

Compensation committee attributes and the treatment of earnings management in bonuses

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PRELIMINARY

Abstract

We examine whether the weights on earning components used to determine CEO cash compensation vary based the extent to which compensation committees have greater ability to understand potential discretion in earnings. Using professional accounting experience or concurrent membership on the audit committee as proxies for greater accounting expertise, we find that concurrent membership on the audit committee is related to lower weight on positive discretionary accruals and greater weight on stock returns, consistent with this expertise results in adjustments to compensation contracts. When expertise derives from professional experience, we find greater weight on earnings and negative discretionary accruals, suggesting that the committee uses its knowledge of earnings quality to weight all earnings measures reflecting executive effort. We also find some support that the contracts are written with the ex-ante expectation of earnings management, not simply adjusted for ex-post outcomes. Together, our results suggest that accounting knowledge in the compensation committee affects the weights of earnings but that weights on earnings susceptible to discretion may also be the result of board structure, in particular, the lack of task separation among the board's committees.

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1. Introduction

We examine whether the presence of accounting expertise on the compensation committee impacts how alternative components of earnings are rewarded in compensation contracts according to the management discretion they likely contain. Research has posited that one reason managers manage earnings is for the rewards in their bonus contracts. However, it is unclear why compensation committee members would allow this to persist. On the one hand, committee members may lack independence and not want to make adjustments for earnings management. Alternatively, compensation committee members may lack the accounting expertise to make such adjustments. But, if committee members have expertise in financial reporting and understand components of reported earnings that may contain more discretion, those committees may write bonus contracts to lower the weight on earnings components with greater potential for earnings management. We examine whether this latter explanation is borne out in the relation between cash incentive pay and firms' earnings.

Using a sample of ExecuComp firms from 2006 – 2010, we examine whether accounting expertise of compensation committee members is related to differential weights in determining cash-based incentive pay on unmanaged earnings and earnings susceptible to discretion. We consider the relation between earnings and non-equity incentive pay as reported on the proxy statement since that figure represents cash payouts for performance-based pay – the form of compensation where we expect potential earnings management to have the greatest impact. Because of changes in proxy statement reporting for this variable, we begin our sample in 2006. We proxy for earnings likely to be susceptible to earnings management using discretionary accruals. To measure accounting and financial reporting expertise, we determine whether the compensation committee member also serves on the firm's audit committee and whether the compensation committee member has experience in accounting and financial reporting. This expertise may allow committee members to unwind potential earnings manipulation, either by writing a contract ex-ante that places less weight on those elements of pay that contain more discretion or by ex-post adjusting the amount of incentive pay despite the outcomes of the performance

measures. Empirically, we observe in proxy statements that the compensation committee retains such discretion in the pay-setting process.

Consistent with the findings of studies in earlier time periods, we find positive weights on earnings and positive discretionary accruals in determining cash incentive pay, and no weight placed on negative discretionary accruals. Having established this benchmark, we allow for the weights on the components of earnings to differ when there is an accounting expert on the compensation committee. Curiously, we find no difference on the weights of the components of earnings when the compensation committee has accounting expertise in its membership or when a member also serves on the firm's audit committee. When we consider these two types of expertise separately, we continue to find no different weights on earnings components, although we do find greater weight on returns when there is overlap with the audit committee. To further disentangle expertise due to accounting experience from expertise resulting from audit committee membership, we partition the firms in those that have both, neither or one of the two. In this partitioning, relative firms that have no expertise on the compensation committee, we find that compensation committees with only accounting expertise place greater weight on both unmanaged earnings and negative discretionary accruals, while those with only audit committee overlap place lower weight on positive discretionary accruals. These two effects appear to offset as we find no differing weights when the compensation committee contains both. Our results suggest that the accounting expertise on the compensation committee may allow the committee to reflect its knowledge about the quality of earnings and weight them accordingly when they best reflect the executive's effort. However, when that expertise results from overlap with the audit committee, the contract may reflect an alternative explanation. Specifically, Laux and Laux (2009) model task separation on the board of directors. Their model, if extended to cash incentive compensation, would predict that when there is overlap on the audit and compensation committees, there will be less weight on earnings, as the overlapping members do not want the additional task of oversight necessary to ensure there is no earnings management in the financial reporting process.

In additional tests, we consider whether any differential weight on earnings or earnings components susceptible to earnings management results from ex-ante consideration of firm-specific earnings properties. First, it may be too costly to write bonus contracts that eliminate earnings management (Evans and Sridhar, 1996), so to obtain the incentive benefits of writing contracts including accounting earnings, contracts allow some degree of earnings management. Relatedly, it may be the case that compensation committee members understand that executives will manage earnings to increase their compensation, so the committee simply writes bonus contracts taking into consideration a certain amount of earnings management. In each case, we would predict a lower weight on overall earnings for firms where the compensation committee might expect higher earnings management. We find evidence that there is lower weight on earnings when the firm has had higher discretionary accruals in the past, even after controlling for earnings volatility. Interestingly, this result obtains for firms with audit committee members also serving on the compensation committee but not when there is accounting expertise on the compensation committee.

Our analysis is subject to a few caveats. First, we make the strong assumption in our research design that discretionary accruals are suitable proxies for earnings management. While this assumption is common in the literature, our results may not speak to earnings management if the assumption is not accurate. Second, we make the assumption that knowledge of the firm's financial reporting process, proxied by membership on the audit committee or professional experience in accounting, would allow the compensation committee members to be more knowledgeable about how and in what accounts earnings management might occur. Since the type of earnings management we are contemplating is "on the margin" decisions by managers that would increase their personal wealth and not the material (deceitful) reporting that would fail to pass tests by the auditors and/or require subsequent restatements, these decisions may be even too subtle to be detected by knowledgeable insiders.

We provide several contributions to the literature. First, while the influence of financial expertise on the audit committee has received much attention in the literature, the role of financial, or more specifically, accounting expertise on the compensation committee has been largely unexplored. Second,

we re-examine the relation between bonus compensation and earnings under a different reporting regime. Prior studies on this issue were conducted using a pre-Sarbanes-Oxley study period. In 2002, the Sarbanes-Oxley Act was enacted with the objective of improving the integrity of financial reporting by decreasing the flexibility in financial reporting and reduced the incentive and ability of managers to manage earnings. Some studies suggest that Sarbanes-Oxley led to better earnings quality and less earnings management (Cohen, Dey, and Lys 2005; Bedard 2006), and other research suggests that, as a result, firms place a greater weight on earnings in bonus contracts in the post-Sarbanes-Oxley period (Carter, Lynch and Zechman, 2009). Thus, we provide evidence on the relation between earnings management and cash incentive compensation in this period of improved earnings quality and heightened scrutiny of executive pay. Third, we examine the impact of accounting expertise on the compensation committee on the pay-setting process. While the accounting expertise of board members has been shown to influence other governance duties, to our knowledge, it has not been examined in the context of the compensation committee setting pay based on reported earnings.

Our paper proceeds as follows. In section 2, we provide background information and highlight other research related to our research question. We present our research design in section 3 and discuss our results in section 4. Section 5 concludes.

2. Background

Recently, there has been increased focus on the role of the compensation committee in setting executive pay. New legislation has required expanded discussion on how the committee sets executive pay to provide more transparency regarding the pay setting process. One important decision, to which greater transparency is thought to be important, is the extent to which firm performance influences annual bonus pay. Compensation committees must determine which performance measures to use and how those measures will be used. Prior research has documented that accounting earnings are frequently used as a performance measure in setting bonuses (Murphy, 2000; Ittner, Larcker and Rajan, 1997). With the inclusion of earnings in the pay setting process, managers have the incentive to make accounting choices

and manage earnings that may increase compensation (e.g., Watts and Zimmerman 1986). Those choices can relate to non-recurring items (e.g., Dechow, Huson, and Sloan 1994; Gaver and Gaver 1998, among others) or ongoing earnings management.

While there is ample evidence that higher levels of earnings are related to higher bonuses (e.g., Lambert and Larcker 1987, Antle and Smith 1985), the extent to which the compensation committee accounts for earnings management in determining compensation remains an open question. On the one hand, research suggests that compensation committees act knowledgeably when determining bonus payments; they do not simply naively weight all earnings components the same when determining bonuses (Dechow, Huson, Sloan 1994; Gaver and Gaver 1998; Adut, Cready and Lopez 2003). However, many of these studies examine effects on compensation of one-time income-reducing items which are typically listed as exclusions in compensation contracts.

Balsam (1998) considers accounting choices more broadly, examining whether there is a different relation between cash compensation and nondiscretionary and discretionary components of earnings. Using a sample of large firms included in the Forbes compensation survey from 1980 to 1993, Balsam (1998) finds that discretionary accruals are positively associated with CEO cash compensation, even after controlling for the value relevance of those accruals, suggesting that managers can increase compensation by managing earnings. However, he also finds that the positive association between CEO cash compensation and discretionary accruals is significantly less than the relation between CEO cash compensation and both cash flow from operations and nondiscretionary accruals. He interprets this as evidence that compensation committees do not “react naively to income increasing discretionary accruals” but “distinguish between the components of income.” In the end, though, his results on discretionary accruals in total seem to be driven by the compensation committee shielding managers from effects of income-reducing items (negative accruals), and not by the compensation committee placing less weight on positive discretionary accruals than on nondiscretionary earnings.

Recognizing that managers’ incentives differ with short horizons, Huson, Tian, Wiedman, and Wier (2012) consider whether the relation between cash compensation and discretionary accruals changes

at the end of CEOs' tenure. Using a sample of voluntary turnovers during the period 1995-2005, they find that the relation between cash compensation and discretionary accruals decreases in CEOs' terminal years, consistent with compensation committees being aware of the "horizon problem" and incorporating that knowledge into pay decisions. In particular, their results suggest that the committee does not reward managers who manage earnings upward to increase income (the relation with positive discretionary accruals is reduced in terminal years) and it protects managers who make significant discretionary expenditures (SG&A).

Despite this literature providing evidence that compensation committees may not be acting naively with respect to reported accounting earnings, it also seems to indicate that to some degree, managers are rewarded for their attempts at managing earnings. For example, while Balsam (1998) finds different weights on cash flow from operations, nondiscretionary accruals, and discretionary accruals, his results suggests that discretionary accruals (both positive and negative) do affect the level of cash compensation. And, Huson et al. (2012) find that positive discretionary accruals have no incremental explanatory power beyond total earnings in cash compensation in non-terminal years, suggesting similar weight on those accruals and other earnings components.

One explanation for the evidence that compensation committees do not unwind earnings management in determining executive compensation is that the committee may not be determining pay in an independent manner. Using different measures of "independence", prior research regarding the composition of the compensation committee provides mixed evidence (Vafeas 2003, Newman and Mozes 1999, Daily, Johnson, Ellstrand, and Dalton 1998, Newman and Wright 1995, Anderson and Bizjak 2003, Guthrie, Sokolowsky, and Wan forthcoming, Sun and Cahan 2009). The findings in these studies range from no relation between insider presence and pay to greater levels of pay or lower pay-performance sensitivity with greater inside members. These studies span different time periods and use different measures of affiliation likely leading to these mixed results. Indeed, independence of compensation committee members has been the focus of recent regulation. In 2004, the NYSE and NASDAQ

implemented new rules requiring independence of the compensation committee for their listing firms.^{1,2} And, there have been recent proposals by the SEC regarding compensation committee membership that will implement the provision of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requiring independent compensation committees.

However, an alternative explanation is that members of the compensation committee may not have the accounting expertise to disentangle attempts to manipulate earnings. This characteristic of the composition of the compensation committee has remained largely unexplored in the literature. With the increased emphasis on earnings quality, accounting expertise may play an increasing role in the pay-setting process; it is possible that the presence of accounting expertise on the compensation committee would help it more efficiently disentangle discretionary components of earnings so that they can be differentially compensated. Different weights on different components of earnings may result from stipulating an ex-ante contract that places less weight on those sources of earnings known by the compensation committee to be more susceptible to potential earnings management.³ Alternatively, the compensation committee may exert ex-post discretion allowed by the incentive plan, lowering the weight on elements of reported earnings thought to have been influenced by potential earnings management.⁴

Prior research provides mixed evidence regarding whether financial expertise on the audit committee is related to the effectiveness of the audit committee (Xie et al. 2003; Carcello and Neal 2003; Carcello et al. 2006; Zhang et al. 2007). But, research that examines the type of financial expertise suggests that *accounting* financial expertise does result in greater audit committee effectiveness

¹ For NASDAQ firms without standing compensation committees, the rules require compensation decisions to be made by the majority of independent directors.

² In addition to compensation committee independence, the rules required all firms to have boards comprised of a majority of independent directors. Chhaochharia and Grinstein (2009) find that the rule changes led to greater decreases in compensation in firms with less independent boards prior to the change, although they do not document a similar effect for compensation committee independence per se.

³ This can take several forms, including (1) writing an ex ante contract in which bonuses are a function of earnings but that weights different earnings components differently, or (2) writing an ex ante contract that bases bonuses on performance measures other than earnings.

⁴ Although bonus contracts may be written ex ante, Morse, Nanda, and Seru (2011) document that bonus payments to CEOs reflect an ex post determination of the weight placed on different performance measures. In a separate analysis of S&P 500 companies' proxy statements, we find that 83% of firms have annual incentives based on formulas, and within those, the compensation committee retains the ability to exercise ex post discretion in awarding bonuses for 68% of them.

(Dhaliwal, Naiker, and Navissi, 2006, Defond, Hann, and Hu, 2005). In keeping with these studies, if accounting expertise is indicative of a better understanding of earnings, we expect compensation committees with expertise to place lower weights on components of earnings more likely to contain discretion.

Second, firm-specific knowledge of the financial reporting process, above and beyond any general accounting expertise, may provide a greater ability to disentangle potential earnings management. Therefore, we also consider whether compensation committee members also serve on the firm's audit committee as a proxy for expertise regarding the firm's accounts. Zheng and Cullinan (2010) find that overlap between the compensation and audit committee results in lower use of option-based pay, and while not testing this directly, they attribute that result to the spillover from the audit to the compensation committee of knowledge of misstatement-inducing effects of option-based pay. We more directly test this possibility by examining the effect on cash incentive compensation. We expect that the audit committee member, also serving on the compensation committee, understands the sources of discretion in earnings and has the ability to undo potential manipulation in determining pay.

An assumption in our research question is that earnings management is harmful to shareholders, and as stewards of the firm, the compensation committee would want to unwind earnings management if it possessed the ability to do so.⁵ We assume that failing to undo earnings management reflects a wealth transfer from shareholders to managers by providing cash compensation for apparent, but not actual, effort. However, there are other incentives to manage earnings, aside from manipulating proxies for effort to increase cash compensation. It is possible that these incentives may also benefit shareholders and might be perceived as 'good' earnings management to be rewarded. However, even if they exist, our assumption may not conflict with these other incentives. First, if earnings management is used to increase equity compensation (Cheng and Warfield, 2005; Bergstresser and Phillipon, 2006), even if these

⁵ We are not considering earnings management that is fraudulent or that would likely result in restatements. Our measure of earnings has been vetted by the audit committee and independent auditors. Rather, we are assuming that this earnings management reflects "on the margin" decisions by executives to influence the proxies used to measure effort and thus will result in additional compensation.

motives also benefit shareholders, the compensation committee may not want to provide additional rewards in the form of greater cash compensation. Second, research has documented that meeting earnings targets for capital markets purposes is a motivation for earnings management (i.e. Healy and Wahlen, 1999). “Successful” earnings management in these settings may reward the executives in other ways by increasing equity prices, and therefore equity compensation, or by alleviating career concerns (Mergenthatler, Rajgopal, and Srinivasan 2011). If so, the compensation committee may also not have any stewardship reason for rewarding such earnings management in compensation. Finally, to the extent that the firm pays bonuses out of separately established pools and the CEO’s earnings-based determinants are different from those of other executives, failing to unwind potential earnings management may unduly favor CEO compensation at the expense of other executives. Nonetheless, this assumption may be descriptively invalid; we discuss the implications of this in the interpretation of our results.

3. Research Design

3.1 Sample and data

We begin our sample selection with all firms in the Execucomp database, from which we obtain CEO compensation data. We limit our sample to non-financial services firms. We merge this data with financial statement data from Compustat and stock returns data from CRSP, resulting in 10,563 firm year observations for fiscal years 2003 through 2010. We start with the sample beginning 2003 because that is when AuditAnalytics Morningstar Governance database begins coverage of compensation committee characteristics. However, because of changes in proxy statement reporting beginning in 2006, discussed in more detail below, we limit the majority of our analyses to 2006-2010, resulting in 5,841 firm-year observations comprising 1,359 unique firms.⁶ As reported in Table 1 Panel A, our observations are spread relatively evenly throughout our sample period, with slightly fewer observations in 2010.

⁶ Our time period provides us two benefits. First, the Sarbanes-Oxley Act placed new restrictions on audit committee composition, including that the committee include at least one individual designated as a financial expert. If financial sophistication among all board members increased, it provides greater potential for power in our study to find accounting expertise on the board. Second, in 2003, the SEC approved new rules requiring the independence of

3.2 Measuring incentive compensation and compensation committee characteristics

Prior to 2006, cash incentive compensation was reported in the annual proxy statement as bonus pay. Beginning in 2006, the SEC required new disclosure in which firms separately report guaranteed or discretionary bonuses as “Bonus” pay and performance-based cash payouts as “Non-Equity Incentive Plan Compensation”. Since our interest is in determining how earnings measures of performance relate to compensation, we use Non-Equity Incentive Plan Compensation (referred to as incentive compensation) as our dependent variable in our analysis. We have two challenges with this measure. First, this measure combines payouts from annual plans with payouts from multi-year plans. While payouts from multi-year plans will have some relation to current year performance, the inclusion of payouts related to prior year performance measures will weaken our ability to detect a relation. Second, this measure is available starting only in 2006, so our sample period is limited. In robustness tests, we consider separately the relation between performance and “Bonus” pay to allow for the possibility that compensation committees may award discretionary bonuses partly due to firm performance. In addition, we consider the combined bonus and non-equity incentive pay for an extended sample window of 2003-2010.

To determine accounting expertise on the compensation committee, we consider whether any member of the committee has experience in accounting or financial reporting. We examine the biographies of the committee members from the Morningstar database. We search for the terms: “certified public accountant”, “cfo”, “chief financial”, “audit partner”, “audit manager”, “controller”, and “accounting director”. In addition, we consider the joint existence of “treasur” and “finance” or “treasur” and “accountant”. We consider a board member to have accounting expertise if the detailed biography contained one of those terms. Using the same dataset, we also determine whether a member of the compensation committee also serves on the audit committee.

the compensation committee for NYSE and NASDAQ firms. As a result, one explanation for the relation between bonus compensation in earnings management, lack of independence on the board, is mitigated in our time period.

In Table 1 Panel B, we report descriptive information on our compensation and financial variables. The mean (median) incentive pay is \$974,600 (\$485,300). In addition, we observe that our sample firms have average (median) book-to-market value of equity ratios of 0.521 (0.448) and annual stock returns of 13.2% (7.2%). In Table 1 Panel C, we report descriptive information on the compensation committees. On average, 78.6% of firms have compensation committee members with either overlap on the audit committee or accounting expertise. However, only 12.6% of compensation committee members have accounting expertise as defined above, and in only 37.3% of our observations is there at least one member of the compensation committee that has accounting expertise. On the other hand, the majority do have some overlap in compensation committee members that also serve on the audit committee. In 72.9% of our sample observations, at least one member of the compensation committee also serves on the audit committee, with an average (median) overlap of 37.9% (33.3%) members.

3.3 Measuring earnings management

We proxy for earnings management using discretionary accruals. Our estimate of discretionary accruals is based on a cross-sectional version of the modified-Jones model.⁷ Following Kasznik (1999), we include cash flow from operations in the model. Considering the recent debate on performance-matched discretionary accruals (Kothari, Leone and Wasley (2005), Dechow, Ge and Schrand (2010), and Dechow, Hutton, Kim and Sloan (2010)), we do not use this specification.

Using all firms in Compustat with total assets greater than \$1 million, we estimate the following regression annually, for each of 15 industries as defined by Barth, Beaver and Landsman (1998):

$$TACC_j = \beta_1 + \beta_2 * 1/AT_j + \beta_3 ADJREV_j + \beta_4 PPE_j + \beta_5 OCF_j + \varepsilon_j \quad (1)$$

where:

⁷ The cross-sectional modified Jones model has been suggested by prior research to provide reasonable measures of discretionary accruals and earnings management (Subramanyam (1996), Bartov et al. (2000), Dechow et al. (1995) and Guay et al. (1996)), although the measurement is imperfect.

TACC _j	=	total accruals, calculated as pretax income (Compustat Data Item PI) less special items (Compustat Data Item SPI) minus net cash flow from operating activities (Compustat Data Item OANCF) scaled by beginning-of-period total assets (Compustat Data Item AT) for firm j
1/AT _j	=	a vector of one's divided by beginning-of-period total assets (Compustat Data Item AT) for firm j
ADJREV _j	=	change in revenues (Compustat Data Item SALE) from the prior year adjusted for the change in accounts receivables (Compustat Data Item RECCH) from the prior year, scaled by beginning-of-period total assets (Compustat Data Item AT) for firm j
PPE _j	=	gross property, plant and equipment (Compustat Data Item PPEGT) scaled by beginning-of-period total assets (Compustat Data Item AT) for firm j
OCF _j	=	change in cash flow from operating activities (Compustat Data Item OANCF) from the prior year scaled by beginning-of-period total assets (Compustat Data Item AT) for firm j

We include an intercept, in addition to the variable 1/AT, to provide additional control for heteroskedasticity and other concerns raised by not controlling for size specifically in the model (Kothari, et al. (2005)). For each firm-year, we estimate discretionary accruals as the difference between actual total accruals and predicted total accruals based on the coefficients from the above estimation. We then use pretax income, adding back special items, less discretionary accruals, scaled by prior year assets, as our proxy for unmanaged earnings.

As reported in Table 1 Panel D, on average (at the median), unmanaged earnings are 8.3% (7.8%) of the prior year's assets. Our estimates of managed earnings, using signed discretionary accruals, are smaller at an average (median) of 1.7% (1.5%) of prior year's assets. Sixty-three percent of the observations have positive managed earnings.

3.4 Relation between compensation and earnings

We examine the relation between compensation and earnings by estimating a series of models of annual incentive compensation on unmanaged earnings, discretionary accruals, and compensation committee characteristics, including variables to control for additional determinants of pay beyond accounting performance. Specifically, we estimate the following models, using firm fixed-effects to control for firm specific factors that affect compensation and are invariant over time.

$$\text{INCENT_COMP}_t = \alpha_1 + \alpha_2 \text{EGS}_{jt} + \alpha_3 \text{SPI}_{jt} + \alpha_6 \text{BTM}_{jt} + \alpha_7 \text{RET}_{jt} + \alpha_i \text{YEAR}_t + \varepsilon_{jt} \quad (2)$$

$$\text{INCENT_COMP}_t = \alpha_1 + \alpha_2 \text{UNMAN}_{jt} + \alpha_3 \text{POS_DA}_{jt} + \alpha_4 \text{NEG_DA}_{jt} + \alpha_5 \text{SPI}_{jt} + \alpha_6 \text{BTM}_{jt} + \alpha_7 \text{RET}_{jt} + \alpha_i \text{YEAR}_t + \varepsilon_{jt} \quad (3)$$

$$\text{INCENT_COMP}_t = \alpha_1 + \alpha_2 \text{UNMAN}_{jt} + \alpha_3 \text{POS_DA}_{jt} + \alpha_4 \text{NEG_DA}_{jt} + \alpha_5 \text{SPI} + \alpha_6 \text{RET}_{jt} + \alpha_7 \text{UNMAN}_{jt} * \text{CC}_{jt} + \alpha_8 \text{POS_DA}_{jt} * \text{CC}_{jt} + \alpha_9 \text{NEG_DA}_{jt} * \text{CC}_{jt} + \alpha_{10} \text{SPI}_{jt} * \text{CC}_{jt} + \alpha_{10} \text{RET}_{jt} * \text{CC}_{jt} + \alpha_{11} \text{CC}_{jt} + \alpha_{12} \text{BTM}_{jt} + \alpha_i \text{YEAR}_t + \varepsilon_j \quad (4)$$

where:

INCENT_COMP_{jt} = non-equity incentive compensation for the CEO as reported in the proxy statement, scaled by beginning total assets of firm j in year t

*Primary independent variables:*⁸

EGS_{jt} = Pretax income (Compustat Data Item PI) less special items (Compustat Data Item SPI) for firm j in year t
 UNMAN_{jt} = Unmanaged earnings for firm j in year t
 POS_DA_{jt} = Discretionary accruals, if greater than zero, and zero otherwise for firm j in year t
 NEG_DA_{jt} = Discretionary accruals, if less than or equal to zero, and zero otherwise for firm j in year t
 SPI_{jt} = Special items (Compustat variable SPI) for firm j in year t

Proxy for attribute of the compensation committee (CC_{jt}):

CC_ACCTEXP_{jt} = 1 if compensation committee for firm j includes at least one member whose experience indicates accounting expertise;
 CC_AUDIT_{jt} = 1 if at least one member of compensation committee for firm j is also on audit committee;

Control variables:

BTM_{jt} = Book value of commons shareholders' equity (Compustat Data Item CEQ) scaled by the market value of shareholders equity (Compustat Data Item MKVALT) for firm j in year t
 RET_{jt} = Cumulative stock returns for firm j for year t
 YEAR_{jt} = Indicator variable for each year 2007 through 2010

We decompose discretionary accruals into potential upward earnings management (POS_DA) and downward earnings management (NEG_DA) in equation (2). We then interact earnings, discretionary

⁸ Since estimated accruals are scaled by lagged assets, we scale compensation by lagged assets to control for size effects on pay.

accruals, special items and stock returns with proxies for compensation committee characteristics of interest (CC) in equation (3). To mitigate the influence of outliers, we winsorize all continuous variables at 1% and 99%.

We use equations (2) to confirm results in prior research. Balsam (1998) finds that discretionary components of earnings receive less weight in bonus contracts than nondiscretionary components of earnings. If that result continues to hold, we expect that α_2 is greater than α_3 .⁹ In addition, if compensation committees shield executives from downwards earnings management or special items, we expect a non-positive coefficient on α_4 and α_5 .

We use equation (3) to test our predictions regarding the impact of compensation committee characteristics on these relations. We expect the relation between positive discretionary accruals and bonuses to be less positive ($\alpha_8 < 0$) when the compensation committee has more accounting expertise. If negative accruals result from earnings management, we expect them to have greater weight ($\alpha_9 > 0$) in the presence of accounting experts on the compensation committee. That is, we expect that the compensation committee will realize the potential ability of negative accruals to increase earnings in future periods and reflect their impact on current period earnings in cash incentive pay. If compensation committees with accounting expertise recognize the direct effect on bonuses from potential earnings management, we might expect greater weight on stock returns as a performance measure in determining bonuses. If so, we expect a positive coefficient on α_{11} .

4. Results

4.1 Main analyses

Table 2 presents the results from estimating the regressions in equations (2) and (3). The first column (A) summarizes the results from estimating equation (2), and the second column (B) summarizes the results from estimating equation (3). As expected, we find a positive and significant coefficient on

⁹ Huson et al. (2012) find that the change in discretionary accruals has no incremental explanatory power for cash compensation beyond that contained in the change in ROA. This would imply, in our regressions, that $\alpha_2 = \alpha_3$.

earnings in Column (A) ($p < 0.01$) and on unmanaged earnings in Column (B) ($p < 0.01$), consistent with higher earnings being rewarded by higher cash compensation. In addition, we find a positive and significant coefficient on returns in both columns (A) and (B) ($p\text{-value} < 0.01$). We find a positive and significant coefficient on positive discretionary accruals ($p\text{-value} < 0.01$) in Column (B), suggesting that positive discretionary accruals do indeed affect incentive compensation. Interestingly, the coefficient on positive discretionary accruals is not significantly different than that on unmanaged earnings (an F-test of the difference in the coefficient on UNMAN and the coefficient on POS_DA is not significant at conventional levels), suggesting that positive discretionary accruals have a similar effect on incentive compensation as unmanaged earnings. In addition, we detect no significant relation between incentive compensation and negative discretionary accruals, consistent with negative discretionary accruals being excluded from incentive compensation. These results can obtain from either (1) compensation committees shielding managers from the effects of negative accruals, if those accruals reflect longer-term investments (Dechow et al., 1994) or (2) managers making negative discretionary accruals when overall earnings are outside of the incentive range (that is, beyond the ceiling in the compensation contracts where additional earnings have no relation to compensation.) In the latter case, the compensation committee does not appear to be unwinding these negative accruals in determining incentive pay.

Table 3 presents the results from estimating the regressions in equations (4). Column (A) summarizes the results from estimating the equation including an indicator variable of whether the compensation committee includes at least one person who is *either* a member of the board's audit committee or who has accounting expertise, as well as associated interaction variables. As in Table 2, we find a positive and significant coefficient on both unmanaged earnings and returns, a positive and significant weight on positive discretionary accruals, no significant weight on negative discretionary accruals, and no difference in the weight on unmanaged earnings and positive discretionary accruals. Interestingly, however, we find little difference in the weight on the earnings variables when an accounting expert or audit committee member serves on the firm's compensation committee (the coefficients on UNMAN x CC, POS_DA x CC, and NEG_DA x CC are generally not significant at

conventional levels). We do find some evidence that when there is overlap with the audit committee, there is greater weight on stock returns (the coefficient on $RETS \times CC$ is positive and significant at $p\text{-value} < 0.10$).

One explanation for the lack of differential weights placed on earnings by compensation committees with various characteristics is the possibility that accounting expertise from professional experience may predict different weights on earnings than would expertise from also serving on the audit committee. If so, our tests in Table 3 do not adequately separate these out as firms have both, some, or neither of these means of accounting knowledge. In particular, accounting expertise may, indeed, indicate knowledge about the quality of reporting earnings and thus willingness to place reliance on them in determining incentive compensation. In this case, we would predict greater weight on earnings and discretionary accruals. Alternatively, while overlap with the audit committee may indicate similar knowledge, that motivation may be offset by the unwillingness of those committee members to incur the additional cost of monitoring (Laux and Laux, 2009). As such, we may expect ex-ante lower weight on earnings and/or discretionary accruals for firms that have only overlap with the audit committee and greater ex-post weight on earnings and discretionary accruals for firms with only accounting expertise. For firms that have compensation committees with both accounting expertise and representation on the audit committee, we have no prediction due to the potentially competing effects.

To consider this, we partition our sample of firms into four categories according to the compensation committee characteristics: firms that have both accounting expertise and representation on the audit committee, firms that have only representation on the audit committee, firms that have only accounting expertise, and firms that have neither overlap nor expertise. Table 4 presents those results. For firms with both overlap and expertise, we find no different weight on earnings relative to firms that have neither. We do, however, find greater weight on stock returns (the coefficient on $RET*CC=Both$ is positive and significant at $p\text{-value} < 0.10$.) The results are consistent with the competing effects leading to no difference, but may also favor the effort aversion associated with overlap as these committees place greater weight on non-earnings performance. When compensation committees have only overlap, we find

less weight on earnings and positive discretionary accruals, although only the coefficient on POS_DA*CC=AuditOnly is significant at conventional levels (p-value < 0.10). This finding is consistent with the assertion that with overlap, the audit committee members are unwilling to bear the cost of oversight necessary to hold potential earnings management behavior in check. Finally, when there is only accounting expertise on the compensation committee, we find greater weight on earnings and greater weight on negative discretionary accruals (p-values < 0.05 and < 0.10, respectively). These findings indicate that committees with accounting expertise are willing to place greater reliance on earnings, and in fact, penalize CEOs for negative discretionary accruals either because they recognize this discretion as earnings management or they understand it to be a valid measure of performance.

In total, these results suggest that accounting expertise on the compensation committee affects the weight on earnings, discretionary accruals and stock returns in determining incentive compensation. And, our results suggest that the source of that expertise matters. Relative to firms with no accounting expertise or overlap on the committee, firms with only accounting expertise place greater weight on earnings and negative discretionary accruals indicating greater knowledge of the quality of the accounting earnings. Alternatively, for firms with only overlap in membership on the audit committee and the compensation committee, we find evidence supporting the predictions of Laux and Laux (2009). If the board separates responsibilities for setting CEO pay (compensation committee) and monitoring (audit committee), they demonstrate that the compensation committee increases pay-to-performance sensitivity of CEO compensation (through option-based pay), because the audit committee, not the compensation committee, has to bear the cost of oversight necessary to hold earnings management behavior in check. Extending their model to cash incentive pay, our findings are consistent with their predictions. When there is less task separation (i.e. where there is overlap with the audit committee), the compensation committee decreases pay-to-performance sensitivity of CEO compensation since the same board members now also bear the oversight costs. Finally, consistent with the potentially conflicting predictions when compensation committees have both accounting expertise and overlap with the audit committee, we find no differential weight on earnings relative to firms with neither.

4.2 Additional Tests

We perform additional tests to examine the consistency of our results to various research design choices or alternative explanations. First, we replace our measures that capture whether there is an accounting expert on the compensation committee or any overlap with the audit committee with continuous variables that capture the proportions (results untabulated). When examining the extent of overlap with the audit committee, our conclusions from Table 3 column B are mainly unchanged. We continue to find no differential weight on the earnings variables, but we now find no different weight on returns, suggesting it is the presence, not the extent, of overlap that matters for altering the weight on earnings. When examining the percent of committee members with accounting expertise, we now find positive weight on special items (p -value < 0.10) and greater weight on positive discretionary accruals (p -value < 0.05) for firms with greater accounting expertise. This finding is consistent with the alternative prediction from Section 4.1 that greater accounting expertise allows the committee to place greater weight on earnings measures if there is greater knowledge of their quality.

Second, we explore whether the decision to place differential weights reflects ex-ante considerations. Compensation committees may be more likely to write contracts taking into consideration potential earnings management rather than make ex-post adjustments. This is similar to the Stein (1989) argument for why firms manage earnings if the capital markets expect such behavior. If the compensation committee expects there to be earnings management, based on prior behavior, then it might write the contract with less weight on overall earnings. And, executives, recognizing that their cash incentive pay would be lower absent any earnings management, use their discretion to manipulate earnings.

A related explanation derives from the model in Evans and Sridhar (1996). Their model considers flexibility in the financial reporting system that may allow for earnings management and causes firms to trade off the incentive effects of encouraging greater effort by contracting on earnings against the possibility of manipulation of those earnings. When there is less financial flexibility in the reporting system, firms will put more weight on earnings because the financial reporting system will curtail

earnings management, and the contract then has greater incentive effects. However, when that is not the case and there is more flexibility in the system, then the compensation contract has to both motivate the agent and discourage earnings management. As a result, there is less weight on earnings.

We examine whether either (or both) of these explanations hold in our data. Our research design does not distinguish between the two explanations, as we use the same variable to proxy for the firm-specific expectation of earnings management and flexibility in the financial reporting system. A finding consistent with either explanation is that the compensation committee places less weight on earnings when there is a higher expectation or likelihood of manipulation. We also examine whether attributes of the compensation committee are related to this decision.

We identify firms for which there is a higher expectation of earnings management or greater flexibility to allow earnings management by their discretionary accrual behavior in the five years prior to our sample period. We compute the average (unsigned) discretionary accruals over this period and define firms as having higher expectation or higher flexibility as firms in the top quintile of average discretionary accruals in 2001-2005. For our analysis, we start with equation (2) and make three changes: (1) we combine unmanaged earnings and discretionary earnings into reported earnings, scaled by total assets, (2) we interact our proxy for higher expectation of manipulation or financial flexibility with reported earnings, and (2) we compute the standard deviation of reported earnings from 2001-2005 and interact it with reported earnings.¹⁰ We include this last variable to control for the possibility that compensation committees will place less weight on earnings when they are more volatile since it is a less precise measure of effort (Lambert and Larcker, 1987). Volatility is a potential correlated omitted variable if high accrual firms also have more volatile earnings. If compensation committee members anticipate earnings management, then we expect that high accrual firms will have less weight on overall earnings in determining cash incentive pay than do other firms. If compensation committee members also serve on the audit committee, and they recognize the incentive for CEOs to manage and the propensity to do so as

¹⁰ We include only the interactive effects, and not also main effects, since we estimate our model using firm fixed-effects and our proxy for higher expectation of manipulation or reporting flexibility is time-invariant in our model.

captured by high accruals, we'd expect this underweighting of earnings to be greater for high accrual firms with overlap on the audit committee. If compensation committee members have accounting expertise and recognize the prior tendencies to have greater discretionary accruals, we expect underweighting of earnings for high accrual firms with accounting expertise.

As reported in Table 5 column A, we find a positive weight on earnings, as expected. And consistent with the hypothesis that compensation committees write ex-ante contracts on earnings that place less weight on earnings when earnings management is expected, we find a negative coefficient on EARNINGS*PREACCR (p-value < 0.10); firms with high accruals in the prior five years place less weight on earnings in determining cash incentive pay. However, inconsistent with expectations, we find that the weight on earnings for those firms whose earnings are expected to be more volatile is not significantly different from other firms.¹¹ In column B, we allow for differential weights when there is overlap between the audit and compensation committees. Consistent with audit committee members recognizing the ex-ante greater potential for discretion and not wanting to incur any extra effort, we find that the lower weight on earnings in high accrual firms to be implemented by firms with overlap. We find no differential weight when there is accounting expertise in the compensation committee. Together, these findings suggest that audit committee members also on the compensation committee recognize the additional effort required and write contracts that reflect their ex-ante expectations.

5. Conclusion

Using a sample of ExecuComp firms from 2006 – 2010, we examine whether accounting expertise of compensation committee members is related to differential weights on unmanaged earnings and earnings susceptible to manipulation in determining cash-based incentive pay. While research posits that executives manage earnings to increase incentive compensation, it is possible that the compensation

¹¹ In untabulated analysis, we estimate the regression including interactions of high accruals and high volatility to with stock returns to allow for the possibility that the lower weight on earnings is replaced by greater weight on returns. While we continue to find lower weight when prior accruals are high, we find no evidence of different weights on stock returns.

committee might place lower weights on performance measures affected by potential earnings management if the committee has sufficient accounting expertise to understand the discretion those measures contain. While we find no evidence of a lower weight when we define expertise as having professional accounting experience, we do find evidence that compensation committees with only accounting expertise place *greater* weight on earnings and negative discretionary accruals. These findings suggest that perhaps accounting knowledge informs the compensation committee of the underlying earnings quality and the committee places greater ex-post weight when these measures better reflect effort. When compensation committees contain members that also serve on the audit committee, we find they place less weight on positive discretionary accruals. While this is consistent with underweighting earnings that are potentially subject to greater discretion, it also supports the task separation argument proposed by Laux and Laux (2009). Finally, after taking into consideration the underlying characteristics of firms' earnings, it appears compensation committees anticipate or expect potential earnings management and therefore write a contract that places lower weight on overall earnings. Overall, our study provides evidence that accounting expertise and other duties of the compensation committee influence the compensation setting process.

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Table 1

Descriptive statistics for sample of 5,841 firm-years between 2006-2010

Panel A: Distribution of firm-year observations across years

2006	1,116
2007	1,250
2008	1,279
2009	1,246
2010	950
	5,841

Panel B: Financial characteristics

	Mean	Median	Std Dev
Incentive compensation (\$ 000)	\$974.6	\$485.3	\$1,635.8
Incentive compensation (scaled by prior year assets)	0.52	0.22	0.70
Assets (\$ millions)	\$7,279.9	\$1,607.6	\$27,910.9
Book-to-market ratio	0.521	0.448	0.439
Stock returns	0.132	0.072	0.539

Panel C: Compensation committee characteristics

	Mean	Median
At least one audit committee member or accounting expert on compensation committee	78.6%	
At least one accounting expert on compensation committee	37.3%	n/a
Proportion of compensation committee that are accounting experts	12.6%	0.0%
At least one audit committee member on compensation committee	72.9%	n/a
Proportion of compensation committee members also on audit committee	37.9%	33.3%

Panel D: Earnings variables*

	Mean	Median	Std Dev
Earnings (scaled by lagged assets)	0.100	0.091	0.123
Unmanaged earnings (scaled by lagged assets)	0.083	0.078	0.097
Managed earnings (scaled by lagged assets)	0.017	0.015	0.068
Positive managed earnings (for 3,702 observations with positive managed earnings)	0.050	0.037	0.051
Negative managed earnings (for 2,139 observations with negative managed earnings)	-0.041	-0.026	0.055

*all earnings variables exclude special items

Table 2
OLS regressions of incentive compensation on earnings, unmanaged earnings, discretionary accruals, and control variables for period 2006-2010

$$\text{INCENT_COMP}_t = \alpha_1 + \alpha_2 \text{EARNINGS}_{jt} + \alpha_3 \text{SPI}_{jt} + \alpha_6 \text{BTM}_{jt} + \alpha_7 \text{RET}_{jt} + \alpha_i \text{YEAR}_t + \varepsilon_{jt} \quad (2)$$

$$\text{INCENT_COMP}_t = \alpha_1 + \alpha_2 \text{UNMAN}_{jt} + \alpha_3 \text{POS_DA}_{jt} + \alpha_4 \text{NEG_DA}_{jt} + \alpha_5 \text{SPI}_{jt} + \alpha_6 \text{BTM}_{jt} + \alpha_7 \text{RET}_{jt} + \alpha_i \text{YEAR}_t + \varepsilon_{jt} \quad (3)$$

	(A)	(B)
Constant	0.34***	0.25***
EARNINGS	1.54***	
UNMAN		2.14***
POS_DA		1.74***
NEG_DA		0.17
SPI	0.41***	0.41***
RET	0.15***	0.15***
BTM	-0.10***	-0.08***
F-test: UNMAN = POS_DA		1.67
F-test: UNMAN = NEG_DA		22.90 ***
n	5,841	5,841
Adjusted R-squared	0.1229	0.1371

Regression estimated used firm-fixed effects model. Year indicator variables included but coefficients not reported in table. Table reports coefficient estimates from OLS estimations, with standard errors cluster-adjusted by firm. *, **, and *** indicate significance at $p < 0.10$, $p < 0.05$, and $p < 0.01$, respectively, based on two-tailed tests.

Variable definitions:

- INCENT_COMP_{jt} = non-equity incentive compensation for the CEO as reported in the proxy statement, scaled by beginning total assets of firm j in year t
- EARNINGS_{jt} = Pretax income (Compustat Data Item PI) less special items (Compustat Data Item SPI) for firm j in year t
- UNMAN_{jt} = Unmanaged earnings for firm j in year t
- POS_DA_{jt} = Discretionary accruals, if greater than zero, and zero otherwise for firm j in year t
- NEG_DA_{jt} = Discretionary accruals, if less than or equal to zero, and zero otherwise for firm j in year t
- SPI_{jt} = Special items (Compustat variable SPI) for firm j in year t
- BTM_{jt} = Book value of commons shareholders' equity (Compustat Data Item CEQ) scaled by the market value of shareholders equity (Compustat Data Item MKVALT) for firm j in year t
- RET_{jt} = Cumulative stock returns for firm j for year t

Table 3
OLS regressions of cash compensation on unmanaged earnings, discretionary accruals, compensation committee characteristics, and control variables for period 2006-2010

$$\text{INCENT_COMP}_t = \alpha_1 + \alpha_2 \text{UNMAN}_{jt} + \alpha_3 \text{POS_DA}_{jt} + \alpha_4 \text{NEG_DA}_{jt} + \alpha_5 \text{SPI} + \alpha_6 \text{RET}_{jt} + \alpha_7 \text{UNMAN}_{jt} * \text{CC}_{jt} + \alpha_8 \text{POS_DA}_{jt} * \text{CC}_{jt} + \alpha_9 \text{NEG_DA}_{jt} * \text{CC}_{jt} + \alpha_{10} \text{SPI}_{jt} * \text{CC}_{jt} + \alpha_{10} \text{RET}_{jt} * \text{CC}_{jt} + \alpha_{11} \text{CC}_{jt} + \alpha_{12} \text{BTM}_{jt} + \alpha_i \text{YEAR}_t + \varepsilon_j \quad (4)$$

	(A)	(B)	(C)
Constant	0.19***	0.20***	0.24***
UNMAN	2.33***	2.43***	2.16***
POS_DA	2.37***	2.35***	1.43***
NEG_DA	-0.91	-0.53	0.24
SP_ITEMS	0.42	0.48	0.30
RET	0.10**	0.11***	0.14***
CC	0.07	0.06	0.02
UNMAN * CC	-0.22	-0.35	-0.04
POS_DA * CC	-0.75	-0.74	0.73
NEG_DA * CC	1.24	0.82	-0.11
SP_ITEMS * CC	-0.00	-0.08	0.35
RET * CC	0.07	0.06*	0.03
BTM	-0.08***	-0.08***	-0.08***
F-test: UNMAN = POS_DA	0.00	0.002	3.16*
F-test: UNMAN = NEG_DA	9.80***	9.51***	15.70***
F-test: UNMAN + UNMAN*CC = 0	52.69***	50.52***	48.99***
F-test: POS_DA + POS_DA*CC = 0	29.64***	27.53***	31.22***
F-test: NEG_DA + NEG_DA*CC = 0	0.60	0.49	0.05
F-test: UNMAN+UNMAN*CC = POS_DA+POS_DA*CC	2.29	2.05	0.01
N	5,841	5,841	5,841
Adjusted R-squared	0.1383	0.1381	0.1381

Regression estimated used firm-fixed effects model. Year indicator variables included but coefficients not reported in table. Table reports coefficient estimates from OLS estimations, with standard errors cluster-adjusted by firm. *, **, and *** indicate significance at $p < 0.10$, $p < 0.05$, and $p < 0.01$, respectively, based on two-tailed tests.

Variable definitions:

- INCENT_COMP_{jt} = non-equity incentive compensation for the CEO as reported in the proxy statement, scaled by beginning total assets of firm j in year t
- UNMAN_{jt} = Unmanaged earnings for firm j in year t
- POS_DA_{jt} = Discretionary accruals, if greater than zero, and zero otherwise for firm j in year t
- NEG_DA_{jt} = Discretionary accruals, if less than or equal to zero, and zero otherwise for firm j in year t
- SPI_{jt} = Special items (Compustat variable SPI) for firm j in year t
- CC_{jt} (Column A) = 1 if compensation committee for firm j includes at least one member of the audit committee OR at least one member whose experience indicates accounting expertise;
- CC_{jt} (Column B) = 1 if at least one member of compensation committee for firm j is also on audit committee;
- CC_{jt} (Column C) = 1 if compensation committee for firm j includes at least one member whose experience indicates accounting expertise;
- RET_{jt} = Cumulative stock returns for firm j for year t
- BTM_{jt} = Book value of commons shareholders' equity (Compustat Data Item CEQ) scaled by the market value of shareholders equity (Compustat Data Item MKVALT) for firm j in year t

Table 4

OLS regressions of cash compensation on unmanaged earnings, discretionary accruals, and control variables for period 2006-2010, interacting earnings and performance variables with partitioning of the data based on compensation committee characteristics

$$\begin{aligned} \text{INCENT_COMP}_t = & \alpha_1 + \alpha_2 \text{UNMAN}_{jt} + \alpha_3 \text{POS_DA}_{jt} + \alpha_4 \text{NEG_DA}_{jt} + \alpha_5 \text{SPI} + \alpha_6 \text{RET}_{jt} \\ & + \alpha_{k1-3} \text{UNMAN}_{jt} * \text{CC}_{jt} + \alpha_{L1-3} \text{POS_DA}_{jt} * \text{CC}_{jt} + \alpha_{m1-3} \text{NEG_DA}_{jt} * \text{CC}_{jt} \\ & + \alpha_{n1-3} \text{SPI}_{jt} * \text{CC}_{jt} + \alpha_{o1-3} \text{RET}_{jt} * \text{CC}_{jt} + \alpha_{p1-3} \text{CC}_{jt} + \alpha_7 \text{BTM}_{jt} + \alpha_i \text{YEAR}_t + \varepsilon_j \end{aligned} \quad (4)$$

Constant	0.19***
UNMAN	2.35***
POS_DA	2.35***
NEG_DA	-0.81
SPI	0.43
RET	0.09**
UNMAN*CC=BOTH	-0.31
POS_DA* CC=BOTH	-0.20
NEG_DA* CC=BOTH	0.85
SPI* CC=BOTH	0.20
RET* CC=BOTH	0.08*
UNMAN*CC=AuditOnly	-0.21
POS_DA*CC=AuditOnly	-1.25*
NEG_DA*CC=AuditOnly	1.39
SPI* CC=AuditOnly	-0.15
RET* CC=AuditOnly	0.06
UNMAN*CC=ExpertOnly	1.24**
POS_DA*CC=ExpertOnly	-0.04
NEG_DA*CC=ExpertOnly	2.79*
SPI*CC=ExpertOnly	0.36
RET*CC=ExpertOnly	0.04
CC=BOTH	0.07
CC=AuditOnly	0.07
CC=ExpertOnly	-0.01
BTM	-0.08***
Observations	5,841
Adjusted R-squared	0.1402

Regression estimated used firm-fixed effects model. Year indicator variables included but coefficients not reported in table. Table reports coefficient estimates from OLS estimations, with standard errors cluster-adjusted by firm. *, **, and *** indicate significance at $p < 0.10$, $p < 0.05$, and $p < 0.01$, respectively, based on two-tailed tests. Variables are as defined in Table 3. CC=Both indicates firms that have both at least one audit committee member on the compensation committee and at least one compensation committee member whose experience indicates accounting expertise. CC=AuditOnly indicates firms that have at least one audit committee member on the compensation committee but no accounting expertise on the compensation committee. CC=ExpertOnly indicates firms that have at least one compensation committee member whose experience indicates accounting expertise but no members also serving on the audit committee. Firms with neither accounting expertise nor overlap with audit committee on the compensation committee are included as the main effects.

Table 5

OLS regressions of cash compensation on earnings and control variables for period 2006-2010, separately for high and low accrual firms defined as being in the top and bottom quintiles of average accruals from 2001-2005

$$\text{INCENTCOMP}_t = \alpha_1 + \alpha_2 \text{EARNINGS}_{jt} + \alpha_2 \text{EARNINGS}_{jt} * \text{PREACCR} + \alpha_3 \text{EARNINGS}_{jt} * \text{PREVOL} + \alpha_4 \text{BTM}_{jt} + \alpha_5 \text{RET}_{jt} + \alpha_i \text{YEAR}_t + \varepsilon_j$$

	(A)	(B)	(C)
Constant	0.29*** (8.15)	0.29*** (8.18)	0.30*** (8.17)
EARNINGS	2.06*** (6.60)	2.04*** (6.24)	1.94*** (5.44)
EARNINGS*PREACCR	-0.93* (-1.96)	0.19 (0.31)	-0.95* (-1.81)
EARNINGS*PREVOL	-0.21 (-0.46)	-0.84 (-1.29)	-0.01 (-0.02)
EARNINGS*CC		0.03 (0.10)	0.28 (0.76)
EARNINGS*PREACCR*CC		-1.37*** (-2.66)	0.11 (0.22)
EARNINGS*PREVOL*CC		0.82 (1.42)	-0.53 (-0.89)
BTM	-0.09*** (-3.03)	-0.09*** (-3.03)	-0.09*** (-3.07)
RET	0.16*** (8.03)	0.16*** (8.00)	0.16*** (8.16)
Observations	5,665	5,665	5,665
Adjusted R-squared	0.10	0.13	0.12

Regression estimated used firm-fixed effects model. Year indicator variables included but coefficients not reported in table. Table reports coefficient estimates from regression estimations, with t-statistics in parentheses. Standard errors are cluster adjusted by firm. *, **, and *** indicate significance at $p < 0.10$, $p < 0.05$, and $p < 0.01$, respectively, based on two-tailed tests. PREACCR_{jt} is an indicator equal to 1 if the firm is the top quintile of average (unsigned) discretionary accruals in the period 2001-2005, and 0 otherwise. PREVOL_{jt} is an indicator equal to 1 if the firm is the top quintile of the standard deviation of earnings in the period 2001-2005, and 0 otherwise. All other variables are as defined in Tables 2 and Tables 3. Column B defines "CC" as at least one member of compensation committee for firm j is also serving on the audit committee. Column C defines "CC" as at least one member of the compensation committee for firm j has experience indicating accounting expertise.