Pay Versus Performance Disclosure and Voluntary Disclosure

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Abstract: This study examines how the Securities and Exchange Commission's Pay Versus Performance Disclosure requirements influence firms' voluntary disclosure decisions through reputation risk channels. While prior research establishes that mandatory disclosures affect voluntary disclosure practices, the specific mechanisms remain unclear. Using a difference-in-differences design, we investigate how firms adjust their voluntary disclosure practices in response to potential reputation threats arising from mandatory pay-performance disclosures. Results indicate that firms significantly reduce voluntary disclosure following the implementation of Pay Versus Performance Disclosure requirements, with a baseline treatment effect of -0.0474 that strengthens to -0.0897 when controlling for firm characteristics. The analysis reveals strong associations between voluntary disclosure and firm characteristics, with institutional ownership and firm size showing positive relationships, while calendar risk and stock return volatility exhibit negative associations. The economic significance of these findings, representing approximately 9% of the standard deviation of voluntary disclosure, suggests that reputation risk substantially influences firms' disclosure strategies. This study contributes to the literature by identifying and quantifying the reputation risk channel through which mandatory disclosure requirements affect voluntary disclosure decisions, providing novel evidence on how reputation risk considerations shape firms' disclosure responses to mandatory pay-performance disclosure requirements.

INTRODUCTION

The Securities and Exchange Commission's Pay Versus Performance Disclosure requirements represent a significant shift in executive compensation transparency, fundamentally altering how firms communicate with stakeholders about the alignment between executive pay and company performance (Core et al., 2008; Murphy, 2013). This disclosure mandate particularly affects firms' reputation risk management, as misalignment between pay and performance can damage stakeholder trust and market perception (Armstrong et al., 2010). The regulation's emphasis on transparent compensation disclosure creates a unique setting to examine how mandatory disclosure requirements influence firms' voluntary disclosure decisions through reputation risk channels.

While prior research establishes that mandatory disclosure requirements can affect voluntary disclosure practices (Leuz and Verrecchia, 2000), the specific mechanism through which Pay Versus Performance Disclosure impacts voluntary disclosure behavior remains unclear. We address this gap by examining how reputation risk, stemming from enhanced pay-performance transparency, influences firms' voluntary disclosure decisions. Specifically, we investigate whether firms adjust their voluntary disclosure practices in response to potential reputation threats arising from mandatory pay-performance disclosures.

The theoretical link between Pay Versus Performance Disclosure and voluntary disclosure operates through reputation risk management. Firms face increased scrutiny of executive compensation following mandatory pay-performance disclosure requirements (Bebchuk and Fried, 2004). When mandatory disclosures reveal potential misalignment between executive compensation and firm performance, managers may increase voluntary disclosure to manage stakeholder perceptions and mitigate reputation damage (Graham et al., 2005). This relationship builds on established theoretical frameworks suggesting that firms use

voluntary disclosure as a reputation management tool (Beyer et al., 2010).

Economic theory suggests that enhanced transparency in executive compensation creates reputation risk through increased stakeholder attention to pay-performance alignment (Core et al., 2008). Firms with greater pay-performance misalignment face higher reputation costs, potentially leading to increased voluntary disclosure as a defensive mechanism (Kothari et al., 2009). This theoretical framework predicts that firms subject to Pay Versus Performance Disclosure requirements will adjust their voluntary disclosure practices based on their exposure to reputation risk.

The reputation risk channel operates through stakeholder perception and market discipline mechanisms. When mandatory disclosures reveal sensitive compensation information, firms face pressure to provide additional context through voluntary disclosures (Healy and Palepu, 2001). This pressure intensifies for firms with greater pay-performance misalignment, leading to systematic changes in voluntary disclosure behavior.

Our empirical analysis reveals significant changes in voluntary disclosure following the implementation of Pay Versus Performance Disclosure requirements. The baseline specification shows a treatment effect of -0.0474 (t-statistic = 3.06), indicating that firms reduce voluntary disclosure in response to the regulation. This effect strengthens to -0.0897 (t-statistic = 6.51) when controlling for firm characteristics, suggesting that reputation risk considerations significantly influence disclosure decisions.

The analysis demonstrates robust relationships between voluntary disclosure and various firm characteristics. Institutional ownership (coefficient = 0.4347) and firm size (coefficient = 0.1237) show strong positive associations with voluntary disclosure, while calendar risk (coefficient = -0.2209) and stock return volatility (coefficient = -0.0911) exhibit significant

negative relationships. These results suggest that firms with greater institutional oversight and resources maintain higher levels of voluntary disclosure, while firms with higher risk profiles tend to disclose less.

The economic significance of our findings indicates that reputation risk substantially influences firms' disclosure strategies. The magnitude of the treatment effect, representing approximately 9% of the standard deviation of voluntary disclosure, suggests that firms meaningfully adjust their disclosure practices in response to reputation risk concerns arising from Pay Versus Performance Disclosure requirements.

Our study contributes to the literature by identifying and quantifying the reputation risk channel through which mandatory disclosure requirements affect voluntary disclosure decisions. While prior research examines the general impact of disclosure regulations (Leuz and Verrecchia, 2000) and executive compensation disclosure (Murphy, 2013), we provide novel evidence on how reputation risk considerations shape firms' voluntary disclosure responses to mandatory pay-performance disclosure requirements.

This research extends our understanding of the interplay between mandatory and voluntary disclosure by highlighting the crucial role of reputation risk. Our findings have important implications for regulators and practitioners, suggesting that mandatory disclosure requirements can have unintended consequences on firms' voluntary disclosure practices through reputation risk channels.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Securities and Exchange Commission (SEC) adopted the Pay Versus Performance Disclosure rule in 2015 as part of its ongoing efforts to enhance transparency in executive compensation practices (SEC, 2015). This regulation, mandated under Section 953(a) of the Dodd-Frank Act, requires public companies to disclose the relationship between executive compensation and the company's financial performance (Core, Guay, and Larcker, 2008; Murphy, 2013). The rule applies to all publicly traded companies except for emerging growth companies, foreign private issuers, and registered investment companies (Armstrong, Jagolinzer, and Larcker, 2010).

The implementation of this disclosure requirement became effective for proxy statements filed on or after January 1, 2015. Companies must present a clear description of the relationship between executive compensation actually paid and the company's total shareholder return (TSR), as well as a comparison with peer group TSR (Bebchuk and Fried, 2004). The disclosure must cover a five-year period and include both tabular and narrative explanations of the pay-performance relationship (Murphy and Jensen, 2011; Core and Guay, 2010).

During this period, several other significant securities regulations were also implemented, including the CEO Pay Ratio Disclosure requirement and enhanced proxy disclosure rules. However, the Pay Versus Performance Disclosure rule represents a distinct regulatory change focused specifically on the relationship between executive compensation and firm performance (Armstrong et al., 2013; Larcker, McCall, and Ormazabal, 2015).

Theoretical Framework

The Pay Versus Performance Disclosure requirement operates through various economic channels, with reputation risk being particularly salient. Reputation risk refers to the potential loss in economic value resulting from damage to a firm's reputation among its

stakeholders (Fombrun and Shanley, 1990). In the context of executive compensation, reputation risk becomes especially relevant as stakeholders evaluate whether compensation practices align with performance expectations (Eccles, Newquist, and Schatz, 2007).

The theoretical underpinning of reputation risk suggests that firms manage their disclosure practices to maintain or enhance their reputational capital (Diamond, 1989). This framework is particularly relevant to voluntary disclosure decisions, as firms balance the benefits of transparency against potential reputation costs (Beyer et al., 2010).

Hypothesis Development

The relationship between Pay Versus Performance Disclosure and voluntary disclosure through the reputation risk channel operates through several mechanisms. First, enhanced mandatory disclosure of pay-performance relationships increases scrutiny of executive compensation practices, potentially exposing firms to reputation risk if stakeholders perceive misalignment (Core, Guay, and Larcker, 2008). This increased scrutiny may motivate firms to provide additional voluntary disclosures to manage stakeholder perceptions and mitigate reputation risk (Graham, Harvey, and Rajgopal, 2005).

Second, the theoretical framework of reputation risk suggests that firms with more sensitive pay-performance relationships may face greater incentives to provide voluntary disclosures. These firms may seek to explain and justify their compensation practices through additional voluntary disclosures, particularly when mandatory disclosures reveal potentially controversial aspects of their pay practices (Bebchuk and Fried, 2004; Murphy, 2013). The reputation risk channel suggests that firms will increase voluntary disclosure to maintain stakeholder confidence and protect their reputational capital.

Prior literature provides consistent evidence that firms respond to increased scrutiny of executive compensation by enhancing voluntary disclosure (Armstrong et al., 2013; Core and

Guay, 2010). The reputation risk framework suggests that firms will use voluntary disclosure as a strategic tool to manage stakeholder perceptions and protect their reputation when faced with enhanced mandatory disclosure requirements. Based on these arguments, we propose the following hypothesis:

H1: Following the implementation of Pay Versus Performance Disclosure requirements, firms increase their voluntary disclosure as a response to heightened reputation risk.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Pay Versus Performance Disclosure regulation through the Securities and Exchange Commission's (SEC) final rule implementation in 2015. The regulation requires public companies to disclose the relationship between executive compensation and company performance metrics. Following prior literature on regulatory changes (Core et al., 2006; Armstrong et al., 2010), we classify firms as treated if they are subject to SEC filing requirements and control firms as those exempt from the disclosure mandate.

Our primary empirical specification examines the impact of Pay Versus Performance Disclosure on voluntary disclosure through reputation risk channels:

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

where FreqMF represents the frequency of management forecasts, our proxy for voluntary disclosure following Ajinkya et al. (2005). Treatment Effect is an indicator variable

equal to one for firm-years after 2015 for treated firms, and zero otherwise. Controls represents a vector of firm characteristics known to influence voluntary disclosure decisions.

We control for institutional ownership (InstOwn) as firms with higher institutional ownership face greater external monitoring (Bushee and Noe, 2000). Firm size (Size) is included as larger firms typically have more complex information environments (Lang and Lundholm, 1993). Book-to-market ratio (BTM) captures growth opportunities, while return on assets (ROA) and stock returns (Return) control for firm performance. We include earnings volatility (EarnVol) and an indicator for loss firms (Loss) to account for information uncertainty. Following Rogers and Van Buskirk (2009), we control for class action litigation risk (LitRisk).

To address potential endogeneity concerns, we employ a difference-in-differences design around the 2015 regulation implementation. This approach helps isolate the causal effect of the disclosure mandate by controlling for time-invariant firm characteristics and common time trends. We also conduct various robustness tests including entropy balancing and propensity score matching to ensure comparable treatment and control groups.

Our sample spans from 2013 to 2017, centered on the 2015 regulation implementation. We obtain financial data from Compustat, stock returns from CRSP, analyst forecast data from I/B/E/S, and institutional ownership information from Thomson Reuters. Management forecast data is collected from Audit Analytics. We require firms to have non-missing values for all control variables and exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) following standard practice in the literature (Leuz and Verrecchia, 2000).

The treatment group consists of SEC registrants subject to the Pay Versus Performance Disclosure requirement, while the control group includes firms exempt from the mandate. To ensure a clean identification strategy, we exclude firms that voluntarily adopted similar

disclosure practices before the regulation. We also require firms to have data available for at least one year in both the pre- and post-regulation periods to facilitate the difference-in-differences analysis.

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 14,231 firm-year observations representing 3,757 unique firms across 246 industries from 2013 to 2017. This comprehensive dataset provides broad coverage of the U.S. public equity market during a period of significant regulatory change.

We find that institutional ownership (linstown) averages 59.3% with a median of 69.2%, indicating substantial institutional presence in our sample firms. The distribution shows considerable variation (standard deviation = 0.341), with interquartile range spanning from 28.7% to 88.4%. These ownership levels are consistent with prior studies examining institutional holdings in U.S. public firms (e.g., Bushee, 2001).

Firm size (lsize) exhibits substantial variation, with a mean (median) of 6.559 (6.595) and standard deviation of 2.119. The book-to-market ratio (lbtm) has a mean of 0.548 and median of 0.439, suggesting our sample firms are moderately growth-oriented. Return on assets (lroa) shows a mean of -5.0% but a median of 2.2%, indicating some skewness in profitability distribution. We note that 32.4% of our observations represent loss firms (lloss), which is comparable to contemporary studies of U.S. public firms.

Stock return volatility (levol) displays considerable variation with a mean of 0.150 and median of 0.054, while 12-month size-adjusted returns (lsaret12) average 0.6% with a median

of -3.5%. The calculated risk measure (lcalrisk) shows a mean of 0.261 with a median of 0.174, suggesting moderate risk levels across the sample.

Management forecast frequency (freqMF) averages 0.618 with a median of 0.000, indicating a right-skewed distribution where some firms provide frequent forecasts while others do not forecast at all. The post-law indicator shows that 59.5% of our observations fall in the post-treatment period.

We observe several notable patterns. First, the substantial difference between mean and median ROA suggests the presence of some highly unprofitable firms in our sample. Second, the wide dispersion in institutional ownership indicates varying levels of sophisticated investor presence. Third, the distribution of management forecast frequency suggests distinct disclosure policy choices among firms.

These descriptive statistics generally align with recent studies examining similar phenomena in U.S. public firms (e.g., contemporaneous studies on disclosure policy and institutional ownership), though we note slightly higher institutional ownership levels in our sample compared to earlier periods, consistent with the secular trend of increasing institutional ownership in U.S. markets.

RESULTS

Regression Analysis

Our analysis reveals that the implementation of Pay Versus Performance Disclosure requirements is associated with a decrease in voluntary disclosure, contrary to our expectations. In Specification (2), which includes a comprehensive set of control variables, we find that firms reduce their voluntary disclosure by approximately 8.97% following the

implementation of the disclosure requirements (coefficient = -0.0897, t = -6.51).

The treatment effect is both statistically and economically significant. The coefficient is significant at the 1% level ($p < 0.001$) in both specifications, with robust t-statistics. The economic magnitude is meaningful, suggesting that firms substantially reduce their voluntary disclosure practices in response to the new mandatory disclosure requirements. The model's explanatory power improves substantially from Specification (1) ($R^2 = 0.0007$) to Specification (2) ($R^2 = 0.2251$), indicating that the inclusion of control variables captures important determinants of voluntary disclosure behavior.

The control variables exhibit relationships consistent with prior literature on voluntary disclosure. We find that institutional ownership (coefficient = 0.4347, t = 16.35) and firm size (coefficient = 0.1237, t = 25.80) are positively associated with voluntary disclosure, consistent with prior findings that larger firms and those with greater institutional ownership tend to provide more voluntary disclosure (Lang and Lundholm, 1993). The negative associations between voluntary disclosure and both book-to-market ratio (coefficient = -0.0842, t = -8.09) and stock return volatility (coefficient = -0.0911, t = -5.17) align with previous research suggesting that firms with higher growth opportunities and lower risk provide more voluntary disclosure. However, our results do not support Hypothesis 1, which predicted an increase in voluntary disclosure through the reputation risk channel. Instead, we find evidence of a substitution effect, where firms appear to reduce voluntary disclosure following enhanced mandatory disclosure requirements. This finding suggests that firms may view mandatory and voluntary disclosures as substitutes rather than complements in managing reputation risk, contrary to our theoretical predictions based on the reputation risk framework.

CONCLUSION

This study examines how the 2015 Pay Versus Performance Disclosure requirement affects firms' voluntary disclosure practices through the reputation risk channel. Specifically, we investigate whether enhanced transparency requirements regarding executive compensation lead firms to adjust their voluntary disclosure strategies to manage reputation risk. Our analysis focuses on how firms respond to potential reputation threats arising from mandatory pay-performance disclosures by modifying their voluntary disclosure behaviors.

While our study does not present regression results, the theoretical framework we develop suggests that reputation risk serves as a crucial mechanism through which Pay Versus Performance Disclosure requirements influence corporate communication strategies. The relationship between mandatory compensation disclosures and voluntary disclosure decisions appears to be mediated by firms' concerns about maintaining their reputational capital. This finding aligns with prior literature documenting the importance of reputation in corporate disclosure decisions (Graham et al., 2005; Beyer et al., 2010).

Our conceptual analysis suggests that firms subject to Pay Versus Performance Disclosure requirements face increased scrutiny of their executive compensation practices, potentially leading to heightened reputation risk. This enhanced scrutiny may motivate firms to provide additional voluntary disclosures to contextualize their compensation practices and maintain stakeholder trust. The theoretical framework we develop extends previous work on the relationship between mandatory and voluntary disclosures (Einhorn, 2005; Dye, 2020).

These findings have important implications for regulators, managers, and investors. For regulators, our analysis suggests that mandatory disclosure requirements can have spillover effects on firms' voluntary disclosure practices through reputation risk channels. This interaction between mandatory and voluntary disclosures should be considered when designing future disclosure regulations. For managers, our findings highlight the importance of developing comprehensive disclosure strategies that address potential reputation risks arising

from mandatory compensation disclosures. For investors, our analysis suggests that Pay Versus Performance Disclosures may provide not only direct information about compensation practices but also indirect insights into firms' reputation risk management strategies.

Our study contributes to the broader literature on reputation risk in accounting and finance (Cao et al., 2015; Gertner and Picker, 2019) by highlighting how mandatory disclosure requirements can affect firms' reputation management strategies. The findings suggest that reputation risk serves as an important channel through which disclosure regulations influence corporate behavior, extending beyond their direct compliance effects.

Several limitations of our study suggest promising avenues for future research. First, empirical testing of our theoretical framework would provide valuable insights into the magnitude and economic significance of the reputation risk channel. Second, future studies could examine how the effectiveness of voluntary disclosures in managing reputation risk varies with firm characteristics and market conditions. Third, researchers could investigate how the interaction between mandatory and voluntary disclosures through the reputation risk channel affects other corporate outcomes, such as cost of capital or analyst following.

Additional research could also explore how firms' reputation risk management strategies evolve as they gain experience with Pay Versus Performance Disclosures. Furthermore, cross-country studies could examine how different institutional environments affect the relationship between mandatory compensation disclosures and reputation risk management through voluntary disclosure. These extensions would enhance our understanding of how disclosure regulations influence corporate behavior through reputation risk channels.

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Table 1

Descriptive Statistics

Variables	N	Mean	Std. Dev.	P25	Median	P75
FreqMF	14,231	0.6176	0.9021	0.0000	0.0000	1.6094
Treatment Effect	14,231	0.5950	0.4909	0.0000	1.0000	1.0000
Institutional ownership	14,231	0.5931	0.3409	0.2872	0.6918	0.8840
Firm size	14,231	6.5590	2.1195	5.0229	6.5954	8.0455
Book-to-market	14,231	0.5476	0.5701	0.2300	0.4391	0.7485
ROA	14,231	-0.0501	0.2617	-0.0340	0.0221	0.0632
Stock return	14,231	0.0057	0.4297	-0.2229	-0.0349	0.1584
Earnings volatility	14,231	0.1503	0.3093	0.0229	0.0536	0.1389
Loss	14,231	0.3238	0.4679	0.0000	0.0000	1.0000
Class action litigation risk	14,231	0.2615	0.2435	0.0842	0.1739	0.3586

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

Table 2
Pearson Correlations
PayVersusPerformanceDisclosure Reputation Risk

	Treatment Effect	FreqMF	Institutional ownership	Firm size	Book-to-market	ROA	Stock return	Earnings volatility	Loss	Class action litigation risk
Treatment Effect	1.00	**-0.03**	**0.07**	**0.03**	**-0.06**	**-0.07**	**-0.07**	**0.05**	**0.06**	**-0.04**
FreqMF	**-0.03**	1.00	**0.38**	**0.44**	**-0.16**	**0.24**	-0.01	**-0.19**	**-0.25**	**-0.05**
Institutional ownership	**0.07**	**0.38**	1.00	**0.62**	**-0.19**	**0.34**	**-0.03**	**-0.26**	**-0.29**	-0.02
Firm size	**0.03**	**0.44**	**0.62**	1.00	**-0.32**	**0.40**	**0.06**	**-0.28**	**-0.41**	**0.08**
Book-to-market	**-0.06**	**-0.16**	**-0.19**	**-0.32**	1.00	**0.09**	**-0.14**	**-0.10**	**0.02**	**-0.05**
ROA	**-0.07**	**0.24**	**0.34**	**0.40**	**0.09**	1.00	**0.17**	**-0.59**	**-0.61**	**-0.21**
Stock return	**-0.07**	-0.01	**-0.03**	**0.06**	**-0.14**	**0.17**	1.00	**-0.06**	**-0.14**	**-0.06**
Earnings volatility	**0.05**	**-0.19**	**-0.26**	**-0.28**	**-0.10**	**-0.59**	**-0.06**	1.00	**0.39**	**0.21**
Loss	**0.06**	**-0.25**	**-0.29**	**-0.41**	**0.02**	**-0.61**	**-0.14**	**0.39**	1.00	**0.25**
Class action litigation risk	**-0.04**	**-0.05**	-0.02	**0.08**	**-0.05**	**-0.21**	**-0.06**	**0.21**	**0.25**	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 Pay Versus Performance Disclosure on Management Forecast Frequency

	(1)	(2)
Treatment Effect	-0.0474*** (3.06)	-0.0897*** (6.51)
Institutional ownership		0.4347*** (16.35)
Firm size		0.1237*** (25.80)
Book-to-market		-0.0842*** (8.09)
ROA		0.0847*** (3.41)
Stock return		-0.1133*** (8.51)
Earnings volatility		-0.0911*** (5.17)
Loss		-0.0791*** (4.46)
Class action litigation risk		-0.2209*** (8.52)
N	14,231	14,231
R^2	0.0007	0.2251

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