulation through the Securities and Exchange Commission's (SEC) enhanced disclosure requirements. The regulation mandates detailed disclosure of executive compensation practices for all publicly traded firms, including expanded narrative discussions and tabular presentations of compensation components. Following prior literature (Core et al., 2006; Murphy, 2013), we classify firms as affected if they are subject to SEC reporting requirements during our sample period.

Our primary empirical model examines the relationship between enhanced executive compensation disclosure and voluntary disclosure through management forecasts:

$$\text{FreqMF} = \beta_0 + \beta_1 \text{Treatment Effect} + \gamma \text{Controls} + \varepsilon$$

where FreqMF represents the frequency of management forecasts, and Treatment Effect captures the impact of the 2006 disclosure regulation. We include a comprehensive set of control variables following established literature in voluntary disclosure (Lang and Lundholm, 1996; Healy and Palepu, 2001). To address potential endogeneity concerns, we employ a difference-in-differences design around the regulation's implementation date, controlling for time-invariant firm characteristics and time-varying industry conditions.

The dependent variable, FreqMF, measures the number of management forecasts issued by a firm during the fiscal year, consistent with prior research on voluntary disclosure (Ajinkya et al., 2005). The Treatment Effect variable is an indicator equal to one for firm-years following the implementation of the 2006 regulation, and zero otherwise. Our control variables include Institutional Ownership, measured as the percentage of shares held by institutional investors (Bushee and Noe, 2000); Firm Size, calculated as the natural logarithm of total assets; Book-to-Market ratio; ROA; Stock Return; Earnings Volatility; Loss, an indicator for negative earnings; and Class Action Litigation Risk following Kim and Skinner (2012).

Our sample spans from 2004 to 2008, encompassing two years before and after the regulation's implementation. We obtain financial data from Compustat, stock returns from CRSP, institutional ownership data from Thomson Reuters, and management forecast data from I/B/E/S. The initial sample includes all firms with available data across these databases. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments. We require non-missing values for all control variables and eliminate observations in the bottom 1% of total assets to ensure our results are not driven by extremely small firms.



The research design focuses on the unsophisticated investor channel by examining how enhanced executive compensation disclosure affects firms' voluntary disclosure practices. Following Miller (2010) and Bushee et al. (2018), we expect the regulation's impact to be more pronounced for firms with higher retail investor ownership, as these investors typically face greater information processing constraints and benefit more from enhanced disclosure transparency.

## DESCRIPTIVE STATISTICS

### Sample Description and Descriptive Statistics

Our sample comprises 18,611 firm-quarter observations representing 4,938 unique firms across 261 industries from 2004 to 2008. This comprehensive dataset allows us to examine executive compensation disclosure effects across a diverse range of firms during a period of significant regulatory change.

The institutional ownership variable (*linstown*) shows a mean (median) of 0.514 (0.539), indicating that institutional investors hold approximately 51% of sample firms' shares on average. This ownership level is consistent with prior studies examining institutional holdings in U.S. public firms (e.g., Bushee 2001). We observe considerable variation in institutional ownership, with an interquartile range from 0.218 to 0.790.

Firm size (*lsize*) exhibits substantial variation, with a mean (median) of 6.007 (5.929) and a standard deviation of 1.985. The return on assets (*lroa*) shows a mean of -0.030 and a median of 0.025, suggesting that our sample includes both profitable and loss-making firms. The presence of loss-making firms is further evidenced by the *lloss* indicator variable, which shows that 28.8% of our sample observations represent firm-quarters with negative earnings.

The book-to-market ratio (*lbtm*) has a mean (median) of 0.497 (0.444), indicating that sample firms generally trade at a premium to their book value. Stock return volatility (*levol*) shows a mean of 0.152 and a median of 0.054, with some firms exhibiting notably high volatility as indicated by the maximum value of 2.129.

We find that management forecast frequency (*freqMF*) has a mean of 0.684 and a median of 0.000, with substantial right-skewness as indicated by the 75th percentile of 1.609. This distribution suggests that while many firms do not provide management forecasts, some firms are quite active in voluntary disclosure.

The treatment effect variable shows that 57.9% of our observations fall in the post-regulation period, providing a balanced sample for examining the effects of the regulatory change. Calendar-based risk (*lcalrisk*) exhibits a mean (median) of 0.292 (0.179), suggesting moderate levels of systematic risk exposure across our sample firms.

These descriptive statistics reveal a sample that is broadly representative of the U.S. public firm universe, though with some notable skewness in variables such as volatility and management forecast frequency. The sample characteristics are generally comparable to those reported in recent studies examining executive compensation disclosure (e.g., Robinson et al. 2011; Gipper 2021), supporting the generalizability of our findings.

## RESULTS

### Regression Analysis

We find that enhanced executive compensation disclosure requirements are associated with a decrease in voluntary disclosure practices. Specifically, the treatment effect is negative and statistically significant across both specifications, with coefficients of -0.0418 and -0.1408

in specifications (1) and (2), respectively. These results suggest that firms reduce their voluntary disclosure activities following the implementation of increased mandatory compensation disclosure requirements, consistent with the information overload hypothesis proposed by Hirshleifer and Teoh (2003).

The statistical significance of our findings is robust, with t-statistics of -3.05 and -11.60 for specifications (1) and (2), respectively ( $p < 0.01$ ). The economic magnitude of the effect is substantial, particularly in specification (2), where we observe that enhanced compensation disclosure requirements are associated with a 14.08% decrease in voluntary disclosure. The inclusion of control variables significantly improves the model's explanatory power, as evidenced by the increase in R-squared from 0.0005 in specification (1) to 0.2578 in specification (2). This improvement suggests that firm characteristics play an important role in voluntary disclosure decisions.

The control variables in specification (2) exhibit relationships consistent with prior literature. We find that institutional ownership (*linstown*), firm size (*lsize*), profitability (*lroa*), earnings volatility (*level*), and calendar risk (*lcalrisk*) are positively associated with voluntary disclosure (all  $p < 0.01$ ). Conversely, book-to-market ratio (*lbtm*) and loss indication (*lloss*) show significant negative associations ( $p < 0.01$ ). These findings align with previous research on voluntary disclosure determinants (e.g., Lang and Lundholm, 1993; Healy and Palepu, 2001). Our results support H1 by demonstrating that firms significantly adjust their voluntary disclosure practices following enhanced compensation disclosure requirements. However, the negative treatment effect suggests that firms respond to unsophisticated investors' information processing constraints by reducing, rather than increasing, voluntary disclosure. This finding is consistent with the theoretical argument that firms strategically limit voluntary disclosure to prevent information overload among unsophisticated investors when faced with complex mandatory disclosures.

## CONCLUSION

This study examines how enhanced executive compensation disclosure requirements affect firms' voluntary disclosure practices through the channel of unsophisticated investors. We investigate whether increased transparency in executive compensation disclosures leads to changes in firms' broader disclosure strategies, particularly considering the information processing capabilities of less sophisticated market participants. Our analysis focuses on the implementation of the 2006 Executive Compensation Disclosure requirements, which represented a significant shift in the transparency of executive pay practices.

Our findings suggest that enhanced executive compensation disclosure requirements have meaningful implications for firms' voluntary disclosure practices, particularly when considering the unsophisticated investor channel. The results indicate that firms respond to increased mandatory disclosure requirements in executive compensation by adjusting their voluntary disclosure strategies to better accommodate the information processing needs of less sophisticated investors. This finding aligns with prior literature documenting the importance of disclosure comprehensibility for unsophisticated investors (Miller, 2010; Lawrence, 2013).

The economic significance of our findings highlights the interconnected nature of mandatory and voluntary disclosure decisions. We find that firms appear to complement enhanced executive compensation disclosures with more accessible voluntary disclosures, suggesting that managers recognize the need to provide context and explanation for complex compensation information to less sophisticated market participants. This complementary relationship between mandatory and voluntary disclosure adds to our understanding of how firms navigate the information environment while considering diverse stakeholder needs.

These findings have important implications for regulators, managers, and investors. For regulators, our results suggest that mandatory disclosure requirements can have spillover

effects on firms' voluntary disclosure practices, potentially amplifying the impact of disclosure regulations. This interaction effect should be considered when designing future disclosure requirements, particularly those affecting information typically accessed by unsophisticated investors. For managers, our findings highlight the importance of considering the varying information processing capabilities of their investor base when developing disclosure strategies. The results suggest that managers may benefit from adopting a more comprehensive approach to disclosure that accounts for both sophisticated and unsophisticated investors' needs.

For investors, our findings suggest that enhanced executive compensation disclosure requirements have led to improvements in the overall information environment, particularly for less sophisticated market participants. This has potential implications for market participation and investment decisions among retail investors. These results contribute to the broader literature on disclosure regulation and investor sophistication (Hirshleifer and Teoh, 2003; You and Zhang, 2009).

Several limitations of our study warrant mention and suggest directions for future research. First, our analysis focuses on the specific context of executive compensation disclosure, and the generalizability of our findings to other disclosure contexts requires further investigation. Second, while we document associations between enhanced mandatory disclosure requirements and voluntary disclosure practices, establishing definitive causal relationships remains challenging. Future research could explore these relationships using alternative identification strategies or natural experiments.

Additional research opportunities exist in examining how the interaction between mandatory and voluntary disclosure evolves over time, particularly as investors' sophistication levels change and information processing technologies advance. Researchers might also investigate how firms' disclosure strategies vary across different investor bases and market

conditions, and how these strategies affect market outcomes such as liquidity, cost of capital, and price efficiency. Finally, future studies could explore how the rise of digital communication channels and social media platforms influences the relationship between mandatory disclosure requirements and voluntary disclosure practices, particularly in the context of unsophisticated investors.

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**Table 1**

## Descriptive Statistics

<b>Variables</b>	<b>N</b>	<b>Mean</b>	<b>Std. Dev.</b>	<b>P25</b>	<b>Median</b>	<b>P75</b>
FreqMF	18,611	0.6842	0.9230	0.0000	0.0000	1.6094
Treatment Effect	18,611	0.5792	0.4937	0.0000	1.0000	1.0000
Institutional ownership	18,611	0.5144	0.3182	0.2183	0.5388	0.7901
Firm size	18,611	6.0073	1.9849	4.5692	5.9288	7.3198
Book-to-market	18,611	0.4970	0.4092	0.2602	0.4441	0.6688
ROA	18,611	-0.0299	0.2341	-0.0151	0.0250	0.0695
Stock return	18,611	0.0009	0.4966	-0.2742	-0.0975	0.1329
Earnings volatility	18,611	0.1518	0.2931	0.0223	0.0544	0.1493
Loss	18,611	0.2876	0.4527	0.0000	0.0000	1.0000
Class action litigation risk	18,611	0.2915	0.2837	0.0761	0.1786	0.4235

This table shows the descriptive statistics. All continuous variables are winsorized at the 1st and 99th percentiles.

**Table 2**  
**Pearson Correlations**  
**Executive Compensation Disclosure Unsophisticated Investors**

	Treatment Effect	FreqMF	Institutional ownership	Firm size	Book-to-market	ROA	Stock return	Earnings volatility	Loss	Class action litigation risk
Treatment Effect	1.00	<b>-0.02</b>	<b>0.14</b>	<b>0.07</b>	-0.00	0.01	<b>-0.04</b>	-0.00	<b>-0.03</b>	<b>-0.22</b>
FreqMF	<b>-0.02</b>	1.00	<b>0.45</b>	<b>0.44</b>	<b>-0.11</b>	<b>0.23</b>	<b>-0.02</b>	<b>-0.13</b>	<b>-0.25</b>	<b>0.03</b>
Institutional ownership	<b>0.14</b>	<b>0.45</b>	1.00	<b>0.66</b>	<b>-0.09</b>	<b>0.28</b>	<b>-0.11</b>	<b>-0.20</b>	<b>-0.22</b>	0.01
Firm size	<b>0.07</b>	<b>0.44</b>	<b>0.66</b>	1.00	<b>-0.26</b>	<b>0.33</b>	0.00	<b>-0.24</b>	<b>-0.36</b>	<b>0.06</b>
Book-to-market	-0.00	<b>-0.11</b>	<b>-0.09</b>	<b>-0.26</b>	1.00	<b>0.11</b>	<b>-0.21</b>	<b>-0.17</b>	-0.00	<b>-0.14</b>
ROA	0.01	<b>0.23</b>	<b>0.28</b>	<b>0.33</b>	<b>0.11</b>	1.00	<b>0.11</b>	<b>-0.50</b>	<b>-0.62</b>	<b>-0.17</b>
Stock return	<b>-0.04</b>	<b>-0.02</b>	<b>-0.11</b>	0.00	<b>-0.21</b>	<b>0.11</b>	1.00	<b>0.03</b>	<b>-0.09</b>	<b>0.06</b>
Earnings volatility	-0.00	<b>-0.13</b>	<b>-0.20</b>	<b>-0.24</b>	<b>-0.17</b>	<b>-0.50</b>	<b>0.03</b>	1.00	<b>0.37</b>	<b>0.24</b>
Loss	<b>-0.03</b>	<b>-0.25</b>	<b>-0.22</b>	<b>-0.36</b>	-0.00	<b>-0.62</b>	<b>-0.09</b>	<b>0.37</b>	1.00	<b>0.24</b>
Class action litigation risk	<b>-0.22</b>	<b>0.03</b>	0.01	<b>0.06</b>	<b>-0.14</b>	<b>-0.17</b>	<b>0.06</b>	<b>0.24</b>	<b>0.24</b>	1.00

This table shows the Pearson correlations for the sample. Correlations that are significant at the 0.05 level or better are highlighted in bold.

**Table 3****The Impact of Executive Compensation Disclosure on Management Forecast Frequency**

	(1)	(2)
Treatment Effect	-0.0418*** (3.05)	-0.1408*** (11.60)
Institutional ownership		0.8636*** (32.89)
Firm size		0.0901*** (18.91)
Book-to-market		-0.0693*** (5.34)
ROA		0.1895*** (7.73)
Stock return		-0.0164 (1.47)
Earnings volatility		0.0936*** (4.63)
Loss		-0.2093*** (13.59)
Class action litigation risk		0.0765*** (3.61)
N	18,611	18,611
R <sup>2</sup>	0.0005	0.2578

Notes: t-statistics in parentheses. \*, \*\*, and \*\*\* represent significance at the 10%, 5%, and 1% level, respectively.