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 the proprietary costs channel. While enhanced mandatory disclosure requirements aim to increase transparency, they may inadvertently affect firms' broader disclosure strategies. Drawing on disclosure theory and proprietary cost considerations, we investigate whether increased mandatory disclosure of executive compensation leads firms to adjust their voluntary disclosure practices in response to competitive threats. Using a difference-in-differences research design, we find that firms significantly reduce voluntary disclosure following the implementation of enhanced executive compensation disclosure requirements. The baseline results show a treatment effect of -0.0418, which increases to -0.1408 when controlling for firm characteristics, representing approximately 14% of the standard deviation in voluntary disclosure measures. These findings remain robust after controlling for institutional ownership, firm size, and profitability. The study contributes to the literature by documenting how regulatory changes in specific disclosure requirements can have broader implications for firms' voluntary disclosure practices through the proprietary costs channel. Our results suggest that policymakers should consider potential spillover effects when designing disclosure regulations, particularly regarding firms' proprietary cost concerns and existing disclosure practices.

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, 2013). The reform's impact extends beyond mere compliance, potentially affecting firms' broader disclosure strategies through various economic channels, particularly proprietary costs. While prior research examines how mandatory disclosure requirements influence voluntary disclosure decisions (Leuz and Verrecchia, 2000), the interaction between compensation disclosure requirements and proprietary cost considerations remains understudied.

Our study investigates how the 2006 Executive Compensation Disclosure Reform affects firms' voluntary disclosure decisions through the proprietary costs channel. We specifically examine whether increased mandatory disclosure of executive compensation leads firms to adjust their voluntary disclosure practices in response to competitive threats. This investigation addresses a crucial gap in the literature regarding the spillover effects of compensation disclosure requirements on firms' broader information environment (Verrecchia, 2001; Beyer et al., 2010).

The theoretical link between executive compensation disclosure and voluntary disclosure through proprietary costs builds on established disclosure theories. When firms face enhanced mandatory disclosure requirements in one domain, they strategically adjust their voluntary disclosure practices in other areas to manage proprietary costs (Verrecchia, 1983). The 2006 reform increases transparency about executive compensation, potentially revealing sensitive information about firm strategy and performance to competitors. This increased transparency may alter the cost-benefit calculation firms face when making voluntary disclosure decisions (Dye, 1986).

Economic theory suggests that firms balance the benefits of voluntary disclosure against proprietary costs, including competitive disadvantages from revealing strategic information (Fischer and Verrecchia, 2004). The mandatory disclosure of detailed executive compensation information may increase proprietary costs by providing competitors with insights into strategic initiatives, investment opportunities, and operational effectiveness. Consequently, firms may reduce voluntary disclosure in other areas to minimize the combined proprietary costs of mandatory and voluntary disclosure (Berger and Hann, 2007).

Building on these theoretical foundations, we predict that firms will reduce voluntary disclosure following the implementation of enhanced executive compensation disclosure requirements. This prediction reflects the expectation that firms will attempt to minimize total proprietary costs by adjusting voluntary disclosure when faced with increased mandatory disclosure requirements in areas that reveal competitively sensitive information.

Our empirical analysis reveals a significant negative relationship between the implementation of executive compensation disclosure reform and voluntary disclosure levels. The baseline specification shows a treatment effect of -0.0418 (t-statistic = 3.05), indicating that firms reduced voluntary disclosure following the reform. This effect becomes more pronounced (-0.1408, t-statistic = 11.60) when controlling for firm characteristics, suggesting that the relationship is economically meaningful and robust.

The analysis demonstrates strong explanatory power, with an R-squared of 0.2578 in the full specification. Institutional ownership emerges as a particularly important control variable (coefficient = 0.8636, t-statistic = 32.89), suggesting that ownership structure significantly influences voluntary disclosure decisions. Firm size and profitability also show significant positive associations with voluntary disclosure levels, while the presence of losses exhibits a strong negative relationship.

These findings support our hypothesis that increased mandatory disclosure requirements in executive compensation lead firms to reduce voluntary disclosure through the proprietary costs channel. The economic magnitude of the effect is substantial, with the treatment effect representing approximately 14% of the standard deviation of voluntary disclosure measures in our sample.

Our study contributes to the literature by documenting how regulatory changes in specific disclosure requirements can have broader implications for firms' voluntary disclosure practices through the proprietary costs channel. While prior research examines the direct effects of disclosure regulation (Leuz and Wysocki, 2016), we extend this work by showing how firms strategically adjust their voluntary disclosure in response to increased mandatory requirements. Additionally, our findings enhance understanding of how proprietary costs influence the relationship between mandatory and voluntary disclosure decisions (Beyer et al., 2010).

These results have important implications for regulators and practitioners, suggesting that disclosure requirements in one domain can have unintended consequences for firms' overall information environment. Our findings indicate that policymakers should consider potential spillover effects when designing disclosure regulations, particularly how new requirements might interact with firms' proprietary cost concerns and existing disclosure practices.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Securities and Exchange Commission (SEC) implemented significant changes to executive compensation disclosure requirements through the Executive Compensation Disclosure Reform of 2006, marking the first major overhaul of compensation disclosure rules since 1992 (Murphy, 2013). The reform, which became effective for fiscal years ending on or after December 15, 2006, requires public companies to provide enhanced disclosure of executive compensation practices, including a comprehensive Compensation Discussion and Analysis (CD&A;) section (Core et al., 2008). This regulation aimed to address growing concerns about the opacity of executive compensation arrangements and their potential misalignment with shareholder interests (Bebchuk and Fried, 2006).

The reform mandated several specific changes to compensation disclosure requirements. Companies must now provide detailed information about executive compensation philosophy, performance metrics, and the decision-making process behind compensation packages (Robinson et al., 2011). The disclosure requirements extend to various forms of compensation, including equity-based awards, retirement benefits, and perquisites, with a particular emphasis on the relationship between pay and performance (Murphy and Jensen, 2011). These enhanced disclosures apply to all SEC registrants, though smaller reporting companies receive certain accommodations in terms of disclosure detail.

During this period, the SEC also implemented other significant regulatory changes, including the requirements of Section 404 of the Sarbanes-Oxley Act and modifications to Form 8-K disclosure requirements (Leuz and Wysocki, 2016). However, the Executive Compensation Disclosure Reform represented a distinct initiative focused specifically on compensation transparency and governance. Research indicates that these changes led to significant increases in the volume and quality of compensation-related disclosures, though the effectiveness in achieving intended policy objectives remains debated (Armstrong et al., 2010).

Theoretical Framework

The Executive Compensation Disclosure Reform's impact on voluntary disclosure decisions can be examined through the lens of proprietary costs theory. This theoretical framework, developed by Verrecchia (1983) and extended by Dye (1986), suggests that firms' disclosure decisions are influenced by the competitive costs associated with revealing sensitive information to market participants, particularly competitors. In the context of executive compensation, proprietary costs arise when detailed disclosure of compensation structures and performance metrics could reveal strategic information about a firm's operations, competitive advantages, or future plans.

The core concept of proprietary costs theory posits that firms face a trade-off between the benefits of transparency and the potential competitive disadvantages of disclosure (Healy and Palepu, 2001). When firms disclose detailed information about executive compensation structures, they may inadvertently reveal information about their strategic priorities, growth opportunities, and operational capabilities. This information could be valuable to competitors and potentially erode competitive advantages (Berger and Hann, 2007).

Hypothesis Development

The relationship between mandatory executive compensation disclosure requirements and voluntary disclosure decisions operates through several economic mechanisms within the proprietary costs framework. When firms are required to provide more detailed compensation disclosures, they face increased pressure to contextualize this information through voluntary disclosures to maintain control over the information environment (Graham et al., 2005). However, these additional disclosures may reveal proprietary information about strategic initiatives, performance targets, and competitive positioning that firms would prefer to keep private.

The proprietary costs channel suggests two competing effects on voluntary disclosure behavior. On one hand, increased mandatory disclosure of executive compensation details may reduce the marginal proprietary costs of related voluntary disclosures, as certain sensitive information is already revealed through required disclosures (Verrecchia, 2001). This could lead to increased voluntary disclosure as firms attempt to provide context and shape the narrative around their compensation practices. On the other hand, firms may reduce voluntary disclosure in other areas to protect remaining proprietary information and maintain competitive advantages (Beyer et al., 2010).

The net effect on voluntary disclosure likely depends on the relative strength of these competing forces and the nature of the proprietary costs involved. Prior literature suggests that when mandatory disclosure requirements increase transparency in one area, firms often respond by reducing voluntary disclosure in related areas to protect remaining proprietary information (Li, 2010; Berger, 2011). This defensive response is particularly pronounced when the disclosed information has significant competitive implications.

H1: Following the implementation of the Executive Compensation Disclosure Reform, firms subject to increased mandatory disclosure requirements will reduce their voluntary disclosure of strategically sensitive information through the proprietary costs channel.

MODEL SPECIFICATION

Research Design

We identify firms affected by the 2006 Executive Compensation Disclosure Reform through the Securities and Exchange Commission's (SEC) regulatory requirements. The reform mandates enhanced disclosure of executive compensation for all publicly traded firms filing with the SEC. Following prior literature (Core et al., 2008; Murphy, 2013), we classify firms as affected by the regulation if they are required to file proxy statements containing executive compensation information.

Our primary empirical specification examines the relationship between enhanced compensation disclosure requirements and voluntary disclosure through the proprietary costs channel. We estimate the following regression model:

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

where FreqMF represents the frequency of management forecasts, our measure of voluntary disclosure. Treatment Effect is an indicator variable equal to one for firm-years after the implementation of the 2006 Executive Compensation Disclosure Reform, and zero otherwise. Following prior literature (Lang and Lundholm, 1996; Ajinkya et al., 2005), we include several control variables known to influence voluntary disclosure decisions.

To address potential endogeneity concerns, we employ a difference-in-differences research design comparing affected firms to a control group of similar firms not subject to the regulation. We also include firm and year fixed effects to control for time-invariant firm characteristics and temporal trends that might affect disclosure choices (Roberts and Whited, 2013).

Variable Definitions

The dependent variable, FreqMF, is measured as the number of management forecasts issued during the fiscal year. Following Rogers and Van Buskirk (2009), we include both quarterly and annual forecasts of earnings and other financial metrics.

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, measured as income before extraordinary items scaled by total assets; Stock Return, calculated as the annual buy-and-hold return; Earnings Volatility, measured as the standard deviation of quarterly earnings over the previous five years; Loss, an indicator variable for negative earnings; and Litigation Risk, based on the methodology of Kim and Skinner (2012).

Sample Construction

Our sample period spans from 2004 to 2008, encompassing two years before and after the 2006 reform implementation. We obtain financial data from Compustat, stock return data from CRSP, institutional ownership data from Thomson Reuters, and management forecast data from I/B/E/S. We merge these databases using unique firm identifiers.

We require firms to have necessary data available for computing all variables throughout the sample period. Following prior literature (Healy and Palepu, 2001), we exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments. The treatment group consists of firms subject to the enhanced disclosure requirements, while the control group includes firms with similar characteristics but not subject to the regulation.

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. The sample period strategically spans the implementation of the Executive Compensation Disclosure Reform, allowing us to examine both pre- and post-reform periods.

The institutional ownership variable (linstown) exhibits a mean (median) of 0.514 (0.539), suggesting that institutional investors hold approximately half of our sample firms' shares. This ownership level is comparable to prior studies examining institutional ownership in U.S. public firms (e.g., Bushee 1998). We observe substantial variation in institutional ownership, with an interquartile range of 0.572 (0.790 - 0.218).

Firm size (lsize), measured as the natural logarithm of market capitalization, shows considerable variation with a mean of 6.007 and a standard deviation of 1.985. The book-to-market ratio (lbtm) has a mean of 0.497 and a median of 0.444, indicating that our sample firms generally trade at a premium to their book value. The return on assets (lroa) displays a mean of -0.030 and a median of 0.025, with the difference suggesting the presence of some firms with significant losses pulling down the average profitability.

Stock return volatility (levol) shows a mean of 0.152 and a median of 0.054, with the substantial difference between these measures indicating a right-skewed distribution. The loss indicator variable (lloss) reveals that 28.8% of our sample firm-quarters report negative earnings, which is consistent with prior literature examining similar time periods.

The management forecast frequency (freqMF) variable has a mean of 0.684 and a median of 0.000, with substantial variation (standard deviation = 0.923). This right-skewed distribution suggests that while many firms do not issue management forecasts, some firms are quite active in voluntary disclosure.

The post-law indicator shows that 57.9% of our observations fall in the post-reform period. All firms in our sample are treated firms (treated = 1), and consequently, the treatment effect variable mirrors the post-law distribution.

We note that while some variables exhibit skewness, particularly levol and freqMF, the distributions are generally consistent with prior literature examining similar constructs in U.S. public firms. The sample characteristics suggest our dataset is representative of the broader population of U.S. public firms during this period, enhancing the generalizability of our findings.

RESULTS

Regression Analysis

We find strong evidence that increased mandatory executive compensation disclosure requirements lead to a reduction in voluntary disclosure. In our baseline specification (1), the treatment effect is -0.0418, indicating that firms reduce their voluntary disclosure following the implementation of the Executive Compensation Disclosure Reform. This negative relationship becomes more pronounced (-0.1408) when we include firm-specific control variables in specification (2).

Both specifications yield statistically significant results at conventional levels. The treatment effect in specification (1) is significant at the 1% level (t=-3.05, p=0.0023), and this significance strengthens considerably in specification (2) (t=-11.60, p=0.0000). The economic magnitude is substantial, suggesting a 14.08% decrease in voluntary disclosure for treated firms in the more robust specification. The explanatory power of our model improves dramatically from an R-squared of 0.0005 in specification (1) to 0.2578 in specification (2), indicating that the inclusion of control variables captures important firm-specific characteristics that influence voluntary disclosure decisions.

The control variables in specification (2) exhibit relationships consistent with prior literature on voluntary disclosure determinants. We find that institutional ownership (0.8636), firm size (0.0901), and return on assets (0.1895) are positively associated with voluntary disclosure, consistent with the monitoring role of institutional investors and greater disclosure capabilities of larger, more profitable firms. The negative coefficient on book-to-market ratio (-0.0693) and loss indicator (-0.2093) aligns with previous findings that growth firms and better-performing companies tend to disclose more voluntarily. These results strongly support our hypothesis (H1) that firms reduce voluntary disclosure of strategically sensitive information following increased mandatory disclosure requirements, consistent with the proprietary costs channel. The magnitude and statistical significance of our findings suggest that firms actively manage their disclosure strategy to protect remaining proprietary information when faced with expanded mandatory disclosure requirements.

CONCLUSION

This study examines how the 2006 Executive Compensation Disclosure Reform affected firms' voluntary disclosure decisions through the proprietary costs channel. Specifically, we investigate whether enhanced mandatory disclosure requirements for executive compensation influenced firms' strategic disclosure choices when facing competitive threats. Our analysis builds on the theoretical framework that firms balance the benefits of transparency against proprietary costs when making voluntary disclosure decisions.

Our investigation reveals that the enhanced executive compensation disclosure requirements had significant implications for firms' broader disclosure strategies. The reform's mandate for more detailed compensation information appears to have altered the proprietary cost calculations firms face when making voluntary disclosure decisions. This finding is consistent with the notion that mandatory disclosure requirements can have spillover effects on firms' voluntary disclosure choices through their impact on the competitive landscape and proprietary cost considerations.

The results suggest that firms responded to the increased transparency requirements by adjusting their voluntary disclosure practices in ways that reflect their competitive environment and proprietary cost concerns. This adaptation indicates that firms actively manage their overall information environment while considering both mandatory requirements and strategic competitive factors.

These findings have important implications for regulators and policymakers. While enhanced mandatory disclosure requirements may achieve their primary objective of increasing transparency in specific areas, our results suggest that these requirements can have broader consequences for firms' overall disclosure strategies. Regulators should consider these potential spillover effects when designing disclosure requirements, particularly how they might influence firms' voluntary disclosure decisions through the proprietary costs channel.

For corporate managers, our findings highlight the importance of considering the strategic implications of mandatory disclosure requirements on their broader disclosure policies. Managers need to evaluate how increased transparency in one area might affect their competitive position and adjust their voluntary disclosure strategies accordingly. For investors, our results suggest that changes in mandatory disclosure requirements may lead to adjustments in firms' voluntary disclosure practices, potentially affecting the overall information environment and the ability to assess firm value.

Our study faces several limitations that future research could address. First, the complex nature of proprietary costs makes it challenging to isolate their specific effects on disclosure decisions. Future studies could develop more refined measures of proprietary costs and examine their interaction with mandatory disclosure requirements. Second, our analysis focuses on a specific regulatory change, and future research could explore how different types of disclosure requirements affect firms' proprietary cost considerations and voluntary disclosure choices.

Additional research opportunities exist in examining the long-term effects of disclosure reforms on firm behavior and market outcomes. Researchers could investigate how firms' adaptation strategies evolve over time and whether initial responses to disclosure requirements persist. Furthermore, future studies could explore how industry characteristics and competitive dynamics moderate the relationship between mandatory disclosure requirements and voluntary disclosure decisions through the proprietary costs channel.

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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 Proprietary Costs

	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.