Executive Compensation Disclosure Reform and Voluntary Disclosure

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Abstract: This study examines how the 2006 Executive Compensation Disclosure Reform influences firms' voluntary disclosure decisions through changes in litigation risk. While prior research establishes that mandatory disclosure requirements affect voluntary disclosure practices, the specific mechanism linking executive compensation disclosure requirements to litigation risk and voluntary disclosure choices remains unexplored. Using a comprehensive dataset of U.S. public firms, we investigate how enhanced mandatory disclosure of executive compensation affects firms' assessment of litigation risk and their subsequent voluntary disclosure strategies. Our empirical analysis reveals that firms significantly reduced their voluntary disclosure following the reform, with a treatment effect of -0.1408. This relationship is particularly pronounced when controlling for firm characteristics, with institutional ownership, firm size, and return on assets emerging as significant determinants. The results demonstrate that increased litigation risk serves as a key mechanism through which compensation disclosure requirements affect voluntary disclosure decisions. The study contributes to the literature by establishing a direct link between compensation disclosure requirements and voluntary disclosure through the litigation risk channel, advancing our understanding of how regulatory reforms affect corporate disclosure behavior. These findings have important implications for policymakers considering future disclosure requirements and their potential unintended consequences on corporate communication

strategies.

INTRODUCTION

The 2006 Executive Compensation Disclosure Reform represents a significant shift in corporate transparency requirements, fundamentally altering how firms communicate executive pay practices to stakeholders. This regulatory change, implemented by the Securities and Exchange Commission (SEC), mandates enhanced disclosure of executive compensation details, including equity-based compensation and retirement benefits (Core et al., 2008; Murphy, 2012). The reform's introduction occurred against a backdrop of increasing public scrutiny of executive compensation and broader demands for corporate accountability, making it a crucial setting for examining how regulatory changes affect firm disclosure behavior through litigation risk channels (Armstrong et al., 2010).

A key unresolved question in the literature concerns how compensation disclosure requirements influence firms' voluntary disclosure decisions through changes in litigation risk. While prior research establishes that mandatory disclosure requirements can affect voluntary disclosure practices (Leuz and Verrecchia, 2000), the specific mechanism through which executive compensation disclosure requirements impact litigation risk and subsequent voluntary disclosure choices remains unclear. This study addresses this gap by examining how the 2006 reform altered firms' assessment of litigation risk and their resulting voluntary disclosure strategies.

The theoretical link between executive compensation disclosure and voluntary disclosure operates primarily through the litigation risk channel. Enhanced mandatory disclosure of executive compensation can increase litigation risk by providing potential plaintiffs with more detailed information about executive incentives and decision-making

(Rogers and Van Buskirk, 2009). This increased scrutiny may lead firms to adjust their voluntary disclosure practices to manage litigation exposure. Building on the theoretical framework of disclosure theory (Verrecchia, 2001), we posit that firms respond to heightened litigation risk by becoming more conservative in their voluntary disclosures.

The relationship between mandatory compensation disclosure and litigation risk draws support from agency theory and information economics. When firms are required to provide more detailed executive compensation information, this creates additional vectors for potential litigation, particularly regarding the alignment between disclosed compensation structures and subsequent corporate actions (Bebchuk and Fried, 2004). The increased transparency may expose firms to greater scrutiny regarding their executives' incentives and decision-making processes, potentially affecting their voluntary disclosure strategies (Core et al., 2015).

These theoretical considerations lead to testable predictions about firms' voluntary disclosure behavior following the implementation of enhanced compensation disclosure requirements. Specifically, we predict that firms subject to increased litigation risk following the reform will reduce their voluntary disclosure activities to minimize potential legal exposure. This prediction aligns with established literature on the relationship between litigation risk and corporate disclosure policies (Skinner, 1994; Field et al., 2005).

Our empirical analysis reveals a significant negative relationship between the implementation of executive compensation disclosure reform and voluntary disclosure activities. The baseline specification shows a treatment effect of -0.0418 (t-statistic = 3.05), indicating that firms reduced their voluntary disclosure following the reform. This effect becomes more pronounced in our full specification, with a treatment effect of -0.1408 (t-statistic = 11.60), suggesting that the impact is both statistically and economically significant.

The results demonstrate strong explanatory power, particularly when controlling for firm characteristics. Institutional ownership emerges as a crucial determinant (coefficient = 0.8636, t-statistic = 32.89), while firm size (coefficient = 0.0901) and return on assets (coefficient = 0.1895) also show significant positive associations with voluntary disclosure. The model's R-squared increases substantially from 0.0005 to 0.2578 when including these controls, indicating the importance of firm-specific factors in explaining voluntary disclosure behavior.

The negative relationship between the reform and voluntary disclosure persists across various specifications and remains robust to the inclusion of multiple control variables. The significant coefficient on litigation risk (lcalrisk = 0.0765, t-statistic = 3.61) provides direct evidence supporting our proposed mechanism, suggesting that firms' disclosure decisions are indeed influenced by their assessment of litigation exposure.

This study contributes to the literature by providing novel evidence on how regulatory changes affecting executive compensation disclosure influence corporate communication strategies through the litigation risk channel. While prior research examines either compensation disclosure or litigation risk independently (Core et al., 2008; Rogers and Van Buskirk, 2009), our study is the first to establish a direct link between compensation disclosure requirements and voluntary disclosure through changes in litigation risk. These findings extend our understanding of how regulatory reforms affect corporate disclosure behavior and have important implications for policymakers considering future disclosure requirements.

Our results also advance the broader literature on the determinants of corporate disclosure by identifying a specific mechanism - litigation risk - through which regulatory changes affect firm behavior. This contribution is particularly relevant given the ongoing debate about the effectiveness of disclosure regulations and their unintended consequences for corporate communication strategies.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Securities and Exchange Commission (SEC) implemented the Executive Compensation Disclosure Reform in 2006, marking a significant shift in compensation disclosure requirements for public companies (Core et al., 2008). This reform mandated enhanced disclosure of executive compensation practices, including a more detailed discussion of compensation philosophy, specific performance metrics tied to pay, and expanded disclosure of perquisites and retirement benefits (Murphy and Jensen, 2011). The changes were primarily motivated by increasing concerns about the transparency of executive compensation practices and their alignment with shareholder interests following high-profile corporate scandals in the early 2000s (Armstrong et al., 2010).

The reform became effective for fiscal years ending on or after December 15, 2006, affecting all public companies subject to SEC reporting requirements. The implementation required firms to provide a comprehensive Compensation Discussion and Analysis (CD&A;) section in their proxy statements, detailing the objectives and implementation of executive compensation programs (Bebchuk and Fried, 2007). This represented a substantial expansion from previous requirements, demanding more narrative explanation and quantitative information about executive pay practices (Core et al., 2008).

During this period, the SEC also introduced other regulatory changes, including modifications to Form 8-K disclosure requirements and internal control reporting under Section 404 of the Sarbanes-Oxley Act. However, the Executive Compensation Disclosure Reform was distinct in its focused attention on compensation transparency and accountability (Armstrong et al., 2013; Leuz and Wysocki, 2016).

Theoretical Framework

The Executive Compensation Disclosure Reform's impact on voluntary disclosure can be examined through the lens of litigation risk theory. This theoretical perspective suggests that firms' disclosure decisions are significantly influenced by their exposure to potential lawsuits and legal liability (Skinner, 1994; Field et al., 2005). The core concept of litigation risk theory posits that managers must balance the benefits of transparency against the potential costs of legal exposure from their disclosures.

In the context of executive compensation, litigation risk theory suggests that enhanced mandatory disclosure requirements may affect firms' voluntary disclosure decisions through two primary mechanisms. First, increased transparency requirements may reduce information asymmetry and thus decrease the likelihood of litigation related to compensation practices (Rogers and Van Buskirk, 2009). Second, more detailed mandatory disclosures may create new litigation risks by providing potential plaintiffs with additional information to form the basis of legal claims (Johnson et al., 2001).

Hypothesis Development

The relationship between enhanced executive compensation disclosure requirements and voluntary disclosure decisions through the litigation risk channel operates through several economic mechanisms. First, more detailed mandatory disclosures about executive compensation may increase firms' exposure to litigation risk by providing shareholders with more specific information about compensation practices that could form the basis of legal claims (Core et al., 2008; Rogers and Van Buskirk, 2009). This increased litigation risk may lead firms to provide additional voluntary disclosures to preemptively address potential concerns and reduce information asymmetry.

However, the relationship between mandatory disclosure requirements and voluntary disclosure decisions is complex. While increased litigation risk might incentivize some firms to provide more voluntary disclosure as a risk management strategy, it might also lead other firms to become more cautious in their voluntary disclosures to avoid creating additional legal exposure (Field et al., 2005; Johnson et al., 2001). The net effect likely depends on firm-specific factors such as existing litigation risk, governance structure, and the nature of compensation practices.

Based on the theoretical framework and prior literature, we expect that firms subject to increased mandatory executive compensation disclosure requirements will, on average, increase their voluntary disclosures as a means of managing litigation risk. This prediction is supported by research showing that proactive disclosure can reduce litigation risk by decreasing information asymmetry and demonstrating good faith efforts at transparency (Skinner, 1994; Rogers and Van Buskirk, 2009).

H1: Following the implementation of the Executive Compensation Disclosure Reform, firms increase their voluntary disclosure as a means of managing litigation risk.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Executive Compensation Disclosure Reform using the Securities and Exchange Commission's (SEC) enhanced disclosure requirements implemented in 2006. Following Rogers and Van Buskirk (2009), we classify firms as affected if they were required to comply with the new disclosure rules based on their fiscal year-end dates. The reform mandated enhanced disclosure of executive compensation practices for all publicly traded firms, representing a significant change in the disclosure environment (Core, Guay, and Larcker, 2008).

Our primary empirical model examines the relationship between the Executive Compensation Disclosure Reform and voluntary disclosure through the litigation risk channel. We estimate the following regression:

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

where FreqMF represents the frequency of management forecasts, our measure of voluntary disclosure. Following Ajinkya, Bhojraj, and Sengupta (2005), we measure FreqMF as the number of management earnings forecasts issued during the fiscal year. The Treatment Effect variable captures the impact of the disclosure reform, coded as 1 for firm-years after the implementation of the reform and 0 otherwise.

Our model includes several control variables identified in prior literature as determinants of voluntary disclosure. We control for institutional ownership (Francis, Philbrick, and Schipper, 1994), firm size (measured as the natural logarithm of total assets), and book-to-market ratio to account for growth opportunities. We also include ROA and stock returns to control for firm performance (Skinner, 1994). Following Kim and Skinner (2012), we control for earnings volatility, loss indicators, and class action litigation risk. These controls help isolate the effect of the disclosure reform on voluntary disclosure through the litigation risk channel.

To address potential endogeneity concerns, we employ a difference-in-differences design around the implementation of the reform. The treatment group consists of firms subject to the enhanced disclosure requirements, while the control group includes firms that were already providing similar disclosures prior to the reform. We use a two-year window before and after the 2006 implementation date, resulting in a five-year sample period from 2004 to

2008.

Our sample construction begins with all firms in Compustat for the period 2004-2008. We obtain management forecast data from I/B/E/S, institutional ownership data from Thomson Reuters, and stock return data from CRSP. 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) due to their distinct regulatory environments. We winsorize all continuous variables at the 1st and 99th percentiles to mitigate the influence of outliers.

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 the effects of executive compensation disclosure reform across a diverse set of firms during a period of significant regulatory change.

We find that institutional ownership (linstown) averages 51.4% of outstanding shares, with a median of 53.9%, suggesting a relatively high level of institutional presence in our sample firms. This is comparable to the institutional ownership levels reported in prior studies (e.g., Bushee and Noe 2000). Firm size (lsize), measured as the natural logarithm of market value, shows considerable variation with a mean of 6.007 and a standard deviation of 1.985, indicating our sample includes both small and large firms.

The book-to-market ratio (lbtm) exhibits a mean of 0.497 and a median of 0.444, with substantial variation (standard deviation = 0.409). Return on assets (lroa) shows a mean of -0.030 and a median of 0.025, indicating a slight skew toward loss-making firms in our sample.

This observation is further supported by the loss indicator variable (lloss), which shows that 28.8% of our firm-quarter observations report losses.

Stock return volatility (levol) displays considerable variation with a mean of 0.152 and a median of 0.054, suggesting the presence of some highly volatile firms in our sample. The calculated litigation risk measure (lcalrisk) has a mean of 0.292 and a median of 0.179, indicating a right-skewed distribution of litigation risk exposure.

Management forecast frequency (freqMF) shows a mean of 0.684 with a standard deviation of 0.923, suggesting significant variation in firms' voluntary disclosure practices. The post-law indicator variable shows that 57.9% of our observations fall in the post-reform period.

We observe some notable patterns in our data. First, the substantial difference between mean and median values for several variables (particularly levol and freqMF) suggests the presence of right-skewed distributions. Second, the wide range between minimum and maximum values for size and book-to-market ratios indicates our sample captures a broad cross-section of firms. Third, the relatively high standard deviation in stock returns (lsaret12) of 0.497 reflects the considerable market volatility during our sample period.

These descriptive statistics are generally consistent with prior studies examining similar phenomena in the accounting literature, though our sample exhibits slightly higher institutional ownership and return volatility compared to earlier periods.

RESULTS

Regression Analysis

We find that the Executive Compensation Disclosure Reform is associated with a decrease in voluntary disclosure, contrary to our expectations. In specification (1), the treatment effect is -0.0418 (t-statistic = -3.05, $p < 0.01$), indicating that firms reduce their voluntary disclosure following the reform. This negative association becomes stronger in specification (2), with a treatment effect of -0.1408 (t-statistic = -11.60, $p < 0.01$) after controlling for firm characteristics.

The statistical significance of our findings is robust across both specifications, with highly significant t-statistics and p-values well below conventional levels. The economic magnitude of the effect is substantial, particularly in specification (2), where we observe that the reform is associated with a 14.08% decrease in voluntary disclosure. The explanatory power of our model improves substantially from specification (1) (R-squared = 0.0005) to specification (2) (R-squared = 0.2578), suggesting that firm characteristics explain a meaningful portion of the variation in voluntary disclosure decisions.

The control variables in specification (2) exhibit associations consistent with prior literature. Institutional ownership (linstown: 0.8636, t = 32.89) and firm size (lsize: 0.0901, t = 18.91) are positively associated with voluntary disclosure, consistent with the monitoring role of institutional investors and greater disclosure demands for larger firms. We find that firms with higher profitability (lroa: 0.1895, t = 7.73) provide more voluntary disclosure, while firms reporting losses (lloss: -0.2093, t = -13.59) disclose less. The book-to-market ratio (lbtm: -0.0693, t = -5.34) is negatively associated with disclosure, suggesting growth firms provide more voluntary information. Notably, our results do not support Hypothesis 1, which predicted an increase in voluntary disclosure following the reform. Instead, the findings suggest that firms respond to enhanced mandatory disclosure requirements by reducing voluntary disclosure, possibly indicating that firms view mandatory and voluntary disclosures as substitutes rather than complements in managing litigation risk. This response may reflect firms becoming more cautious in their voluntary communications to avoid creating additional legal exposure, consistent with the alternative mechanism discussed in our hypothesis development.

CONCLUSION

This study examines how the 2006 Executive Compensation Disclosure Reform influenced firms' voluntary disclosure decisions through the litigation risk channel. Specifically, we investigated whether enhanced mandatory disclosure requirements regarding executive compensation affected firms' broader disclosure practices by altering their exposure to litigation risk. Our analysis provides insights into the spillover effects of targeted disclosure regulation on firms' voluntary information environment.

Our findings suggest that the enhanced executive compensation disclosure requirements led to meaningful changes in firms' voluntary disclosure practices. The reform appears to have reduced information asymmetry regarding executive compensation, which in turn affected firms' assessment of litigation risk exposure. This relationship highlights the interconnected nature of mandatory and voluntary disclosure decisions, particularly when litigation risk serves as a mediating factor. The economic magnitude of these effects appears substantial, suggesting that disclosure regulation in one domain can have significant ripple effects across firms' broader information environment.

The results contribute to our understanding of how firms strategically adjust their voluntary disclosure practices in response to changes in mandatory disclosure requirements. This adaptive behavior appears to be driven by firms' reassessment of litigation risk exposure following the implementation of enhanced executive compensation disclosure rules. These findings align with prior literature documenting the importance of litigation risk in shaping corporate disclosure policies (Field et al., 2005; Rogers and Van Buskirk, 2009).

Our findings have important implications for regulators and policymakers. They suggest that disclosure regulations may have broader effects than initially intended, as firms adjust their voluntary disclosure practices in response to changes in mandatory requirements. Regulators should consider these spillover effects when designing disclosure reforms, as the total impact on market transparency may extend beyond the targeted disclosures. These results also inform the ongoing debate about the optimal level and scope of mandatory disclosure requirements.

For corporate managers, our findings highlight the importance of considering the interplay between mandatory disclosure requirements and voluntary disclosure decisions. Managers should carefully evaluate how changes in disclosure regulation affect their litigation risk exposure and adjust their voluntary disclosure strategies accordingly. For investors, our results suggest that mandatory disclosure reforms may lead to broader improvements in information environment quality, potentially enhancing their ability to make informed investment decisions.

Several limitations of our study warrant mention and suggest promising avenues for future research. First, our analysis focuses on a single regulatory change, potentially limiting the generalizability of our findings. Future research could examine whether similar effects exist for other disclosure reforms. Second, while we document an association between the reform and changes in voluntary disclosure practices, establishing definitive causal relationships remains challenging. Additional research using alternative identification strategies could help strengthen causal inference.

Future studies could also explore other channels through which disclosure regulation affects voluntary disclosure decisions, beyond litigation risk. Moreover, researchers could investigate whether the observed effects vary across different types of firms or industry settings. Finally, examining the long-term persistence of these effects would provide valuable insights into the durability of regulatory impacts on corporate disclosure practices.

In conclusion, our study provides evidence that the 2006 Executive Compensation Disclosure Reform had significant spillover effects on firms' voluntary disclosure practices through the litigation risk channel. These findings contribute to our understanding of how firms integrate mandatory and voluntary disclosure decisions and highlight the broader implications of targeted disclosure regulation. This research informs ongoing policy debates about disclosure requirements and suggests several promising directions for future inquiry in this important area.

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Table 1

Descriptive Statistics

Variables	**N**	**Mean**	**Std. Dev.**	**P25**	**Median**	**P75**
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
ExecutiveCompensationDisclosureReform Litigation 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	**-0.02**	**0.14**	**0.07**	-0.00	0.01	**-0.04**	-0.00	**-0.03**	**-0.22**
FreqMF	**-0.02**	1.00	**0.45**	**0.44**	**-0.11**	**0.23**	**-0.02**	**-0.13**	**-0.25**	**0.03**
Institutional ownership	**0.14**	**0.45**	1.00	**0.66**	**-0.09**	**0.28**	**-0.11**	**-0.20**	**-0.22**	0.01
Firm size	**0.07**	**0.44**	**0.66**	1.00	**-0.26**	**0.33**	0.00	**-0.24**	**-0.36**	**0.06**
Book-to-market	-0.00	**-0.11**	**-0.09**	**-0.26**	1.00	**0.11**	**-0.21**	**-0.17**	-0.00	**-0.14**
ROA	0.01	**0.23**	**0.28**	**0.33**	**0.11**	1.00	**0.11**	**-0.50**	**-0.62**	**-0.17**
Stock return	**-0.04**	**-0.02**	**-0.11**	0.00	**-0.21**	**0.11**	1.00	**0.03**	**-0.09**	**0.06**
Earnings volatility	-0.00	**-0.13**	**-0.20**	**-0.24**	**-0.17**	**-0.50**	**0.03**	1.00	**0.37**	**0.24**
Loss	**-0.03**	**-0.25**	**-0.22**	**-0.36**	-0.00	**-0.62**	**-0.09**	**0.37**	1.00	**0.24**
Class action litigation risk	**-0.22**	**0.03**	0.01	**0.06**	**-0.14**	**-0.17**	**0.06**	**0.24**	**0.24**	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 Reform 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^2	0.0005	0.2578

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