The role of corporate governance in mitigating the selective disclosure of executive stock option information

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Abstract

We examine the nature and extent of statutory executive stock option (ESO) disclosures by Australian listed companies over the 2001 to 2004 period, and the influence of corporate governance mechanisms on these disclosures. Our study is motivated by the sensitive nature of ESO information, in particular price and value-related information on options, and the incentives of managers to withhold such information. Also, since 2001, Australian corporate regulators have progressively introduced more onerous ESO disclosure requirements to harmonise with international accounting standards. Consistent with the regulators' intentions, our results show a progressive increase in overall compliance from 2001 to 2004. However, despite the improved compliance, the results reveal managements' continued reluctance to disclose more sensitive ESO information. Factors associated with good internal governance, including board independence, audit committee independence and effectiveness, and compensation committee independence and effectiveness are found to contribute to improved compliance. Similarly, certain external governance factors are associated with improved disclosure, including external auditor quality, shareholder activism (as proxied by companies identified as poor performers by the Australian Shareholders' Association), and regulatory intervention. Our findings, particularly for sensitive ESO disclosures, have important implications for corporate regulators, standard setters, financial statement preparers, shareholders, and other stakeholders concerned about ESOs.

Key Words: executive stock options, selective disclosure, compliance, corporate governance

JEL Classification: M40, M41

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1. Introduction

Over the past decade much criticism has been levelled at corporations for paying executives excessive non-performance-linked remuneration (Boyd and Clegg, 2002; Hill and Yablon, 2002). The recent financial crisis has intensified these criticisms, leading to calls for further regulatory intervention (Hepworth and Durkin, 2008). In the past, regulatory intervention has primarily focused on enhancing the mandatory disclosures in annual reports. Ideally annual report disclosures should provide shareholders with sufficient information to evaluate the appropriateness of executive remuneration practices. Disclosures can be particularly informative for more complex remuneration arrangements involving executive stock option (ESO) plans where the potential for large rewards are considerable. However, where remuneration practices appear excessive or reduce a company's competitive advantage, executives have incentives to provide opaque disclosures and withhold sensitive information. As there is little known about these disclosure practices, we examine ESO disclosure compliance by Australian listed companies and focus on the role of corporate governance in influencing compliance with the disclosure of sensitive ESO information.

The Australian regulatory setting is a particularly interesting one in which to examine ESO disclosure compliance. Between 2001 and 2004 numerous controversial amendments were introduced in Australia to align its ESO disclosure standards with international best practice.¹ These changes were comprehensive and involved amendments to the Australian *Corporations Act* and various Australian accounting standards (see Appendix A). Whilst it could be expected that more onerous disclosure regulations would be accompanied by greater compliance (see Clarkson et al. 2006; Coulton et al. 2003), it is not clear how effective these rules were over time and for specific disclosure items.

¹ Prior to 2003, accounting standard enforcement in Australia was rated lower than the United States (U.S.) and the United Kingdom (UK) and as a consequence, this environment provided considerable discretion to managers in their treatment of statutory disclosures (see Hope, 2003).

We consider two research questions arising from the above motivations: (1) what is the nature and extent of compliance with ESO disclosure requirements in annual reports and do they change over time, in particular, do firms withhold significantly more sensitive ESO disclosures, compared to non-sensitive ESO disclosures?; and (2) how does corporate governance influence compliance with ESO disclosures? As in prior studies, we construct comprehensive disclosure indices to test disclosure compliance. However, we also develop a separate disclosure index for sensitive ESO disclosure items (value and price-related option information).

In answer to the first research question, our study reveals that companies increased ESO disclosure compliance from 73 percent to 83 percent over the study period. Interestingly, a detailed examination of the nature of the non-disclosed items reveals that firms were significantly more likely to withhold the more sensitive value and price-related option information, compared to the non-sensitive information. Importantly, lower compliance with these sensitive items is masked in a simple analysis of aggregate disclosure scores.

In answer to our second question, our findings indicate that internal governance mechanisms, including board independence and audit committee independence and effectiveness, explain ESO disclosure compliance (with both overall and sensitive items). Additionally, compensation committee independence and effectiveness explains compliance with sensitive disclosures but not overall compliance. With regard to external governance mechanisms, external auditor quality and regulatory intervention in the form of new and more comprehensive disclosure regulations, as well as corporate regulators' guidance and enforcement actions, successfully enhance overall compliance. Shareholder activism is also associated with lower overall compliance, but no association is evident with sensitive disclosures.

This study makes several important contributions. It is the first to provide a comprehensive analysis of the nature and extent of statutory ESO disclosures by Australia's largest corporations. Importantly, the findings indicate that companies appear to be reluctant to disclose sensitive information, which is not evident in aggregated disclosure analysis. Second, the study provides evidence that internal and external corporate governance is important in explaining compliance with ESO disclosures. In particular, we show that shareholder activism and the independence and effectiveness of the compensation committee are important influencing factors in ESO disclosure decisions. Third, the findings provide evidence that compliance has increased over time, indicating that the efforts by corporate regulators and standards setters to enhance financial reporting have been effective in improving compliance with ESO disclosure obligations.

The remainder of this paper is organised as follows. Section 2 reviews the literature and theory pertinent to ESO disclosures and develops the hypotheses. The sample, data, and the research design are outlined in section 3. Section 4 reports the descriptive statistics on ESO disclosure compliance and results of the univariate and multivariate tests. Robustness tests are reported in section 5 and the paper concludes in Section 6 with a summary and discussion of the findings.

2. Theoretical background and hypotheses

2.1. Disclosure overview

It is widely acknowledged that, due to information asymmetry, capital markets will not function efficiently or fairly without regulatory intervention (Cooper and Keim, 1983). While a policy of full disclosure can mitigate the information asymmetry problem, managers often have incentives to suppress or distort public disclosures (Beaver, 1998).² Hence, managers

² For example, Aboody and Kazsnik (2000) show that managers of U.S. firms disclose bad news prior to a stock option award period and delay the disclosure of good news, which is consistent with managers making disclosure decisions to increase

face a trade-off between the costs and benefits of disclosure. Regulatory intervention aims to redress the reluctance of managers to reveal information and reduce the information gap between informed and uninformed investors by ensuring a minimum level of disclosure to investors and other stakeholders (Healy and Palepu, 2001). However, an increasing body of literature shows that managers exercise considerable discretion in their compliance with disclosure regulation (Clarkson et al. 2006; Morris et al. 2004; Nelson and Percy, 2005; Nelson and Percy, 2008; Owusu-Ansah and Yeoh, 2005; Street and Gray, 2002; Taplin et al. 2002; Tower et al. 1999). This lack of compliance suggests that even in the presence of high quality accounting regulations, disclosures may be sub-optimal, particularly where management has incentives to avoid compliance (Ball et al. 2003), and where regulatory enforcement and corporate governance are weak.

2.2. Disclosure of statutory stock option information

Despite the controversial nature of ESO disclosures, relevant literature is limited to a small number of studies. UK studies by Conyon et al. (2002) and Forker (1992) find evidence of an association between stock option disclosures and certain board characteristics, but they do not comprehensively examine the influence of governance characteristics on the extent of compliance, or examine the disclosure of sensitive ESO information.

Nelson and Percy (2005) examine the transparency of ESO disclosures provided by Australian listed companies in accordance with accounting standards AASB1028 (1995) and AASB1017 (1997) for the financial years 2000 and 2002. They find compliance averaged only 45 percent of total statutory disclosures for the period, but it increased from 40 percent in 2001 to 50 percent in 2002; a change they attribute to the change in management behaviour following the corporate scandals and collapses in 2001. While Nelson and Percy examine compliance, they do not examine specific types of disclosures, the influence of governance

stock-based compensation. That is, managers appear to selectively time trading and disclosures at the expense of shareholders (Core, 2001).

factors, or whether disclosures improved after 2002.³ Interestingly, Bassett et al. (2007) extend Nelson and Percy (2005) to employee stock options and find, for 2003, a higher level of compliance (75 percent) for these disclosures. However, they do not investigate why compliance is higher for employee, as opposed to executive, stock options. One possibility is that managers may be more willing to disclose information about employees, as compared to executives, due to the sensitive nature of ESO information. By avoiding the disclosure of sensitive items, managers may be attempting to avoid unwelcome remuneration scrutiny by shareholders.

Given that the disclosure of ESO information is controversial, in that ESOs can result in potentially large wealth transfers to managers, it can be expected that firms have incentives not to disclose ESO information that is considered more sensitive. Hence, we expect that by dividing ESO disclosures into sensitive and non-sensitive disclosures, we will find compliance with sensitive disclosures to be lower. This expectation is summarised in the following hypothesis:

H1: Companies are more likely to be forthcoming with non-sensitive ESO disclosures than sensitive ESO disclosures.

While firms may be reluctant to disclose sensitive ESO information, other characteristics can influence disclosure compliance, such as corporate governance. As outlined above, the disclosure compliance research is inconclusive on the impact of corporate governance and regulatory enforcement on the disclosure of sensitive executive remuneration information. However, governance structures should ensure that agency costs are minimised and stakeholders receive reliable information about the value of their investment in the firm (Bushman and Smith, 2003). Regulatory intervention in the form of disclosure regulations act

³ Nelson and Percy (2008) extend Nelson and Percy (2005), examining compliance with stock option disclosures required by s.300A (1)(c) and s.300 (1)(d) of the *Corporations Law/Act* for financial years 2000 and 2002. Similar to Nelson and Percy (2005), corporate governance factors are not considered by Nelson and Percy (2008).

as an external governance mechanism and is likely to lead to more effective shareholder monitoring in circumstances where managers have incentives to withhold information (Ferrarini and Moloney, 2005). Thus, we expect that both effective regulation and effective corporate governance mechanisms are pre-conditions for ensuring useful corporate disclosure about sensitive ESO information.

2.3. The role of internal corporate governance

Following prior research, three aspects of internal governance are likely to directly or indirectly impact on compliance with ESO disclosure obligations: (a) board independence and effectiveness, (b) audit committee independence and effectiveness, and (c) compensation committee independence and effectiveness.

(a) Board independence and effectiveness

Governance research views the board of directors as being the “lynchpin of corporate governance” (Gillan, 2006, p. 385). Board independence (independent chairperson and a majority of independent directors on the board) is almost universally viewed as a desirable governance characteristic. When the roles of CEO and chairperson are combined, agency problems may arise because the one person has the ability, and the influence, to opportunistically distort the information flow to outsiders (Ho and Wong, 2001; Yermack, 1996). Similarly, a larger proportion of independent directors on the board are more effective in monitoring management because they are less aligned to management (Fama and Jensen, 1983). Empirical research generally supports these claims. CEO duality is found to be associated with lower quality disclosure (Bassett et al. 2007; Cheng and Courtnay, 2006; Forker, 1992) and greater board independence is found to be associated with more comprehensive statutory disclosures and greater disclosure of stock option information (Chen and Jaggi, 2000; Conyon et al., 2002). Hence, we expect the independence of a company’s board of directors is positively associated with ESO disclosures.

In prior studies the effectiveness of the board is often examined by reference to its structure (size) and activity (frequency of meetings) (Gillan, 2006). While a board's monitoring ability increases with board size, the benefits may be negated by the incremental cost of less effective communication and reduced decision making capabilities associated with larger groups (John and Senbet, 1998). In analysing the effectiveness of small boards, Yermack (1996) finds a negative relation between board size and firm value. In contrast, Bradbury et al. (2006) find a positive relation between board size and high accounting quality. Findings for board activity are less equivocal. Vafeas (1999) shows that boards that meet more frequently outperform those that meet less frequently. Although not previously addressed in disclosure research, we expect that boards that meet more frequently are more effective in ensuring corporate compliance with mandatory ESO disclosure obligations.

(b) Audit committee independence and effectiveness

The independence of the audit committee is claimed to be a necessary requirement for the committee to be able to carry out its responsibilities objectively (Abbott et al. 2004; Felo et al. 2003). As a consequence, financial reporting quality is expected to be of a higher standard in the presence of an independent audit committee. Research in various contexts (e.g. Bradbury et al., 2006; Cotter and Silvester, 2003; Wright, 1996) supports this association. Hence, we also expect that the independence of a company's audit committee is positively associated with ESO disclosures.

As with board effectiveness, audit committee structure (size) and activity (meeting frequency) are claimed to contribute to better corporate governance. Recent evidence also suggests that expertise (the accounting experience of the audit committee) contributes to better governance. Consistent with these claims Felo et al. (2003) find that larger audit committees positively influence financial reporting quality. Anderson et al. (2004) find that audit committee size is inversely related to the firm's cost of debt, which they attribute to the

influence of the committee size on disclosure transparency. For firms with more active audit committees, Abbott et al. (2004) and Naiker and Navissi (2005) find evidence of higher quality financial reporting. Also, Felo et al. (2003), and Naiker and Navissi (2005) report that the accounting experience of the audit committee is positively associated with higher quality financial reporting and accounting. We therefore expect the level of audit committee effectiveness (size, activity, and expertise) is positively associated with ESO disclosures.

(c) Compensation committee independence and effectiveness

The compensation committee is responsible for evaluating management's performance and creating appropriate remuneration packages. In determining the nature and amount of compensation for company executives, compensation committees can help alleviate agency problems by constructing and implementing incentive schemes that are designed to align the goals of senior management with those of shareholders (Uzun et al. 2004). While the existence of a compensation committee appears to influence ESO disclosures (Nelson and Percy, 2005), there is no known disclosure research that specifically examines the effectiveness of the compensation committee on company disclosures.⁴ However, compensation committee independence and effectiveness is likely to be a strong influence for a number of reasons. First, a more independent compensation committee is less aligned to management and hence, is more likely to encourage more transparent disclosures. Second, a more active compensation committee is better able to monitor the appropriateness of the remuneration packages more frequently. Third, a larger compensation committee has more resources to construct, evaluate, and monitor the compensation packages of senior management and ensure the alignment with the goals of the shareholders and performance of the company. Thus, an independent and effective compensation committee should engender a

⁴ Clarkson et al. (2006) examine the independence of the compensation committee when investigating the quality of CEO remuneration disclosures. However, it formed part of a single governance factor consisting of non-compensation committee variables. Hence, it is not possible to determine the exact relationship between the independence of the compensation committee and disclosure, in their study.

remuneration environment where management have few incentives to withhold ESO information.

In summary, it is expected that board, audit, and compensation committee independence and effectiveness are positively associated with the level of compliance with ESO disclosure obligations (both overall and those items classified as sensitive disclosure items). These expectations are summarised in the following hypothesis:

H2: Internal corporate governance mechanisms are associated with a higher level of ESO disclosure compliance for (a) overall and (b) sensitive disclosure items.

2.4. The role of external corporate governance

In addition to the internal corporate governance mechanisms of a company, external mechanisms are created by independent parties to act as a form of external monitoring of the company. It is expected that increased monitoring will result in reduced information asymmetry and lower agency costs, thereby increasing compliance with ESO disclosures. External monitors of company behaviour include, external auditors, those acting on behalf of shareholders, and corporate regulators.

(a) External auditor size

It is frequently argued that larger audit firms invest more than smaller audit firms to maintain their reputation as providers of quality audits. As a consequence, larger audit firms are more likely to exert a greater influence over a company's disclosure and compliance practices than smaller audit firms (Owusu-Ansah, 2005). Consistent with these arguments numerous studies find a positive association between auditor size (as measured by the "Big-N/non-Big-N" dichotomy) and disclosure compliance (Bassett et al. 2007; Owusu-Ansah, 2005; Street and Gray, 2002). Similar, we expect a positive association between audit firm size and ESO disclosure compliance.

(b) Shareholder activism

Shareholder activism represents an external governance mechanism that often arises in response to poor governance by boards of directors (Gillan and Starks, 1998). The Australian Shareholders' Association (ASA) is a shareholder activist organisation that monitors annual reports and other disclosures for the largest Australian listed companies and challenges companies that do not act in the best interests of their shareholders.⁵ The ASA focuses particularly on questioning poor financial performers who inappropriately reward executives with higher remuneration, including ESOs. Managers of poor-performing companies therefore have incentives to avoid ASA scrutiny by providing opaque or non-compliant ESO disclosures. Therefore, those firms classified as poor performers by the ASA are expected to produce a lower level of ESO disclosure compliance than non-poor performers.

(c) Regulatory intervention

Regulatory intervention includes scrutiny by corporate regulators, new or amended regulations, and regulatory enforcement practices. Hence in this study, regulatory intervention is an indirect measure of the effect of the corporate regulator's actions on ESO disclosures. Demands for regulatory intervention increased considerably following the corporate collapses and scandals of the early 2000s. In response, new accounting standards were introduced in Australia in 2003 and 2004 that required far more onerous equity-based compensation disclosures (see Appendix A).⁶ Also, the corporate regulator, the Australian Investment and Securities Commission (ASIC), released option valuation guidelines and significantly increased its surveillance of corporate disclosure in annual reports. Prior evidence indicates that some of these changes had a positive effect on CEO remuneration disclosures (Clarkson et al. 2006; Coulton et al. 2003). Similarly, with the continuing scrutiny on executive

⁵ The ASA was established with the objective of protecting and enhancing the interests of shareholders by "pressing for improvements in transparency and accountability in relation to company performance, executive remuneration, treatment of minority shareholders, risk management, and dividend policy" (ASA, 2006).

⁶ The number of items requiring disclosure increased significantly from 2001 to 2004, i.e. 2001: 28 items, 2002: 28 items, 2003: 52 items, 2004: 64 items.

compensation, and the particular focus on stock options, we expect the extent of compliance with ESO disclosures to increase over the extended period from 2001 to 2004.

In summary, it is expected that external auditor quality, more shareholder activism (as proxied by ASA scrutiny), and greater regulatory intervention are associated with greater ESO disclosure compliance. These expectations are summarised in the following hypothesis with respect to external governance and ESO disclosures:

H3: External corporate governance mechanisms are associated with a higher level of ESO disclosure compliance for (a) overall and (b) sensitive disclosure items.

3. Sample, data, and research design

3.1. Sample and data

The sample is sourced from the Standard and Poor's Australian Securities Exchange (ASX) Top 300 Constituent List as at 30 June 2004. For these Top 300 companies, the annual reports for the study period 2001 to 2004 were obtained from the *Connect 4 Annual Report Collection* and *Aspect-Huntley Annual Reports Online* databases and scrutinised for ESO information. The majority (226) of these companies disclosed material ESOs in all years where reports were available, which clearly highlights the popularity of this type of compensation among the larger Australian companies. To ensure sample homogeneity across the study period for testing and comparative purposes, firms were deleted if they: were not listed for the full four-year study period (38 firms); did not have a 30 June financial year end (49 firms); were listed as a trust (20 firms); or, were domiciled in a foreign country (4). A final sample of 115 firms met these criteria. These reports were manually searched for ESO compliance information to construct the dependent variable. Data for the independent variables were also sourced from company annual reports with the exception of the ASA

shareholder activism variable, which was sourced from *Equity*, the quarterly journal published by the ASA.

3.2. Measurement of ESO disclosure compliance

Consistent with prior research, the extent of compliance with ESO disclosures is measured using disclosure indices.⁷ These indices (for overall and sensitive items) consist of requirements in AASB1028 (1995; 2002), AASB1017, AASB1046, and s.300 (1)(d), s.300 (5), and s.300A(1)(c) of the *Corporations Act 2001*. The items in the disclosure indices are awarded a score of one if the item is disclosed and a score of zero if the item is not disclosed. Where an item is not applicable to a particular company, the company is not penalised. Instead, that item is not included in the calculation of the final index score.

An overall compliance score is calculated for all applicable regulations (pooled) for each year of the study period. In order to derive a score out of one (or 100 percent) for each firm, the number of items disclosed, that is, items coded as one in the index are added together. The total number of statutory disclosures identified is then divided by the total possible number of statutory disclosures.⁸ This method of calculating compliance scores allows for all items within the disclosure index to be weighted equally.

Similarly, for each year, a sensitive-item score is derived from the overall statutory disclosure item list. The process used to identify sensitive items follows the findings of Nelson and Percy (2005, 2008). Their findings provide evidence of firms' reluctance to disclose certain statutory, price-related ESO information in 2000 and 2002. These disclosure items, which included the amount, price, and value of option information were the most contentious in the commentary period prior to the introduction of the standards and as a result, were expected to be the most costly to comply with following the introduction of the

⁷ In this study, "compliance" and "extent of compliance" refer to 'average' compliance by firms. Except for assessing the disclosure sensitivity, no attempt is made to measure the importance, comprehensiveness, or quality of these disclosures.

⁸ The results are quantitatively the same when we use the same scoring method but determined by each regulation rather than by pooling the regulations.

standards. Appendix B provides a full list of all the disclosure items included in the overall- and sensitive-item disclosure indices.

Based on these indices two dependent variables are created: (1) the extent of overall disclosure (*COMPLNCE*) and (2) the extent of sensitive disclosure (*SENSCOMP*). Research question one (nature and extent of compliance) and research question two (effect of corporate governance) are examined using both dependent variables.

3.3. Measurement of corporate governance

Consistent with prior research, corporate governance variables are initially identified and measured as follows:

Internal:

- CEOCHAIR* = 2 for separate CEO/Chair and non-executive chair (100 percent independence);
= 1 for separate CEO/Chair and executive chair (some independence);
= 0 otherwise (no independence);
- BRDNONEX* = percentage of non-executive directors on the board;
- BRDSIZE* = total number of directors on the board;
- BRDMTGS* = the number of board meetings held during the year;
- ACMEET* = the number of audit committee meetings held during the year;
- ACINDP* = percentage of non-executive directors on audit committee;
- ACSIZE* = the number of members on audit committee;
- ACACCEXP* = percentage of directors with accounting expertise on audit committee;
- CCMTGS* = the number of compensation committee meetings held during the year;
- CCSIZE* = the number of members on compensation committee;
- CCINDP* = percentage of non-executive directors on the compensation committee;

External:

- AUDITOR* = 1 for Big 4 auditor; 0 otherwise;
- POORPER* = 1 for the year ASA identified company as poor performer, 0 otherwise;
- REGINTVN* = 1 for 2002; 2 for 2003; 3 for 2004 (2001 is the base case and equals 0).

3.4. Hypothesis testing procedures

To determine the nature and extent of compliance with ESO disclosures (research question one), we examine the summary statistics of the dependent variables, overall compliance (*COMPLNCE*) and sensitive compliance (*SENSCOMP*). Statistical tests of differences between the sensitive and non-sensitive compliance scores are performed to test hypothesis 1. We then formally investigate hypotheses 2 and 3 using multivariate regression procedures to

test the corporate governance factors that may influence ESO disclosures and to answer research question two.

To measure the effect of internal corporate governance on the extent of ESO compliance (hypothesis 2), we follow Larcker et al. (2007) by using principal component analysis (PCA) to reduce the large number of highly collinear internal governance variables into factors that identify the underlying dimensions of corporate governance. As reported in Table 1, the significant correlations among most of the individual governance variables strongly support the PCA approach.

[INSERT TABLE 1 HERE]

Initial PCA of the eleven internal governance variables identified four interpretable factors: *BRDINDP*, *BRDACTY*, *ACOMMEE*, and *CCOMMEE* (see Table 2).⁹

[INSERT TABLE 2 HERE]

The factor scores from each of the four factors identified in Table 2 are then used in a regression model to examine the effect of internal governance (hypothesis 2). The effect of external governance (hypothesis 3) is examined using the individual variables, *AUDITOR*, *POORPER*, and *REGINTVN* in a multivariate regression model.

The two models used to examine the extent of compliance with ESOs disclosure, and test the hypothesised associations with internal and external governance characteristics, are presented in equation 1 below.

$$\begin{aligned}
 COMPLNCE_{it} \text{ or } SENSCOMP_{it} = & \\
 & \beta_1 + \beta_2 BRDINDP_{it} + \beta_3 BRDACTY_{it} + \beta_4 ACOMMEE_{it} + \beta_5 CCOMMEE_{it} + \\
 & \beta_6 AUDITOR_{it} + \beta_7 POORPER_{it} + \beta_8 REGINTVN_{it} + \\
 & \beta_9 CEOREMUN_{it} + \beta_{10} LEVERAGE_{it} + \beta_{11} SIZE_{it} + \beta_{12} PERFORM_{it} + \beta_{13} LOSS_{it} + \\
 & \beta_{14} LOSSPERF_{it} + \varepsilon_{it}
 \end{aligned} \tag{1}$$

⁹ Prior to conducting PCA, several governance variables were converted into categorical variables after detecting non-normal distributions (Keller et al. 1990). This approach is consistent with those commonly adopted in similar accounting-based research.

Where:

Dependent variables:

(1)*COMPLNCE* = total number of statutory disclosures made divided by total possible number of statutory disclosures.

(2)*SENSCOMP* = total number of sensitive disclosures made divided by total possible number of sensitive disclosures.

Independent variables:

BRDINDP = Board independence (Factor scores derived from PCA);

BRDACTY = Board activity (Factor scores derived from PCA);

ACOMMEE = Audit committee independence and effectiveness (Factor scores derived from PCA);

CCOMMEE = Compensation committee independence and effectiveness (Factor scores derived from PCA);

AUDITOR = 1 for Big 4 auditor; 0 otherwise;

POORPER = 1 for the year ASA identified company as poor performer; 0 otherwise;

REGINTVN = 1 for 2002; 2 for 2003; 3 for 2004 (2001 is the base case and equals 0) (captures increasing regulatory activity).

Control variables:

CEOREMUN = total CEO remuneration scaled by the median of total CEO remuneration for all sample firms;

LEVERAGE = total debt divided by total assets;

SIZE = log of total assets;

PERFORM = return on assets measured as net income divided by total assets;

LOSS = 1 for loss making company; 0 otherwise;

LOSSPERF = loss dummy multiplied by performance (captures the size of the loss).

Significant, positive coefficients on the *BRDINDP*, *BRDACTY*, *ACOMMEE*, and *CCOMMEE* variables would indicate support for hypothesis 2. A significant, negative coefficient on *POORPER* and significant, positive coefficients on *AUDITOR* and *REGINTVN* variables would provide support for hypothesis 3. A random effects generalised least square (GLS) regression procedure is used to estimate models 1 and 2¹⁰ to control for any serial dependence in the data.¹¹

The control variables included in equation 1 (*CEOREMUN*, *LEVERAGE*, *SIZE*, *PERFORM*, *LOSS* and *LOSSPERF*) control for other non-governance factors likely to explain disclosure compliance. Excessive executive remuneration has been frequently criticised in recent years, particularly where there is no obvious link to firm performance. The negative

¹⁰ Model 2 is also estimated using a GLS Tobit regression model because the dependent variable, *SENSCOMP*, is a limited dependent variable (Gujarati, 2003). The results are consistent with the GLS regression.

¹¹ The rejection of a fixed effects model (following the Hausman test results) led to the application of a random effects generalised least squares (GLS) regression model to test the panel data.

reactions have resulted in severe declines in share prices for some companies (Hill and Yablon, 2002). Consequently, executives have incentives to limit remuneration disclosures where the remuneration may be perceived as excessive in comparison with other companies. Hence, we expect relative CEO remuneration (*CEOREMUN*) to be negatively associated with the level of compliance with ESO disclosures.

Companies that are more highly leveraged incur more monitoring costs and attempt to reduce these costs through increased disclosure (Jensen and Meckling, 1976). However, Jensen (1986) argues that increased leverage is expected to reduce disclosure because leverage helps to control the free cash-flow problem, and the agency costs of debt are controlled through restrictive covenants in debt agreements rather than through increased disclosure. Accordingly, Jensen finds an inverse association between debt and disclosure. Also, Eng and Mak (2003) and Hossain et al. (1995) find a negative relation between leverage and voluntary disclosure. However, Ferguson et al. (2002) find a positive relation between leverage and voluntary disclosure. Following these findings, we expect an association between leverage and compliance with ESO disclosure obligations, but make no prediction about the direction of the association.

Disclosure studies frequently document an association between disclosure and company size (Ho and Wong, 2001; Nelson and Percy, 2005; Owusu-Ansah and Yeoh, 2005), and firm performance (including both profitability and loss-making status) (Coulton et al. 2003; Owusu-Ansah and Yeoh, 2005; Taplin et al., 2002). We expect similar factors are associated with the ESO disclosure compliance in our study.

4. Results

4.1. Descriptive statistics

Table 3 reports the descriptive statistics on all continuous and dichotomous variables used in the study for the pooled sample of 460 firm years.

[INSERT TABLE 3 HERE]

4.2. Nature of compliance and univariate testing

Table 4 Panel A shows that the overall compliance (pooled) for the 2001 to 2004 period is 77 percent, indicating that while compliance is high, it would be expected to be higher because these disclosures are mandated.¹² However, compliance has steadily increased each year since 2001, with the highest level of compliance in 2004 (83 percent).

When examining compliance in more detail, non-sensitive disclosures exhibit a high level of compliance (81 percent) for the 2001 to 2004 period, in contrast to much lower compliance for sensitive disclosures (45 percent). These statistics indicate that firms withhold approximately half of the required sensitive information. The significant difference between compliance with sensitive disclosures compared to non-sensitive disclosures is further supported by strong results obtained from the paired sample t-tests in each year of the study. Although there is low compliance with sensitive disclosures, compliance has progressively increased from 2001 (28 percent) to 2004 (67 percent). The progressive increase in overall and sensitive disclosures over the study period coincides with the increased guidance and enforcement efforts by corporate regulators and standard setters.

[INSERT TABLE 4 HERE]

Table 4 Panel B presents the average compliance levels for each regulation for ESO disclosures. The *Corporations Act 2001* has the highest levels of compliance, whilst AASB1028 (1995) '*Accounting for Employee Entitlements*' has the lowest levels. The lower

¹² Materiality is a possible explanation for non-disclosure in some cases where the number of stock options used in a firm is relatively small.

compliance may be due to the distinct types of information required to be disclosed by the different regulations. For example, AASB1028 (1995) requires more price and value-related (sensitive) information regarding stock options than the *Corporations Act*, thereby contributing to the low levels of less than 70 percent average compliance with AASB1028 (1995). As for the year-by-year results, the comparative t-tests for each regulation further demonstrate that managers choose to selectively disclose sensitive option information.

The Table 4 results for non-sensitive disclosures (*NONSENS*) reveal a high level of compliance across all regulations, suggesting a willingness on the part of companies to disclose this type of information. In contrast, sensitive disclosures exhibit poor compliance, with AASB1028 (1995) as low as 25 percent. Consistent with hypothesis 1, firms' compliance with sensitive disclosures is lower than that of non-sensitive disclosures across all years and regulations. Notably, this low compliance is not immediately evident upon investigation of the overall disclosure scores, indicating that these low compliance scores are being masked by the higher overall compliance.

4.3. Multivariate test results

Hypotheses 2 and 3 predict that internal and external governance mechanisms, respectively, are associated with a higher level of ESO disclosure compliance for both overall and sensitive items. Table 5 presents the pooled results of estimating the model used to test hypotheses 2 and 3 for the full study period.¹³ The following discussion focuses on the results for the overall compliance model, and where significantly different, the results for the sensitive and non-sensitive disclosure models are contrasted and explained.¹⁴

¹³ The models were also estimated separately on a year-by-year basis. The untabulated results are consistent with the pooled results but are generally weaker due to the smaller sample size across years (n=115).

¹⁴ Untabulated correlation results indicate several statistically significant, but no high correlations among the non-governance independent variables. Also, White's tests revealed no evidence of heteroskedasticity in the data.

4.3.1. Internal corporate governance (H2)

Contrary to expectation, the board independence (*BRDINDP*) coefficient is negative (-0.019) and significant ($p < 0.01$). *BRDINDP* captures chairman independence and the proportion of non-executives on the board. While this result is contrary to expectation, it suggests that where companies lack chairperson and board independence, companies mitigate the agency problems associated with this lack of independence by providing more ESO disclosures. The board activity (*BRDACTY*) coefficient is not significant.

[INSERT TABLE 5 HERE]

Consistent with expectations, the audit committee independence and effectiveness (*ACOMMEE*) coefficient is positive (0.022) and significant ($p < 0.01$). *ACOMMEE* primarily captures the number of meetings, independence, size, and accounting expertise of the audit committee. In support of Hypothesis 2, the results indicate that audit committees that meet regularly, are larger, more independent, and have greater accounting expertise are associated with greater ESO compliance.

The compensation committee independence and effectiveness (*CCOMMEE*) coefficient is positive and significant at the 10 percent level for overall compliance, providing some support for Hypothesis 2a. In support of Hypothesis 2b, the results indicate that a more independent and effective compensation committee (measured by greater independence, more meetings, and larger size) is associated with greater compliance with sensitive ESO disclosures, as evidenced by a positive (0.034) and significant ($p < 0.05$) coefficient for *CCOMMEE*. Additionally, the *CCOMMEE* coefficient is not significantly associated with non-sensitive disclosures, further suggesting that an independent and effective compensation committee encourages a remuneration environment where managers have few incentives to provide opaque or non-compliant sensitive disclosures.

Taken together, the results for internal governance provide support for an association between internal governance mechanisms, including independent and effective audit committees and compensation committees, and higher levels of compliance with ESO disclosures.¹⁵

4.3.2. *External corporate governance (H3)*

The external auditor quality (*AUDITOR*) coefficient is positive (0.058) and significant ($p < 0.05$). Consistent with the hypothesis, it appears that there is evidence of a Big-4 auditor reputation effect, and these auditors encourage higher overall compliance. However, this result appears to be driven by the non-sensitive rather than the sensitive disclosures. Hence, it indicates that external auditors may not be as effective in monitoring such specific types of disclosure; rather focusing their efforts on ensuring companies disclose a reasonable amount of ESO information in general.

Companies identified by the ASA as poor performers disclosed less of the required information for ESOs with the *POORPER* coefficient being negative (-0.051) and significant ($p < 0.05$).¹⁶ This result suggests that the ASA's classification is successful in identifying those companies that may also be at risk of performing poorly in other areas of their operations, such as disclosure. Contrary to prediction, the *POORPER* coefficient is not significant for sensitive disclosures. However, the *POORPER* coefficient is significant ($p < 0.05$) and negative (-0.056) for non-sensitive information. These results suggest that while poor performers disclose less non-sensitive information, they are disclosing similar levels of

¹⁵ Providing further support for this conclusion, untabulated results using the individual corporate governance variables, instead of the governance factors in the regression models, show that a less independent Chairperson is associated with greater overall and non-sensitive disclosures. A decline in audit committee meetings is associated with greater non-sensitive disclosures, while an increase in compensation committee meetings is associated with an increase in non-sensitive disclosures. Larger audit committees are more likely to exhibit greater overall, sensitive, and non-sensitive disclosures.

¹⁶ Other ASA monitoring outcomes, including ESO practices considered sub-standard and various actions by companies considered detrimental to shareholders, were examined but were not found to be associated with disclosure levels.

sensitive information, as compared to non-poor performers. Perhaps these poor performers are attempting to divert attention away from their poor performance.¹⁷

As predicted, the regulatory intervention (*REGINTVN*) coefficient is positive (0.024) and significant ($p < 0.01$), indicating that compliance has progressively increased from 2001 to 2004.¹⁸ The *REGINTVN* coefficient is not significantly associated with non-sensitive disclosures. This result, taken together with the results of sensitive compliance, indicates that the trend is consistent with the effects of the major corporate collapses experienced in Australia during the early 2000s, regulatory intervention, and increased guidance and enforcement efforts by ASIC particularly for sensitive disclosures, may have motivated companies to improve disclosure.

In summary, it appears that external governance mechanisms, such as external auditor quality, more shareholder activism, and greater regulatory intervention encourage greater ESO disclosure compliance.

The results also indicate that several control variables are significantly related to ESO disclosures. Consistent with expectations, the CEO remuneration (*CEOREMUN*) coefficient is negative (-0.011) and significant ($p < 0.01$) for sensitive disclosures, indicating that higher levels of CEO remuneration are associated with lower levels of compliance with sensitive ESO information.¹⁹ The *CEOREMUN* coefficient is not significantly associated with non-sensitive disclosures, confirming that managers have greater incentives to withhold the sensitive ESO information when CEO remuneration levels are higher. Further, the results also indicate that companies with larger losses disclose less of the required information, evidenced by a negative (-0.078) and significant ($p < 0.01$) *LOSSPERF* coefficient. This result complements the ASA poor performer result by confirming that companies that are

¹⁷ These results are insensitive to the use of a one-period lagged measure of ASA poor performer.

¹⁸ In sensitivity analysis, the regression models were re-estimated using year dummy variables to test for the changes in the extent of disclosure over the study period. The results (unreported) are consistent with those of the primary regressions.

¹⁹ Other forms of director remuneration are also used as alternatives to *CEOREMUN*, including total director remuneration, total director fees, and total director salary. These remuneration variables are not significant.

performing poorly disclose less information on ESOs. The insignificant coefficients on the other control variables included in the model (*LEVERAGE*, *SIZE*, *PERFORM*, and *LOSS*) indicate that these proxies have no influence on the level of disclosure compliance after controlling for the other factors previously discussed.²⁰

5. Robustness tests

A number of robustness tests are conducted to test the sensitivity of our results to potential biases in the measurement of the disclosure compliance and governance variables.

5.1. Alternate disclosure indices

Alternative disclosure indices were created by using only those disclosure items that remained constant over the period of this study. The untabulated results are consistent with those reported in Table 5, with the exception that compensation committee independence and effectiveness (*CCOMMEE*), CEO remuneration (*CEOREMUN*), and firms making larger losses (*LOSSPERF*), are no longer significantly associated with sensitive disclosures. The lack of significance for these variables may be attributable to the reduced disclosure items remaining in the index, for example, 53 percent in 2001 and 2002; 44 percent in 2003; and 35 percent in 2004, which significantly limits the variability of the compliance scores. Generally, the results support the main regression results.

5.2. Corporate governance indices

Initially, principal component analysis was used to develop a composite measure of internal corporate governance. To increase the credibility of the findings of this study from using this analysis, we conduct additional testing using a corporate governance index. Corporate

²⁰ The variable *LEVERAGE* was also measured as total liabilities divided by total assets. Firm size was also tested using market capitalisation as a proxy. The variable *PERFORM* was also tested using Return on Equity measured as (net profit minus preference dividends) divided by average ordinary shareholder's equity. The results show *LEVERAGE*, *SIZE* and *PERFORM* were not significant using these alternate measures. In sensitivity analysis, the inclusion of a dummy variable to control for cross-listing status in our models produced insignificant coefficient results in all regression tests and had no impact on previously reported findings. The insignificant results are potentially due to the small number of firms in our sample that are cross-listed.

governance indices have been frequently used in capital markets research in the U.S. (Brown and Caylor, 2006; Gompers et al. 2003). These studies find corporate governance is significantly associated with equity prices and firm value. Coulton et al. (2003) use a corporate governance index, in an Australian context to test for an association between governance variables and transparency of CEO remuneration disclosures. However, they find that corporate governance is not associated with transparency. Hence, commercially available indices may capture a broader range of governance characteristics. Both Beekes and Brown (2006) and Gallery et al. (2008) use the Horwath Report for its corporate governance index, for the Australian Top 300 companies listed. These studies find that corporate governance is associated with more informative price-sensitive disclosures and International Financial Reporting Standards (IFRS) disclosures, respectively.

Following the prior research, we use both a self-constructed governance index and Horwath Report rankings. The self-created governance index is significantly associated with sensitive ESO disclosures, indicating that better governance structures are more likely to encourage improved disclosure of sensitive information. The untabulated results report that the Horwath index is not significant, possibly due to the reduced sample size from several firms not receiving a ranking from this index. These results suggest that commercially available indices may be too broad to capture the effect of corporate governance on compliance, whereas a self-created, more focused index may be more effective.

5.3. The impact of changes in governance characteristics

A change model is estimated to examine whether changes in corporate governance are associated with changes in compliance over time. Generally, the results (untabulated) are weaker than the main findings, possibly due to the small variation in governance variables from year-to-year. Also, the smaller sample size may have reduced the power of the model.

The changes model was estimated for changes on a year-by-year basis (n=345) and for changes from the beginning to the end of the sample period (n=115).

6. Summary and discussion

The investigation of the nature and extent of compliance with ESO disclosures has produced important revelations about companies' disclosure behaviour. In answer to research question one, overall, companies were not fully compliant with the statutory disclosures for ESOs even after the introduction of the new regulations and the intervention by ASIC, indicating that some companies are continuing to be selective in the disclosure of ESO information. On closer examination of the disclosure indices for each regulation, it was revealed that companies were significantly less likely to disclose the more sensitive price and value-related information about options, as compared to non-sensitive information. When total disclosure is examined, it was also apparent that the lower compliance for sensitive option information is masked by the overall higher compliance when disclosure scores were examined in aggregate.

In answer to research question two, internal governance factors, such as board independence are negatively and significantly associated with increased compliance with ESO disclosures. There appears to be a substitution effect whereby firms mitigate the agency costs associated with this lack of independence by increasing ESO disclosures. Further, companies with more independent and effective audit committees are more likely to exhibit higher compliance. Interestingly, more independent and effective compensation committees are more likely to encourage greater compliance with sensitive ESO disclosures.

From the external governance perspective, the results show that shareholder activism has a negative and significant association with the level of overall compliance. However, poor performing companies appear to disclose similar levels of sensitive disclosures as non-poor performing companies, perhaps in an effort to direct attention away from the poor performance of the company. Further, the external auditor also acts as an effective monitor of

the company's overall disclosure behaviour; but less effective at monitoring sensitive disclosures. Last, compliance has increased from 2001 to 2004, suggesting that the additional media and regulatory attention brought on both the use of ESOs by companies and on financial reporting processes has motivated companies to increase compliance. It also appears that ASIC's introduction of option valuation guidelines, and their surveillance project conducted in 2003, has contributed to greater compliance in 2003 and 2004.

While it is reassuring to observe a general increase in ESO disclosure over time, the inconsistent level of compliance observed within years across standards, provides evidence to standard setters of either disclosure avoidance or interpretation difficulties for companies in complying with statutory disclosures where requirements may be ambiguous and open to interpretation.²¹ This issue is still evident in the final year of our study period with 83 percent compliance overall. Of interest to regulators is that the nature of compliance illustrates the very low transparency of companies with important, but sensitive, components of the ESO disclosures, which is masked by apparently high overall compliance. Importantly, the findings of the study show the adoption of stronger internal governance structures (consistent with many of the best practices advocated by the ASX) and certain external factors (including the ASA monitoring action) enhance compliance. Finally, our findings highlight the importance of distinguishing between different types of disclosures in disclosure research, particularly in contexts where managers have strong incentives to avoid disclosure obligations.

²¹ As previously indicated, there may be some instances where ESO disclosures were immaterial due to a small number of options used by some companies.

Changes to Australian ESO disclosures regulations: 2001-2004

Date effective	Legislation	Effect on ESO disclosures
November 1998	Practice Note 68 ' <i>New Financial Reporting and Procedural Requirements</i> ' <i>Applicable: 2001 - 2004</i>	<ul style="list-style-type: none"> • PN 68.60 was issued to state that the 'amount' of options granted, as specified in the <i>Corporations Law/Act</i> disclosure requirements, included the 'value' of options granted.
June 2001	<i>Corporations Act 2001 (CA) s.300A (1)(c) and s.300(1)(d)</i> <i>Applicable: 2001 – 2004</i>	<ul style="list-style-type: none"> • Remains unchanged from the <i>Corporations Law</i>. • Applies to directors and the five highest remunerated executives. • Disclosures made in the directors' report : <ul style="list-style-type: none"> • Value, number, and type of options granted.
30 June 2003	ASIC guidelines for valuing stock options granted (ASIC, 2003) <i>Applicable: 2003</i>	<ul style="list-style-type: none"> • Provided authoritative guidance on option valuation models to assist companies to value their options for disclosure in the directors' report. • (These guidelines became redundant with the introduction of AASB1046).
Date effective	Accounting standards	Effect on ESO disclosures
FY* ending on or after 30 June 1995	AASB 1028 ' <i>Accounting for Employee Entitlements</i> ' <i>Applicable: 2001 - 2002</i>	<ul style="list-style-type: none"> • Basic disclosure regarding ESO plans: <ul style="list-style-type: none"> • Options granted, exercised, held, etc. • No measurement or recognition criteria were specified.
FY ending on or after 30 June 1997	AASB1017 ' <i>Related Party Disclosures</i> ' <i>Applicable: 2001 – 2003</i>	<ul style="list-style-type: none"> • Applied to directors only. • Basic disclosures: <ul style="list-style-type: none"> • Number of options acquired, disposed of, held, and terms of options. • No measurement or recognition criteria specified.
FY beginning on or after 1 July 2002	AASB 1028 ' <i>Employee Benefits</i> ' <i>Applicable: 2003 - 2004</i>	<ul style="list-style-type: none"> • Replaced AASB1028 (1994). • Comprehensive disclosure requirements for details regarding options at beginning, during, and end of reporting period: <ul style="list-style-type: none"> • Granted, exercised, lapsed, and outstanding • No measurement or recognition criteria specified.
FY ending on or after 30 June 2004	AASB1046 ' <i>Director and Executive Disclosure by Disclosing Entities</i> ' <i>Applicable: 2004</i>	<ul style="list-style-type: none"> • Replaced requirements of AASB1017. • Applied to specified directors and specified executives. • Comprehensive disclosures: <ul style="list-style-type: none"> • Details of options granted, exercised, vested, and outstanding. • Value of options granted must be disclosed • Measurement principles provided to enable option value to be calculated.
*FY = Financial year; Applicable = years of study period requirements apply to.		

Indices for statutory ESO disclosures
(S = Sensitive disclosure; NS = Non-sensitive disclosure)

Corporations Act 2001	Reference	S/NS
<i>Annual director's report - specific information to be provided by listed companies for each director and each of the 5 named officers of the company receiving the highest emolument.</i>		
1. Amount of options granted	s.300A (1)(c)	S
<i>Annual director's report - specific information – details of options granted for each director and each of the 5 named officers of the company receiving the highest emolument.</i>		
2. Company, registered scheme or disclosing entity granting option	s.300 (5)	NS
3. Name of person option is granted to	s.300 (5)	NS
4. Number of shares over which the option is granted	s.300 (5)	NS
5. Class of shares over which the option is granted	s.300 (5)	NS

AASB1028 Accounting for employee entitlements (1995)	Reference	S/NS
<i>Nature of Equity Based Compensation Scheme</i>		
1. Number of employees eligible to participate	Para 14 (d)(i)	NS
2. Number of options employees are able to acquire	Para 14 (d)(i)	NS
3. Type of option employees are able to acquire	Para 14 (d)(i)	NS
4. Exercise date or period of options	Para 14 (d)(i)	NS
<i>Price Information</i>		
1. Price(s) to be paid for any options issued (or how price will be determined)	Para 14 (d)(ii)	S
<i>Number and Type Up to and at Reporting Date</i>		
1. Number of options acquired/become entitled to acquire up to reporting date (options granted)	Para 14 (d)(iii)	NS
2. Type of options acquired/become entitled to acquire up to reporting date (options granted)	Para 14 (d)(iii)	NS
3. Number of options still available as at reporting date	Para 14 (d)(iii)	NS
4. Type of options still available as at reporting date	Para 14 (d)(iii)	NS
5. Market price of options as at reporting date	Para 14 (d)(iii)	S
<i>Number and Type Issued During the Year</i>		
1. Number of shares issued from exercise of options during the year	Para 14 (d)(iv)	NS
2. Type of shares issued from exercise of options during the year	Para 14 (d)(iv)	NS
3. Total market value of shares issued (as result of exercise of options) at issue date	Para 14 (d)(iv)	S
4. Total amount received/receivable from shares issued (as result of exercise of options)	Para 14 (d)(iv)	NS
<i>Accounting Policy Information</i>		
1. Accounting policy for options	Para 14 (d)(v)	NS
2. Any amounts recognised in the accounts and consolidated accounts	Para 14 (d)(v)	NS

Indices for statutory ESO disclosures (cont.)
(S = Sensitive disclosure; NS = Non-sensitive disclosure)

AASB1028 Employee benefits (2002)	Reference	S/NS
<i>Options at the beginning of the reporting period (held)</i>		
1. Number of options outstanding	Para 6.4 (a)(i); (b)(i)	NS
2. Grant dates of options outstanding	Para 6.4 (a)(ii); (b)(ii)	NS
3. Do options held have voting rights (Y/N)	Para 6.4 (a)(iii); (b)(iii)	NS
4. Do options held have dividend rights	Para 6.4 (a)(iii); (b)(iii)	NS
5. Terms under which options become vested	Para 6.4 (a)(iv); (b)(iv)	NS
6. Extent to which options are vested	Para 6.4 (a)(iv); (b)(iv)	NS
7. Conversion rights of options outstanding	Para 6.4 (a)(v); (b)(v)	NS
8. Exercise dates of options outstanding	Para 6.4 (a)(v); (b)(v)	NS
9. Exercise price of options outstanding	Para 6.4 (a)(v); (b)(v)	NS
10. Expiry dates of options outstanding	Para 6.4 (a)(v); (b)(v)	NS
<i>Options granted during the reporting period</i>		
1. Number of options granted	Para 6.5 (a)(i); (b)(i); (c)(i)	NS
2. Grant dates of options granted	Para 6.5 (a)(ii); (b)(i); (c)(i)	NS
3. Do options granted have voting rights	Para 6.5 (a)(iii); (b)(iii); (c)(iii)	NS
4. Do options granted have dividend rights	Para 6.5 (a)(iii); (b)(iii); (c)(iii)	NS
5. Performance conditions of options granted	Para 6.5 (a)(iv); (b)(iv); (c)(iv)	NS
6. Conversion rights of options granted	Para 6.5 (a)(iv); (b)(iv); (c)(iv)	NS
7. Exercise dates of options granted	Para 6.5 (a)(iv); (b)(iv); (c)(iv)	NS
8. Exercise prices of options granted	Para 6.5 (a)(iv); (b)(iv); (c)(iv)	NS
9. Expiry dates of options granted	Para 6.5 (a)(iv); (b)(iv); (c)(iv)	NS
10. Fair value of any consideration received for options granted	Para 6.5 (a)(v); (b)(v); (c)(v)	S
<i>Options exercised during the reporting period</i>		
1. Number of options exercised during the period	Para 6.6 (a); 6.7(a)	NS
2. Grant dates of options exercised	Para 6.6 (b); 6.7(b)	NS
3. Exercise dates of options exercised	Para 6.6 (c); 6.7(c)	NS
4. Expiry dates of options exercised	Para 6.6 (d); 6.7(d)	NS
5. Exercise prices of options exercised	Para 6.6 (e); 6.7(e)	NS
6. Aggregate proceeds received from plans	Para 6.6 (f); 6.7(f)	NS
7. Number of shares issued from exercise of options	Para 6.6 (g); 6.7(g)	NS
8. Fair value of shares issued as at issue date	Para 6.6 (g); 6.7(g)	S
9. Basis for determining the fair value	Para 6.6; 6.7	S
<i>Options lapsed during the reporting period</i>		
1. Number of options lapsed during the period	Para 6.8	NS
<i>Options at the end of the reporting period</i>		
1. Number of options outstanding	Para 6.9 (a)(i); (b)(i)	NS
2. Grant dates of options outstanding	Para 6.9 (a)(ii); (b)(ii)	NS
3. Do options have voting rights	Para 6.9 (a)(iii); (b)(iii)	NS
4. Do options have dividend rights	Para 6.9 (a)(iii); (b)(iii)	NS
5. Terms under which options become vested	Para 6.9 (a)(iv); (b)(iv)	NS
6. Extent to which options are vested	Para 6.9 (a)(iv); (b)(iv)	NS
7. Conversion rights of options	Para 6.9 (a)(v); (b)(v)	NS
8. Exercise dates of options outstanding	Para 6.9 (a)(v); (b)(v)	NS
9. Exercise prices of options outstanding	Para 6.9 (a)(v); (b)(v)	NS
10. Expiry dates of options outstanding	Para 6.9 (a)(v); (b)(v)	NS

Indices for statutory ESO disclosures (cont.)
(S = Sensitive disclosure; NS = Non-sensitive disclosure)

AASB1017 Related party disclosures	Reference	S/NS
<i>Shares, units, options and other equity instruments of directors</i>		
1. Aggregate number of options acquired (granted)	Para 4.15 (a)	NS
2. Issuing Entity and Class of option acquired (granted)	Para 4.15 (a)	NS
3. Aggregate number of options disposed of	Para 4.15 (b)	NS
4. Issuing Entity and Class of option disposed of	Para 4.15 (b)	NS
5. Nature of terms and conditions – if on more favourable terms and conditions	Para 4.15 (c)	NS
6. Aggregate number of options held as at reporting date	Para 4.16	NS
7. Issuing Entity and Class of options held as at reporting date	Para 4.16	NS

AASB1046 Director and executive disclosures by disclosing entities	Reference	S/NS
<i>Options provided as remuneration</i>		
1. Number of options granted	Para 8.2 (a)(i)	NS
2. Number of options vested	Para 8.2 (a)(ii)	NS
3. Value per option at grant date	Para 8.2 (b)(i)	S
4. Exercise price per share or unit	Para 8.2 (b)(ii)	NS
5. Amount, if any, paid or payable by recipient	Para 8.2 (b)(iii)	NS
6. Expiry date	Para 8.2 (b)(iv)	NS
7. Date or dates when options may be exercised	Para 8.2 (b)(v)	NS
8. Summary of service and performance criteria to be met before beneficial interest vests in individual	Para 8.2 (b)(vi)	NS
<i>Equity instruments provided on exercise of remuneration options</i>		
1. Number of equity instruments	Para 8.3 (a)	NS
2. When no. of options exercised differs from no. of equity instruments disclosed under (1), the no. of options exercised	Para 8.3 (b)	NS
3. Amount paid per instrument	Para 8.3 (c)	S
4. Amount unpaid per instrument	Para 8.3 (d)	S
<i>Options holdings</i>		
1. Options outstanding at the start of reporting period	Para 8.4 (a)	NS
2. Options granted during reporting period as remuneration	Para 8.4 (b)	NS
3. Options exercised during the reporting period	Para 8.4 (c)	NS
4. Options resulting from any other change during reporting period	Para 8.4 (d)	NS
5. Options outstanding at reporting date	Para 8.4 (e)	NS
6. Options vested at reporting date	Para 8.4 (f)	NS
7. Options vested and exercisable at reporting date	Para 8.4 (g)	NS
8. Options vested and unexercisable at reporting date	Para 8.4 (h)	NS

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Table 1
Pearson and Spearman bivariate correlations for internal governance variables

	<i>CEOCHAIR</i>	<i>BRDINDP</i>	<i>BRDSIZE</i>	<i>BRDMTGS</i>	<i>ACMEET</i>	<i>ACINDP</i>	<i>ACSIZE</i>	<i>ACACCEXP</i>	<i>CCMTGS</i>	<i>CCSIZE</i>	<i>CCINDP</i>
<i>CEOCHAIR</i>		0.255**	0.145**	0.100*	0.151**	0.152**	0.099*	0.136**	0.161**	0.164**	0.119*
<i>BRDINDP</i>	0.306**		0.219**	0.080	0.313**	0.401**	0.227**	0.094*	0.227**	0.218**	0.208**
<i>BRDSIZE</i>	0.177**	0.332**		-0.030	0.483**	0.289**	0.407**	0.152**	0.409**	0.387**	0.241**
<i>BRDMTGS</i>	0.027	0.088	0.015		0.187**	0.127**	0.178**	0.135**	0.220**	0.181**	0.147**
<i>ACMEET</i>	0.164**	0.313**	0.483**	0.192**		0.462**	0.387**	0.316**	0.457**	0.374**	0.295**
<i>ACINDP</i>	0.195**	0.396**	0.308**	0.120*	0.379**		0.402**	0.200**	0.282**	0.334**	0.412**
<i>ACSIZE</i>	0.100**	0.216**	0.403**	0.161**	0.305**	0.209**		0.190**	0.214**	0.458**	0.223**
<i>ACACCEXP</i>	0.167**	0.079	0.191**	0.128**	0.302**	0.170**	0.093*		0.157**	0.140**	0.177**
<i>CCMTGS</i>	0.208**	0.252**	0.424**	0.228**	0.439**	0.290**	0.184**	0.205**		0.509**	0.473**
<i>CCSIZE</i>	0.182**	0.233**	0.396**	0.177**	0.359**	0.291**	0.454**	0.118*	0.575**		0.569**
<i>CCINDP</i>	0.136**	0.145**	0.264**	0.200**	0.259**	0.397**	0.175**	0.189**	0.532**	0.462**	

*, ** Significant at 0.05 and 0.01 levels respectively.
Pearson (Spearman) correlations are shown in the upper (lower) diagonal.
CEOCHAIR is coded as 2 for separate CEO/Chair and non-executive chair, 1 for separate CEO/Chair and executive chair, 0 otherwise (categorical); *BRDSIZE* is measured as total number of directors on the board (continuous); *BRDINDP* is measured as percentage of non-executive directors on the board (continuous); *ACMEET* is measured as the number of audit committee meetings held during the year (continuous); *ACINDP* is coded as 2 for 100 percent non-executive directors on audit committee (100 percent independence), 1 for any non-executive directors on audit committee (some independence), and 0 otherwise (no independence) (categorical); *ACSIZE* is coded as 3 for 4+ members on audit committee, 2 for 3 members on audit committee, 1 for 2 members on audit committee, and 0 otherwise (categorical); *ACACCEXP* is coded as 2 for 100 percent of directors with accounting expertise on audit committee, 1 for at least one director with accounting expertise on audit committee, and 0 otherwise (categorical); *CCMTGS* is the number of compensation committee meeting held during the year; *CCSIZE* is 3 for 4+ members on compensation committee, 2 for 3 members on compensation committee, 1 for 2 members on compensation committee, 0 otherwise; *CCINDP* is 2 for 100 percent non-executive directors on compensation committee (100 percent independence), 1 for any non-executive directors on compensation committee (some independence), 0 otherwise (no independence).

Table 2
Governance factors identified in principal component analysis

Factor	Factor name	Governance variables	Factor loadings
1	<i>BRDINDP</i> Board Independence	Chairperson independence Non-executive directors	0.812 0.749
2	<i>BRDACTY</i> Board Activity	Board meetings	0.808
3	<i>ACOMMEE</i> Audit Committee Independence and Effectiveness	Audit committee meetings Audit committee independence Audit committee size Audit committee expertise Board size	0.655 0.401 0.639 0.739 0.513
4	<i>CCOMMEE</i> Compensation Committee Independence and Effectiveness	Compensation committee meetings Compensation committee size Compensation committee independence	0.758 0.804 0.836

Table 3
Descriptive statistics - ESO disclosure explanatory variables (N=460)

Variable - continuous	Mean	Median	Std. dev
<i>CEOCHAIR</i>	1.709	2	1.709
<i>BRDINDP</i>	0.719	0.75	0.157
<i>BRDSIZE</i>	6.554	6	1.956
<i>BRDMTGS</i>	11.34	11.00	3.663
<i>ACMEET</i>	3.306	3	1.786
<i>ACINDP</i>	1.687	2	0.592
<i>ACSIZE</i>	1.928	2	0.820
<i>ACACCEXP</i>	0.685	1	0.582
<i>CCMTGS</i>	1.86	2.00	1.758
<i>CCSIZE</i>	1.61	2.00	1.039
<i>CCINDP</i>	1.36	2.00	0.798
<i>CEOREMUN</i>	1.509	1	1.429
<i>LEVERAGE</i>	0.164	0.161	0.146
<i>SIZE</i>	8.466	8.435	0.830
<i>PERFORM</i>	230.50	230.50	132.935
Variable - dichotomous	Coding	No. of firms in sample	Percentage of sample
<i>POORPER</i>	1	421	91.5
<i>AUDITOR</i>	1	411	89.3
<i>LOSS</i>	1	142	30.9

Definitions:

CEOCHAIR is 2 for separate CEO/Chair and non-executive chair, 1 for separate CEO/Chair and executive chair, 0 otherwise; *BRDINDP* is percentage of non-executive directors on the board; *BRDSIZE* is total number of directors on the board; *BRDMTGS* is the number of board meetings held during the year; *ACMEET* is the number of audit committee meetings held during the year; *ACINDP* is 2 for 100 percent non-executive directors on audit committee (100 percent independence), 1 for any non-executive directors on audit committee (some independence), and 0 otherwise (no independence); *ACSIZE* is 3 for 4+ members on audit committee, 2 for 3 members on audit committee, 1 for 2 members on audit committee, and 0 otherwise; *ACACCEXP* is 2 for 100 percent of directors with accounting expertise on audit committee, 1 for at least one director with accounting expertise on audit committee, and 0 otherwise; *CCMTGS* is the number of compensation committee meetings held during the year; *CCSIZE* is coded as 3 for 4+ members on compensation committee, 2 for 3 members on compensation committee, 1 for 2 members on compensation committee, and 0 otherwise; *CCINDP* is 2 for 100 percent non-executive directors on compensation committee (100 percent independence), 1 for any non-executive directors on compensation committee (some independence), and 0 otherwise (no independence); *CEOREMUN* is total CEO remuneration scaled by median of total CEO remuneration for all sample firms; *LEVERAGE* is total debt divided by total assets; *SIZE* is the log of total assets; *PERFORM* is return on assets measured as net income divided by total assets (ranked); *POORPER* is 1 for the year ASA identifies as poor performer, 0 otherwise; *AUDITOR* is 1 for Big 4 auditor, 0 otherwise; *LOSS* is 1 for loss, 0 otherwise.

Table 4

Descriptive statistics and mean difference tests – sensitive and non-sensitive ESO disclosures

	Overall disclosure (<i>COMPLNCE</i>)		Sensitive disclosure (<i>SENSCOMP</i>)		Non-sensitive disclosure (<i>NONSENS</i>)		Mean Difference
	<i>N</i>	Mean (Median)	<i>N</i>	Mean (Median)	<i>N</i>	Mean (Median)	t-stat (z-stat)
<i>Panel A: Compliance with ESO disclosures for each year</i>							
2001	115	0.7262 (0.7500)	115	0.2844 (0.2500)	115	0.7941 (0.8300)	-21.555** (-9.179)**
2002	115	0.7806 (0.7857)	115	0.3649 (0.3300)	115	0.8464 (0.8800)	-17.877** (-8.917)**
2003	115	0.7586 (0.7742)	98	0.5348 (0.5000)	115	0.7687 (0.8000)	-7.557** (-6.045)**
2004	115	0.8266 (0.8636)	103	0.6672 (0.7100)	115	0.8396 (0.8700)	-7.097** (-5.984)**
Pooled	460	0.7730 (0.7857)	431	0.4543 (0.4300)	460	0.8103 (0.8500)	-23.985** (-15.801)**
<i>Panel B: Compliance with individual ESO disclosure regulations</i>							
Corporations Act	287	0.9498 (1.0000)	287	0.7770 (1.0000)	288	0.9931 (1.0000)	-8.668** (-7.918)**
AASB1028 (1995)	230	0.6737 (0.6875)	230	0.2478 (0.0000)	230	0.7776 (0.8120)	-24.188** (-12.510)**
AASB1028 (2002)	230	0.7440 (0.7750)	226	0.4351 (0.3333)	230	0.7648 (0.8056)	-13.301** (-8.788)**
AASB1017	322	0.8283 (0.8571)	NA	NA	322	0.8283 (0.8571)	NA
AASB1046	115	0.8938 (0.9375)	94	0.6844 (0.6667)	115	0.9124 (1.0000)	-5.664** (-4.480)**

** Significant at the 0.01 levels (one-tailed tests).

The t-statistic is derived using a paired sample t-test. The t-test examines whether the mean difference between *SENSCOMP* and *NONSENS* is significant and negative (i.e. *SENSCOMP* is lower than *NONSENS*). The z-stat represents the results of the Wilcoxon Signed Rank test.

COMPLNCE is the identified number of statutory disclosures divided by total possible number of statutory disclosures; *NONSENS* is the identified number of non-sensitive disclosures divided by total possible number of non-sensitive disclosures;

SENSCOMP is the identified number of sensitive disclosures divided by total possible number of sensitive disclosures. If the related non-sensitive disclosure clearly indicates the non-applicability of a sensitive disclosure (i.e. no options granted), a score is not recorded for that item.

NA = type of disclosure was not applicable

Legislation and accounting standards are applicable to the study period as follows:

Corporations Act: 2001 to 2004

AASB1028(1995): 2001 and 2002

AASB1028(2002): 2003 and 2004

AASB1017: 2001 to 2003

AASB1046: 2004

Table 5
Results of regression analysis for ESO disclosures and corporate governance factors – Pooled results for the period 2001-2004

Variables	Pred. Sign	Overall disclosure (<i>COMPLNCE</i>)		Sensitive disclosure (<i>SENSCOMP</i>)		Non-sensitive disclosure (<i>NONSENS</i>)	
		Coeff	z-stat	Coeff	z-stat	Coeff	z-stat
Constant		0.595	4.23**	0.282	0.89	0.657	4.66**
<i>BRDINDP</i>	+	-0.019	-2.58**	-0.027	-1.60*	-0.019	-2.52**
<i>BRDACTY</i>	+	-0.000	-0.02	-0.001	-0.03	-0.001	-0.13
<i>ACOMMEE</i>	+	0.022	2.40**	0.051	2.47**	0.018	1.98*
<i>CCOMMEE</i>	+	0.011	1.28^	0.034	1.86*	0.009	1.05
<i>AUDITOR</i>	+	0.058	2.27*	0.020	0.35	0.067	2.60**
<i>POORPER</i>	–	-0.051	-2.10*	-0.001	-0.02	-0.056	-2.28*
<i>REGINTVN</i>	+	0.024	4.32**	0.129	10.47**	0.003	0.48
<i>CEOREMUN</i>	–	-0.011	-1.50^	-0.052	-3.34**	-0.007	-1.02
<i>LEVERAGE</i>	?	-0.010	-0.26	0.074	0.84	-0.027	-0.70
<i>SIZE</i>	+	0.012	0.71	-0.006	-0.16	0.014	0.83
<i>PERFORM</i>	+	0.000	0.58	0.000	1.03	0.000	0.26
<i>LOSS</i>	–	-0.018	-0.68	0.009	0.16	-0.027	-1.03
<i>LOSSPERF</i>	–	-0.078	-2.55**	-0.116	-1.73*	-0.071	-2.32**
R-square (overall)		0.136		0.263		0.091	
Wald Chi-square		69.87		168.58		70.81	
p-value		0.000		0.000		0.000	
N		460		431		460	

^, *, ** Significant at the 0.1, 0.05 and 0.01 levels (one-tailed test when coefficient sign is predicted, two-tailed when coefficient sign is not predicted), respectively. The z-statistic is derived using a random effects generalised least squares regression model.

Alternative dependent variables: *COMPLNCE* is the identified number of statutory disclosures divided by total possible number of statutory disclosures; *SENSCOMP* is the identified number of sensitive disclosures divided by total possible number of sensitive disclosures; *NONSENS* is the identified number of non-sensitive disclosures divided by total possible number of non-sensitive disclosures.

Independent variables:

BRDINDP is the independence of the Board of Directors; *BRDACTY* is the number of board meetings; *ACOMMEE* is the independence and effectiveness of audit committee; *CCOMMEE* is the independence and effectiveness of the compensation committee; *AUDITOR* is 1 for Big 4 auditor and 0 otherwise; *POORPER* is 1 for the year ASA identifies as poor performer, 0 otherwise; *REGINTVN* is 1 for 2002, 2 for 2003, 3 for 2004 (2001 is the base case and equals 0); *CEOREMUN* is total CEO remuneration scaled by median of total CEO remuneration for all sample firms; *LEVERAGE* is total debt divided by total assets; *SIZE* is the log of total assets; *PERFORM* is return on assets measured as net income divided by total assets (ranked); *LOSS* is 1 for loss and 0 otherwise; *LOSSPERF* is the loss dummy multiplied by performance.