

AUDIT COMMITTEE COMPOSITION, COMPENSATION COMMITTEE COMPOSITION, AND COMPENSATION TRANSPARENCY

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Abstract

The increase in executive and director compensation in recent years has resulted in increased scrutiny of corporate compensation practices. Similarly, a recent survey indicates that 75 percent of directors and 75 percent of institutional investors believe that the manner in which executive pay is determined in the US is damaging to the image of corporate America (Perkins 2008). Investors, regulators, and other stakeholders have called on firms to provide greater transparency concerning these practices. My results from a sample of US firms indicate that compensation committee composition plays a greater role in the transparency of compensation practices than does audit committee composition. In addition, the independence of committee members is more important than their financial expertise. Investors, regulators, and other stakeholders outside of the US looking to increase the transparency of corporate compensation practices should look to increase the independence of compensation committees as one possible way to increase the transparency of corporate compensation practices.

Keywords: Compensation Transparency, Compensation Committee, Audit Committee

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A list of sample firms is available upon written request. The details for each firm's scores are available directly from Standard & Poor's. I thank Standard & Poor's for providing the details for each firm's scores to me. All other data are publicly available.

1. Introduction

Issues surrounding compensation practices for executives and directors have received more intense scrutiny recently from investors, regulators, and firms themselves throughout the world. In 2006, the US Securities and Exchange Commission (SEC) issued new rules requiring firms to provide information "... to provide investors with a clearer and more complete picture of compensation to principal executive officers, principal financial officers, the other highest paid executive officers and directors" (SEC 2006). Absent regulation such as the 2006 SEC rules, what can regulators and investors in non-US countries do to encourage firms to disclose more information concerning their compensation packages? One possible solution could involve existing corporate governance structures such as the audit committee and compensation committee. Both board committees are likely to play a role in disclosure decisions concerning compensation packages as the audit committee has primary responsibility for corporate reporting decisions while the compensation committee has

primary responsibility for compensation decisions. Laksmana (2007) reports a positive relationship between compensation committee independence and the level of compensation-related disclosures in a 1993 sample, but not in a 2002 sample. It is unclear why the relationship "disappeared" in the more recent sample. One goal of this paper is an attempt to provide more evidence concerning this relationship. An additional goal of this research is to provide insight into what audit committee and compensation committee features (independence and financial expertise) may be related to greater transparency concerning executive and director compensation practices.

Why is compensation transparency important? Vafeas and Afxentiou (1998) find that the link between executive compensation and firm performance improved after the SEC adopted new compensation disclosure rules in 1992. The additional transparency required by the SEC may have motivated compensation committees to strengthen the "pay for performance" relationship since investors and other stakeholders had more information

concerning executive compensation. Similarly, a recent survey indicates that 75 percent of directors and 75 percent of institutional investors believe that the manner in which executive pay is determined in the US is damaging to the image of corporate America (Perkins 2008). Lack of transparency into a firm's compensation model may explain at least a part of this problem. As executive compensation has increased in recent years, shareholders and regulators have looked for ways to provide more insight and transparency into how executive compensation is determined.

In 2002, Standard & Poor's published an analysis of the transparency and disclosure practices concerning financial reporting, ownership structure and investor rights, and board and management structure and processes of the firms comprising the S & P 500 (Patel and Dallas 2002). I use a subset of this report to measure disclosure transparency concerning director compensation, executive compensation, and director and executive compensation combined.

While controlling for board size, blockholder ownership, and firm size, and using a sample that predates the Sarbanes-Oxley Act and Dodd-Frank Act, I find that compensation committee composition plays a larger role in compensation transparency than does audit committee composition. In addition, greater financial expertise of committee members does not seem to be related to greater compensation transparency. The implication of my findings is that regulators around the world should work to increase the independence of compensation committees as one way to increase compensation transparency.

The rest of the paper is as follows. I first review prior literature related to my study and develop my hypotheses. Next, I describe the sample selection process and define the variables used in the paper. I then present my empirical results, followed by a discussion of the results. I close the paper by noting some limitations and offering some concluding comments.

2. Background Information and Hypotheses

2.1. Compensation Disclosures

In 2006, the SEC passed new rules concerning executive compensation and related party disclosures. These new rules, the SEC's first concerning compensation disclosures in nearly 15 years, are designed "... to provide investors with a clearer and more complete picture of compensation to principal executive officers, principal financial officers, the other highest paid executive officers and directors" (SEC 2006). The new rules require firms to disclose all components of executive compensation and to provide the information in table form in one area of their proxy statements. In addition, firms must provide a Compensation Discussion and Analysis

(CD&A) in their proxy statements. This must include a discussion and analysis of the factors used in determining the figures presented in the compensation table, including the outcomes the firm is trying to reward. To help investors better understand the new disclosures, they are subject to the SEC's "plain English" requirements. Under the SEC's "plain English" requirements, firms are expected to use short sentences, everyday language, and avoid the use of technical and legal jargon, among other principles. Although there have been issues with the implementation of these rules, it appears that they may eventually improve the transparency of executive and director compensation. A recent survey indicates that 80 percent of institutional investors and close to 75 percent of directors believe that the CD&A has improved the transparency of executive compensation practices (Perkins 2008).

2.2. Compensation Committee Member Independence

Compensation committees are generally responsible for setting executive compensation. The NYSE requires that listed firms have compensation committees consisting solely of independent directors. Although Nasdaq does not require independent compensation committees, it does require that executive compensation be approved by an independent compensation committee or by a majority of independent directors. The rationale for these requirements is that non-independent directors may be biased toward CEOs, resulting in compensation plans that are not necessarily in shareholders' best interests. The empirical evidence concerning whether compensation committee independence results in executive compensation plans that are more in shareholders' interests is mixed, with Vafeas (2003) providing evidence supporting greater compensation committee independence and Daily et al. (1998) and Anderson and Bizjag (2003) finding no evidence that non-independent compensation committees award more generous compensation packages. As noted above, Laksmana (2007) reports a positive relationship between compensation committee independence and the level of compensation-related disclosures in a 1993 sample, but not in a 2002 sample. Given the mixed results concerning executive compensation and disclosures related to compensation, I offer the following non-directional hypotheses:

H1a: There is a relationship between independent compensation committee membership and compensation transparency.

H1b: There is a relationship between inside compensation committee membership and compensation transparency.

H1c: There is a relationship between gray compensation committee membership and compensation transparency.

2.3. Audit Committee Member Independence

Although a firm's compensation committee is primarily responsible for compensation decisions, a firm's audit committee is likely involved in decisions concerning the disclosures related to executive compensation. Therefore, the composition of a firm's audit committee may impact what information concerning compensation is disclosed.

The Sarbanes-Oxley ACT (SOX) prohibits non-independent directors from serving on corporate audit committees. The implicit assumption is that lack of independence increases audit committee members' motivation to "go along" with management's disclosure decisions. Because independent audit committee members are not expected to simply accept management's assertions, their presence is expected to improve reporting transparency. Although not specifically addressing compensation disclosure issues, previous studies (Abbott, Parker, and Peters 2004 and Bédard, Chtourou, and Courteau 2004) support the notion that independent audit committee members are associated with greater reporting transparency. Based on this, I offer the following hypotheses:

H2a: There is a positive relationship between independent audit committee membership and compensation transparency.

H2b: There is a negative relationship between inside audit committee membership and compensation transparency.

H2c: There is a negative relationship between gray audit committee membership and compensation transparency.

2.4. Compensation Committee and Audit Committee Member Financial Expertise

There are no requirements in the US that any member of the compensation committee have any particular training or background in finance or accounting. However, there are two reasons why this type of training may be useful for compensation committee members. First, financial expertise may help compensation committee members better understand the link between current performance measures (which may be used as part of an incentive program) and future shareholder returns. For example, training in performance measurement systems such as the Balanced Scorecard may help compensation committee members design more optimal compensation packages. Second, this expertise may help committees better explain the logic underlying executive compensation contracts to shareholders and regulators. One of the complaints from the SEC and others is that firms are not doing an adequate job in their CD&A (which is prepared by the compensation committee) of explaining the link between performance measures used to determine

compensation and shareholder returns. Having people trained in understanding the links between current and future performance measures could lead to more transparent disclosures related to compensation. I believe this is the first paper to empirically test the relationship between compensation committee financial expertise and compensation disclosure transparency.

Although the compensation committee is more directly involved in compensation-related disclosures, it is likely that the audit committee has at least some involvement in these disclosure decisions. Both the NYSE and Nasdaq require listed firms to have at least one financial expert on their audit committee. The assumption underlying this requirement is that financial experts are better suited to ask the "right questions" of management and auditors and to identify potential red flags concerning a firm's financial reporting and disclosures. Extant research (e.g., Abbott, Parker, and Peters 2004; Bédard, Chtourou, and Courteau 2004; Davidson, Xie, and Xu 2004; DeFond, Hann, and Xu 2005; Krishnan and Visvanathan 2007; Chan and Li 2008) supports this assumption.

It is not clear that "all" financial experts would be likely to improve reporting transparency. Although an "independent" expert may use his or her expertise to improve transparency, an "inside" or "gray" expert may be motivated to use his or her expertise to confuse financial statement readers concerning compensation issues. In fact, Felo and Solieri (2009) and Felo (2010) both find that the impact of financial experts on different measures of reporting transparency differs based on the independence of the individuals. Therefore, I combine financial expertise and independence in the following hypotheses:

H3a: There is a positive relationship between independent financial experts on the compensation committee and compensation transparency.

H3b: There is a negative relationship between inside financial experts on the compensation committee and compensation transparency.

H3c: There is a negative relationship between gray financial experts on the compensation committee and compensation transparency.

H4a: There is a positive relationship between independent financial experts on the audit committee and compensation transparency.

H4b: There is a negative relationship between inside financial experts on the audit committee and compensation transparency.

H4c: There is a negative relationship between gray financial experts on the audit committee and compensation transparency.

3. Research Method

3.1. Sample Selection

My initial sample consists of the 460 US firms included in the Patel and Dallas (2002) survey of transparency and disclosure practices (see below). I drop six firms because I could not obtain annual meeting proxy statements covering board activities for 2001 and 2002. I drop another eight firms because firm size data for the 2001 fiscal year are not available on COMPUSTAT for these firms. I drop an additional 19 firms because corporate governance data are not available through the Investment Responsibility Research Center (IRRC) database. My final sample consists of 427 firms. The median (mean) market value of equity for the sample firms at the end of their 2002 fiscal year is \$6,828 million (\$16,415).

3.2. Compensation Transparency Measures

In 2002, Standard & Poor's published an analysis of the transparency and disclosure practices of the firms comprising the S&P 500 and of firms throughout the world (Patel and Dallas 2002). The study identifies 98 disclosure items related to "financial transparency and information disclosure," "ownership structure and investor rights," and "board and management structure and process." Firms receive one point for every one of the 98 items they disclose in their annual reports, 10Ks, or proxy statements (composite index).⁵¹ Of the 98 items, there are seven relating to executive compensation and four relating to director compensation. I use the individual indices (executive compensation and director compensation) and the combined index in my empirical tests. Please see Appendix A for a list of the items included in my measures.

It is important to note that the S&P index does not attempt to assess the *quality* or *accuracy* of firm disclosures. Rather, it simply assesses whether firms simply disclose the information. As a result, firms voluntarily disclosing misleading information may score relatively high on the index. Patel and Dallas (2002) report that overall composite scores are significantly negatively correlated with market risk, indicating that firms with higher scores are viewed as less risky by capital market participants. In addition, Chen, Chung, Lee, and Liao (2007) find that firms having higher composite overall scores have smaller equity spreads and higher equity liquidity, indicating that greater transparency reduces information asymmetry. This evidence seems to indicate that firms with higher S&P scores are not using voluntary

disclosures to reduce reporting transparency. Although I am only using a subset of the S&P index, it seems reasonable to conclude that higher scores are an indication of greater transparency concerning executive and director compensation.

3.3. Explanatory Variables

My first set of explanatory variables concern the independence status (independent, gray, or inside) of the members of the compensation and audit committees of the board of directors. I use the independence classifications provided by the Investment Responsibility Research Center (IRRC). According to the IRRC, any director currently employed by the firm is an inside director. Gray directors have some relationship to the firm that may impair their independence. For example, former employees, family members of executive officers, officers and directors of providers of professional services to the firm, and customers or suppliers to the firm are all considered to be gray directors. All other directors are classified as independent directors.

A second set of explanatory variables combines whether a compensation committee member or audit committee member satisfies the SEC's definition of an "audit committee financial expert" with the individual's independence status as described above. According to SEC regulations, an audit committee financial expert must be able to understand generally accepted accounting principles and financial statements, assess accounting estimates, accruals, and reserves, understand the preparation, auditing, and analysis of financial statements comparable in complexity to the firm's statements, understand internal controls and procedures, and understand audit committee functions. Individuals can obtain this knowledge through education, work experience (in public accounting, corporate accounting, as a financial officer, or in preparing, auditing, or evaluating financial statements), or by supervising accounting or finance personnel (SEC 2003). I analyzed company proxy statements to determine the background of each compensation committee and audit committee member. Based on this analysis, I classify individuals as financial experts if they have past employment experience in finance or accounting, professional certification in accounting, or any other comparable experience or background which results in financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities. Consequently, CPAs, senior executives such as CEOs, CFOs, and senior vice-presidents, and managing partners of professional services firms are considered to be financial experts. I then combine independence classification with an individual's financial expertise classification to get the following explanatory variables: the percentage of compensation and audit committee members who are independent financial experts, the percentage of

⁵¹ They also calculate an index based only on annual report disclosures. Because sophisticated analysts are likely to consult all three documents when analyzing a firm, I limit my analysis to the composite indices.

compensation and audit committee members who are inside financial experts, and the percentage of compensation and audit committee members who are gray financial experts.

3.4. Control Variables

Jensen (1993) and Yermack (1996) both report evidence that smaller boards are associated with better corporate governance. Similarly, Beasley (1996) finds that board size is positively related to the likelihood of financial statement fraud. Since disclosure decisions are part of corporate governance, I control for board size in my analyses. Based on past results, I expect board size to be negatively related to compensation transparency.

It is possible that ownership structure is related to reporting transparency. For example, more concentrated ownership (relatively high shares owned by 5% blockholders) may lead to more transparency as these owners use their “strength” to demand additional disclosure about the firm’s activities, especially if the blockholders cannot obtain the information on their own. On the other hand, concentrated ownership may also lead to less transparency as concentrated ownership reduces the need for monitoring of management because the owners use their “strength” to directly monitor management. Limited empirical evidence seems to support the second possibility. For example, Hossain, Marks, and Mitra (2006) find that concentrated ownership is related to less voluntary disclosure of quarterly foreign sales data by US firms and Kelton and Yang (2008) find that firms with broad ownership are more likely to disclose information over the Internet than are firms with concentrated ownership. Therefore, I expect a negative relationship between the extent of blockholder ownership and compensation transparency. I measure blockholder ownership at the end of the 2002 fiscal year using information from the WRDS database.

I include firm size as a control variable because larger firms may devote more resources to corporate reporting and therefore, provide more information. In fact, Eng and Mak (2003) find a positive relationship between firm size and voluntary disclosure. In addition, Patel and Dallas (2002) report a slightly positive correlation (.06) between firm size and overall transparency rankings. Using COMPUSTAT data, I compute firm size as the natural log of a firm’s market value of equity at the end of the 2002 fiscal year. I expect firm size to be positively related to compensation transparency.

Since only four of my sample firms did not have a Big Five auditor during the sample period, I do not control for auditor type in my regression models.

4. Empirical Results

4.1. Descriptive Statistics

The average director compensation transparency score for the 427 firms in my sample is 2.12 (out of 4.00), the average executive compensation transparency score is 6.43 (out of 7.00), and the average total compensation transparency score is 8.55 (out of 11.00). On average, 92.69 percent of compensation committee members classified as independent, 0.10 percent as inside, and 7.22 percent as gray. On average, 78.81 percent of compensation committee members are independent financial experts, 0.10 percent are inside financial experts⁵², and 6.14 percent are gray financial experts. The remaining compensation committee members (14.95 percent) do not qualify as financial experts. The average percentage of independent audit committee members is 91.11 percent and the average percentage of gray audit committee members is 8.89 percent. There are no inside audit committee members in my sample. On average, 74.69 percent of audit committee members are independent financial experts and 6.92 percent are gray financial experts. The average board consists of 10.99 members. On average, 13.52 percent of shares are held by 5 percent blockholders. The average market value of equity of firms in my sample is approximately \$16,415 million. However, the median value is much smaller (\$6,828 million), suggesting that the sample includes some small and mid-sized firms. Please see Table 1 for a summary of these statistics.

⁵² All inside compensation committee members in the sample qualify as financial experts based on their current executive positions in the firm.

Table 1. Descriptive statistics

Variable	Mean	Median	Std Dev
DIRCOMP	2.12	2.00	0.49
EXECCOMP	6.43	6.00	0.65
COMBCOMP	8.33	9.00	0.76
COMPIND	92.69%	100.00%	15.41%
COMPINS	0.10%	0.00%	1.45%
COMPGRY	7.22%	0.00%	15.34%
COMPINDSEC	78.81%	80.00%	23.36%
COMPINSSEC	0.10%	0.00%	1.45%
COMPGRYSEC	6.14%	0.00%	13.92%
ACIND	91.11%	100.00%	15.29%
ACGRY	8.89%	0.00%	15.29%
ACINDSEC	74.69%	75.00%	22.44%
ACGRYSEC	6.92%	0.00%	12.99%
BRDSIZE	10.99	11.00	2.93
BLOCK%	13.32%	11.84%	13.14%
MVE (\$ million)	16.413	6.828	32.766

N = 427 in all cases.

DIRCOMP is a firm's score on the Director Compensation Index.

EXECCOMP is a firm's score on the Executive Compensation Index.

COMBCOMP is a firm's score on the Combined Compensation Index.

COMPIND is the percentage of independent directors on the compensation committee.

COMPINS is the percentage of inside directors on the compensation committee.

COMPGRY is the percentage of gray directors on the compensation committee.

COMPINDSEC is the % of compensation committee members who are independent SEC experts.

COMPINSSEC is the % of compensation committee members who are inside SEC experts.

COMPGRYSEC is the % of compensation committee members who are gray SEC experts.

ACIND is the percentage of independent directors on the audit committee.

ACGRY is the percentage of gray directors on the audit committee.

ACINDSEC is the percentage of audit committee members who are independent SEC experts.

ACGRYSEC is the percentage of audit committee members who are gray SEC experts.

BRDSIZE is the number of board members.

BLOCK% is the percentage of shares held by 5% blockholders.

MVE is the market value of equity at the end of the 2002 fiscal year.

4.2. Director Compensation Transparency Results

As shown in Table 2, director compensation transparency is positively related to the percentage of independent compensation committee members and negatively related to the percentage of gray compensation committee members. The percentage of inside compensation committee members is not related to transparency. These results support hypotheses 1a and 1c.⁵³ I find no evidence of a relationship between audit committee independence and director compensation transparency.⁵⁴ When considering independence and financial expertise together, I find a positive relationship between director compensation transparency and the percentage of compensation committee members who are independent financial experts and a negative relationship between director compensation transparency and the percentage of compensation

committee members who are gray financial experts when they are tested individually. There is no relationship between the percentage of compensation committee members who are inside financial experts and director compensation transparency. When I include all three in one regression model, only the percentage of compensation committee members who are independent financial experts is significant. These results provide solid support for hypothesis 3a and partial support for hypothesis 3c. Neither of the audit committee independence and expertise variables is significant. Of the three control variables, only board size is statistically significant, although it is positively related in all models tested, not negatively related as expected.

⁵³ I cannot run a regression model with all three compensation committee independence variables included since the three variables would sum to 100%.

⁵⁴ I cannot test hypothesis 2b since there are no inside audit committee members. Also, since the percentage of gray audit committee members is by definition 100% - % of independent AC members, the test of hypothesis 2c is identical to the test of hypothesis 2a.

Table 2. Results of Regression of Directors Compensation Transparency

MODEL	Exp Rel	1	2	3	4	5	6	7	8	9	10
BRDSIZE	-	.147 (2.753)***	.142 (2.663)***	.146 (2.755)***	.142 (2.656)***	.153 (2.836)***	.144 (2.698)***	.148 (2.753)***	.147 (2.745)***	.145 (2.707)***	.147 (2.729)***
BLOCK%	-	.048 (.969)	.062 (1.266)	.050 (1.002)	.062 (1.260)	.045 (.903)	.055 (1.114)	.050 (1.002)	.057 (1.146)	.057 (1.159)	.048 (.965)
LN(MVE)	+	-.053 (-9.67)	-.045 (-832)	-.054 (-964)	-.045 (-817)	-.058 (-1.047)	-.048 (-.878)	-.054 (-9.64)	-.048 (-9.01)	-.048 (-884)	-.052 (-941)
COMPIND	?		.132 (2.738)***								
COMPINS	?			-.021 (-.439)							
COMPGRY	?				-.130 (-2.707)***						
ACIND	+					-.042 (-.861)					
COMPINDSEC	+						.133 (2.783)***			.110 (1.938)*	
COMPINSSEC	-							-.021 (-.439)		-.016 (-.328)	
COMPGRYSEC	-								-.100 (-2.074)**	-.042 (-.732)	
ACINDSEC	+										.035 (.617)
ACGRYSEC	-										.018 (.307)
F-statistic		2.848**	4.047***	2.184*	4.004***	2.320*	4.110***	2.184*	3.231**	2.833**	1.779

Variable Definitions are the same as for Table 1.

*, **, *** Indicates significance at the ten-percent, five-percent and one-percent levels, respectively.

4.3. Executive Compensation Transparency Results

As shown in Table 3, executive compensation transparency is positively related to the percentage of independent compensation committee members and negatively related to the percentage of inside and gray compensation committee members. These results support hypotheses 1a, 1b, and 1c, although the results for 1a and 1c are somewhat marginal. I find a positive relationship between audit committee independence and executive compensation transparency, providing support for hypotheses 2a and 2c.⁵⁵ I find a negative relationship between executive compensation transparency and the percentage of compensation committee members who are inside and gray financial experts, both individually and when combined together. However, I find no relationship between the percentage of compensation committee members who are independent financial experts and executive compensation transparency. These results provide solid support for hypothesis 3b and 3c. The percentage of gray financial experts on the audit committee is negatively related to executive compensation transparency, but the percentage of independent financial experts is not. None of the control variables are significant in any regression model.

⁵⁵ As noted before, I cannot test hypothesis 2b since there are no inside audit committee members. Also, since the percentage of gray audit committee members is by definition 100% - % of independent AC members, the test of hypothesis 2c is identical to the test of hypothesis 2a.

Table 3. Results of Regression of Executive Compensation Transparency

MODEL	Exp Rel	1	2	3	4	5	6	7	8	9	10
BRDSIZE	-	-.003 (-.065)	-.025 (-.470)	-.018 (-.339)	-.025 (-.466)	-.018 (-.338)	-.023 (-.430)	-.018 (-.339)	-.022 (-.410)	-.019 (-.353)	-.015 (-.286)
BLOCK%	-	.019 (.392)	.029 (.573)	.021 (.427)	.027 (.549)	.028 (.558)	.022 (.437)	.021 (.427)	.026 (.525)	.028 (.574)	.022 (.445)
LN(MVE)	+	-.081 (-1.475)	-.068 (-1.228)	-.081 (-1.469)	-.068 (-1.227)	-.069 (-1.254)	-.071 (-1.278)	-.081 (-1.469)	-.070 (-1.265)	-.078 (-1.413)	-.070 (-1.274)
COMPIND	?		.094 (1.927)*								
COMPINS	?			-.114 (-2.367)**							
COMPGRY	?				-.083 (-1.710)*						
ACIND	+					.109 (2.251)**					
COMPINDSEC	+						.063 (1.296)			.005 (.092)	
COMPINSSEC	-							-.114 (-2.367)**		-.117 (-2.415)**	
COMPGRYSEC	-								-.094 (-1.953)*	-.095 (-1.670)*	
ACINDSEC	+										-.034 (-.594)
ACGRYSEC	-										-.108 (-1.893)*
F-statistic		1.137	1.812	2.289*	1.613	2.128*	1.300	2.289*	1.837	2.225**	1.445

Variable Definitions are the same as for Table 1.

*, **, *** Indicates significance at the ten-percent, five-percent and one-percent levels, respectively.

4.4. Combined Compensation Transparency Results

Table 4 displays regression results when I use the combined compensation transparency score as my dependent variable. As one can see, combined compensation transparency is positively related to the percentage of independent compensation committee members and negatively related to the percentage of inside and gray compensation committee members. These results support hypotheses 1a, 1b, and 1c. All three combined compensation committee

independence and financial expertise variables are related to combined compensation transparency as expected, although only inside and gray financial expertise are significant when all three variables are included in one regression model. These results provide solid support for hypothesis 3b and 3c. None of the audit committee variables are statistically significant. Firm size is negatively related to combined compensation transparency in most of the models, although the relationship is marginal. Board size is positively related in one regression model.

Table 4. Results of Regression of Combined Executive and Director Compensation Transparency

MODEL	Exp Rel	1	2	3	4	5	6	7	8	9	10
BRDSIZE	-	.093 (1.723)*	.072 (1.343)	.082 (1.523)	.072 (1.340)	.083 (1.544)	.075 (1.395)	.082 (1.523)	.078 (1.452)	.079 (1.484)	.082 (1.521)
BLOCK%	-	.048 (.965)	.065 (1.330)	.051 (1.027)	.064 (1.304)	.053 (1.065)	.055 (1.109)	.051 (1.027)	.060 (1.209)	.062 (1.264)	.050 (1.009)
LN(MVE)	+	-.104 (-1.900)*	-.088 (-1.614)	-.105 (-1.911)*	-.087 (-1.601)	-.097 (-1.757)*	-.092 (-1.684)*	-.105 (-1.911)*	-.092 (-1.668)*	-.098 (-1.811)*	-.094 (-1.709)*
COMPIND	?		.167 (3.476)***								
COMPINS	?			-.112 (-2.325)**							
COMPGRY	?				-.157 (-3.263)***						
ACIND	+					.067 (1.381)					
COMPINDSEC	+						.141 (2.948)***			.077 (1.362)	
COMPINSSEC	-							-.112 (-2.325)**		-.111 (-2.313)**	
COMPGRYSEC	-								-.147 (-3.056)***	-.109 (-1.933)*	
ACINDSEC	+										-.006 (-.113)
ACGRYSEC	-										-.082 (-1.434)
F-statistic		2.094*	4.405***	2.715**	4.043***	2.051*	3.547***	2.715**	3.711***	3.814***	1.781

Variable Definitions are the same as for Table 1.

*, **, *** Indicates significance at the ten-percent, five-percent and one-percent levels, respectively.

5. Discussion

In summary, compensation committee composition seems to have a larger influence on compensation transparency than does audit committee composition. Generally speaking, compensation committee independence (non-independence) is positively (negatively) related to transparency, indicating that independent directors attempt to ensure that stockholders and other interested parties outside the firm have adequate information to evaluate director and executive compensation. I report some evidence that audit committee independence is related to greater transparency, although that evidence is limited to just the executive compensation measure. When I combine independence and financial expertise, compensation committee composition also seems to have a larger influence than audit committee composition. Using the director compensation transparency measure, the percentage of independent financial experts on the compensation committee and the percentage of gray financial experts on the compensation committee are statistically significant when tested individually, and the percentage of independent financial experts remains significant when combined with the other two measures. Using the executive and combined measures, the percentage of inside and gray financial experts are significant when tested alone and with the other measures. I find evidence of a marginal relationship between gray financial experts on the audit committee and executive compensation transparency.

All in all, it appears from my evidence that independence plays a larger role in compensation transparency than does financial expertise. My results generally indicate that regulators and other stakeholders may want to focus on compensation committee composition when considering ways to enhance compensation transparency. Specifically, firms should be encouraged to add independent directors to their compensation committees, whether they have financial expertise or not. Similarly, firms should be encouraged to exclude inside and gray directors from their compensation committees.

6. Limitations

One limitation concerns my transparency measures. As noted above, the S&P index concerns whether an item is disclosed, not the quality or accuracy of the disclosure. As a result, firms that disclose misleading information could have relatively high scores on this index. Although I am only using a subset of the scores, the fact that Patel and Dallas (2002) report that overall scores are significantly negatively correlated with market risk indicates that firms scoring high on this index are not voluntarily disclosing misleading information.

A second limitation is that since I have data from only one year, I only provide evidence of associations between variables. I am not able to indicate the direction of the relationship. For example, I am not able to document that an increase in the percentage of inside compensation committee members causes compensation transparency to decrease.

Another limitation concerns the expertise measure I use in my analysis. I base this classification on information provided in company proxy statements. Although there is a minimum level of information that must be provided (experience over the last five years), some firms provide much more information on their directors than do other firms. As a result, a director who was a CFO seven years ago may not be classified as an accounting expert if the firm only provides information for the previous five years.

7. Concluding Remarks

The increase in executive and director compensation in recent years has resulted in increased scrutiny of corporate compensation practices. Investors, regulators, and other stakeholders have called on firms to provide greater transparency concerning these practices. My results from a sample of US firms prior to the passage of the Sarbanes-Oxley Act and the Dodd-Frank Act indicate that compensation committee composition plays a greater role in the transparency of compensation practices than does audit committee composition. In addition, the independence of committee members is more important than their financial expertise. Investors, regulators, and other stakeholders outside of the US looking to increase the transparency of corporate compensation practices should look to increase the independence of compensation committees as one possible way to increase compensation transparency.

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Appendix A
Questions Used to Assess Compensation Disclosure Transparency
Taken From Patel and Dallas (2002)

Director Compensation Index

- Discuss decision-making process of directors' pay?
- Are specifics of directors' salaries disclosed (numbers)?
- Form of directors' salaries disclosed (cash, shares, etc.)?
- Specifics disclosed on performance-related pay for directors?

Executive Compensation Index

- Is there a remuneration/compensation committee?
- Names on remuneration/compensation committee?
- Discuss the decision-making of managers/ (not board) pay?
- Numbers of managers' (not board) salaries disclosed?
- Form of managers' (not board) salaries disclosed?
- Specifics disclosed on performance-related pay for managers?
- Details of the CEO's contract disclosed?