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Two Papers on "How Perceptions of Fairness and Influences of Social Capital and Source Credibility Matter to Compensation Committees And Investors"

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TWO PAPERS ON “HOW PERCEPTIONS OF FAIRNESS AND
INFLUENCES OF SOCIAL CAPITAL AND SOURCE CREDIBILITY
MATTER TO COMPENSATION COMMITTEES AND INVESTORS”

by
Anne M. Wilkins

A Dissertation

Presented in Partial Fulfillment of the Requirements for the
Degree of
Doctor of Business Administration
In the
Coles College of Business
Kennesaw State University

Kennesaw, GA
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2012



**Coles College of Business
Doctor of Business Administration**

Dissertation Defense: January 6, 2012

DBA Candidate: Anne M. Wilkins

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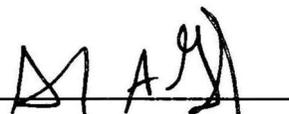
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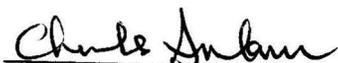
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My dissertation is dedicated to my grandmother, Marie Monroe Wilkins; a truly incredible woman.

ABSTRACT

TWO PAPERS ON “HOW PERCEPTIONS OF FAIRNESS AND INFLUENCES OF SOCIAL CAPITAL AND SOURCE CREDIBILITY MATTER TO COMPENSATION COMMITTEES AND INVESTORS”

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This paper uses an experimental research design to examine the influences of social capital, source credibility, and fairness on the decision making process of compensation committee members when making an executive compensation decision as well as whether an expectation gap exists between the committee members and nonprofessional investors regarding the judgment. One hundred and one public company compensation committee members and ninety nine nonprofessional investors completed an executive compensation case indicating their support on a scale of 0 to 100 of revising executive incentive pay financial performance targets mid-compensation cycle.

I find outcome fairness to shareholders and management significant influences on compensation committee member judgments. In addition, I found more experienced compensation committee members had less support for the compensation proposal. I found a surprising expectation gap between nonprofessional investors and compensation committee members as the members held the CEO more accountable for financial performance than the nonprofessional investors. In addition, I found marginal support that the nonprofessional investors were influenced by the manipulated influences of social capital and source credibility whereas the compensation committee members were not influenced.

Overall, my results indicate that the compensation committee members are not under the undue influence of the CEO but consider pay for performance and shareholder fairness as their top influences on executive pay decisions. My results provide preliminary evidence that compensation committee members should further improve communication with shareholders and other stakeholders regarding the rationale for their decisions including information about the consideration of fairness in their judgments.

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CHAPTER 1- INTRODUCTION/LITERATURE REVIEW

Compensation committees operate in a difficult environment. Shareholders, the public, even the government are concerned compensation committee members may be too connected with management to exercise independent judgment (Landau et al., 2009). Extant academic research on compensation committee judgments is limited and primarily archival. In light of the difficult environment that compensation committees face, as well as the lack of academic research on this important governance monitoring function (Daily et al., 1998), my research examines compensation committee member judgments.

Using social capital, source credibility, and fairness theory, Paper 1 in an experimental research design examines whether compensation committee member support (dependent variable) for an executive compensation proposal (to change performance targets during a cycle) will increase under conditions of high social capital and high source credibility (manipulated in the experimental case instrument) and also increase when the compensation committee member perceives process fairness to shareholders to be higher (if the change is made), outcome fairness to shareholders to be higher (if the change is made), and outcome fairness to management to be lower (if the change is not made). The three fairness independent variables are measured in the case instrument. The study uses a 2 X 2 experimental design with a case scenario proposing reducing management's performance targets during a compensation cycle, due to significantly greater than anticipated expenses related to a reduction in workforce and the closing of several underperforming stores. The case scenario was adapted from a public

company proxy statement. Eighty-one compensation committee members assessed their support for a compensation judgment, outcome fairness to management and shareholders, and procedural fairness to shareholders.

I do not find that social capital, source credibility, or process fairness are significant in determining compensation committee member support for the executive compensation proposal. Rather, the overall focus of the members in their evaluation of the proposal is on outcome fairness. I find outcome fairness to the CEO and outcome fairness to the shareholders are significantly related to compensation committee members' support for reducing performance targets during a compensation cycle. In addition, more experienced compensation committee members are less supportive of changing the performance targets. Finally, there are a number of significant interactions among the independent variables, including the interaction between outcome fairness to shareholders and process fairness to shareholders. This interaction suggests compensation committee member support for the proposal relies on both process and outcome fairness being present.

Overall, the research in Paper 1 indicates compensation committee members are balancing their obligation to monitor (consistent with agency theory) with their responsibility to retain and attract executive talent (consistent with resource dependence theory). The research does not demonstrate that the members are under the control of the CEO, but instead consider pay for performance and fairness to shareholders the top influences on their executive compensation judgments. This is the first study actually testing the influences on compensation committee members' executive compensation judgments.

Paper 2 extends Paper 1 by providing lightly adapted experimental case materials from Paper 1 to nonprofessional investors to determine if an expectation gap exists between compensation committee members and nonprofessional investors. The manipulated variables are the same as in Paper 1 to provide comparability within the case instrument provided to the two groups, compensation committee members and nonprofessional investors. The variable of interest in Paper 2 is the group variable, indicating investor or compensation committee member.

Corporate governance perceptions of nonprofessional investors are important to our economy, as corporate governance is designed to protect investors from expropriation of their capital investment in the company (Jensen and Meckling, 1976). Investor protection from expropriation has been shown to positively influence the economy by enhancing savings, thus channeling the savings to real investment, which allows capital to flow to more productive uses, increasing economic growth (La Porta et al., 2000). In addition, a lack of confidence in corporate governance could result in new legislation which may potentially erode board discretion in executive pay, increase tax rates on CEO compensation, and increase costs of compliance reducing corporate profits (Heineman, 2010; George, 2010; Stewart, 2010; Dillon, 2009).

Using social identity and attribution theory, I hypothesize an expectation gap will exist between compensation committee members and nonprofessional investors on CEO responsibility for the failure to meet incentive performance targets, support for compensation committee judgments as well as process or outcome fairness to shareholders. Surprisingly, compensation committee members significantly attribute more responsibility to the CEO for the failure to meet the performance targets, and there

are no significant differences between nonprofessional investors and compensation committee members in support for the compensation proposal or process or outcome fairness to shareholders.

Further exploratory analyses suggest that nonprofessional investors are influenced by the experimental manipulations of social capital and source credibility in the compensation case, whereas the manipulations have no significant effect on compensation committee members' judgments (in Paper 1). This result may indicate nonprofessional investors believe compensation committees are influenced by the CEO more than the members actually appear to be, thus indicating a need for compensation committee members to improve their communications and explanations of executive compensation decisions. Compensation committees may be able to improve investor satisfaction, and thus reduce the need for costly regulation, by more effectively communicating the rationale behind their executive compensation decisions and their efforts to balance fairness to shareholders with retaining executive talent.

CHAPTER 2 (PAPER 1)- THE ROLES OF SOCIAL CAPITAL, SOURCE CREDIBILITY, AND FAIRNESS IN COMPENSATION COMMITTEE JUDGMENTS

INTRODUCTION

Corporate stakeholders, the public, and even the government are concerned about executive compensation issues, including the fairness of Chief Executive Officer (CEO) compensation, pay for performance, and the perception that executives and boards have exploited the system to their advantage (Dillon, 2009). Hogan et al. (2010) describe the current environment as creating intense pressure for boards to revisit their executive compensation decisions and procedures.

Given the environment that public company compensation committee members are operating in, I examine three factors relevant to the CEO compensation decision – social capital (i.e., who suggested nomination to the board – the CEO or an independent search firm), source credibility (i.e., who suggests changes in performance targets – the CEO or a compensation committee member), and fairness (i.e., perceived fairness of the compensation decision process to shareholders and outcome fairness to shareholders and management) to provide insights into potentially important influences on compensation committee members' judgments. Extant academic research on compensation committee judgments is limited and primarily archival. The existing research typically focuses on the relationships between compensation committee characteristics and various outcomes, such as pay for performance (Sun and Cahan, 2009), backdating stock options (Collins et al., 2009), managerial opportunism (Kalyta, 2009), and transparency (Lakshmana, 2008).

Hermanson et al. (2011) is an exception, as they examine the compensation committee process through interviews of public company compensation committee members. My research extends Hermanson et al. (2011) by examining influences on judgments of compensation committee members using an experimental methodology.

The lack of direct insight into influences on directors' judgments is an important gap in governance research (Brundin and Nordvist, 2008). Although there is some academic research on influences on judgments reached by audit committees (e.g., Bierstaker et al., 2011; DeZoort et al., 2003, 2008; DeZoort and Salterio, 2001), audit committees generally have one significant objective, sound financial reporting. However, compensation committee judgments have to reflect two sometimes-competing perspectives, promoting long-term shareholder value and retaining and rewarding executive talent, in the same judgment (Hermanson et al., 2011). In light of the difficult environment that compensation committees face, as well as the lack of academic research on this important governance monitoring function (Daily et al., 1998), my research provides an important contribution to academic research.

In terms of social capital, I examine the influence of social capital between the CEO and the compensation committee members. Board members often have prior social or professional affiliations with the CEO, and these affiliations may have facilitated their identification as a board nominee (Clune et al., 2011; Cohen et al., 2010; Beasley et al., 2009). While prior social or professional affiliations may increase the collegiality of the board and facilitate the board's provision of expert counsel to management (Stevensen and Radin, 2009; Westphal, 1999), these same affiliations may affect the ability of the board member to be truly independent even in the absence of direct economic ties (Clune

et al., 2011). CEO influence on the appointment of board members has been shown to increase CEO bonuses and opportunism in executive perquisites, as well as decrease the transparency of executive compensation (Hwang and Kim, 2009; Laksmana, 2008; Kalyta, 2008). I expect compensation committee members identified as board nominees by the CEO to be more likely to support the CEO in executive pay proposals than compensation committee members identified as board nominees by an independent search firm.

The second influence I examine is source credibility. The recipient of a communication evaluates the trustworthiness (source credibility) of the sender in determining whether to believe the communication. Source credibility may be a function of the expertise of the communicator or whether the communicating party has any evident bias with respect to the ultimate outcome (Birnbaum and Stegner, 1979). The Securities and Exchange Commission (SEC) requires public companies to disclose the specific incentive performance targets for executive compensation to shareholders (Doubleday and Knieriem, 2007); however, the majority of the public company compensation committee members interviewed by Hermanson et al. (2011) cited instances in which the board had revised previously established performance targets in the middle of a compensation cycle. In addition, Hermanson et al. (2011) found that the CEO often was the initiator of the proposal to revise the performance targets. Since compensation committee members may view compensation proposals initiated by the CEO as less credible (as the CEO has a direct financial interest in the outcome) than proposals initiated by directors, I expect to find less support from compensation committee members for executive compensation proposals initiated by the CEO.

The third influence I examine is the compensation committee members' assessments of the process fairness to shareholders and outcome fairness to shareholders and management of their executive compensation judgments. Compensation committees have to strike a balance between paying enough to retain high performing executive talent versus creating value for shareholders by keeping executive compensation more modest (Hermanson et al., 2011; Randolph-Williams, 2010). A NYSE compensation committee member describes the process in Hermanson et al. 2011 (1):

Compensation is a zero-sum game. We want to attract good management and reward fairly, but shareholders are never happy with compensation. We want to be fair and arrive at a Pareto optimal solution where all are a bit uncomfortable...

Both outcome and procedural fairness perceptions have been widely studied in management, with positive fairness perceptions having favorable implications for organizational behavior (Colquitt et al., 2001; Cropanzano and Greenberg, 1997; Greenberg, 1990). There is more limited research on fairness in accounting; however, perceptions of fairness have been shown to increase support for external auditors (Bierstaker et al., 2011), increase the willingness to report unethical behavior (Zhang et al., 2008), decrease opportunistic behavior (Cohen et al., 2007), and decrease budget slack (Wentzel, 2002). Since fairness perceptions have been shown to have positive effects on organization behavior, I expect that compensation committee members who perceive outcome or process fairness to shareholders low (of making the change) will have judgments more favorable to shareholder interests (and to be less supportive of executive compensation proposals that favor management).

In addition to these three main factors, I examine whether various experience measures of the compensation committee members are associated with support for the

executive compensation proposal. Specifically, I consider whether the participant had prior experience with the issue addressed in the case, the participant's years of compensation committee experience, and whether the participant had experience as a corporate CEO. Prior research on audit committee members has found a variety of relationships between members' judgments and their years of experience, as well as their prior experience with similar issues (e.g., Bierstaker et al., 2011).

I examine these issues by asking U.S. public company compensation committee members to complete a written case. The case involves a scenario in which there is a proposal to reduce management's performance targets during a compensation cycle, due to significantly greater than anticipated expenses related to a reduction in workforce and the closing of several underperforming stores. Using a 2 X 2 between-subjects design, I randomly manipulate the level of social capital and source credibility. Social capital was manipulated by whether the member was identified as a nominee for the board by the company's CEO (high social capital) or an independent search firm (low social capital). Source credibility was manipulated by whether the change in targets was suggested by a compensation committee member (high credibility) or by the CEO (low credibility). The participants were asked about their level of support for making the adjustment to targets, perceived fairness of the compensation decision process to shareholders, and outcome fairness to shareholders and management, as well as a number of other questions about professional experience, demographics, etc.

Based on responses from 81 U.S. public company compensation committee members, I do not find that social capital, source credibility, or process fairness are significant in determining compensation committee member support for the executive

compensation proposal. Rather, the overall focus of the members in their evaluation of the proposal is on outcome fairness. I find that outcome fairness to the CEO and outcome fairness to the shareholders are significantly related to compensation committee members' support for reducing performance targets during a compensation cycle. In addition, more experienced compensation committee members are less supportive of changing the performance targets. Finally, there are a number of significant interactions among the independent variables, including the interaction between outcome fairness to shareholders and process fairness to shareholders. This interaction suggests that compensation committee member support for the proposal relies on both process and outcome fairness being present, which is consistent with Blader and Chen (2011) who found that higher status individuals (such as compensation committee members) require both process and outcome fairness.

Overall, the study indicates compensation committee members are balancing their obligation to monitor (consistent with agency theory) with their responsibility to retain and attract executive talent (consistent with resource dependence theory). The research does not demonstrate that the members are under the control of the CEO, but instead consider pay for performance and fairness to shareholders the top influences on their executive compensation judgments. This is the first study actually testing the influences on compensation committee members' executive compensation judgments.

The next section provides background information and develops the hypotheses. Following sections present the method, results, and conclusion.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The compensation committee of a public company's board of directors is tasked with oversight of the executive compensation program. The committee typically selects the compensation consultant (if any), reviews and approves the committee charter, develops meeting agendas and information flow, makes executive compensation decisions, and completes the annual compensation discussion and analysis included in the annual proxy statement to shareholders (Hermanson et al., 2011).

Compensation committees are an important monitoring device to protect shareholder interests from managerial opportunism (Daily et al., 1998). This role reflects agency theory, as the company uses compensation incentives and effective monitoring to protect stakeholder value (see Jensen and Meckling, 1976); however, the committee also recognizes that the top executive team represents an important organizational resource of the company, consistent with resource dependence theory (Hermanson et al., 2011; Cohen et al., 2008; Murphy and Zabochnik, 2004). Compensation committees' judgments require striking a balance between mitigating excessive risk while encouraging reasonable risks, rewarding outstanding CEO performance while limiting pay when performance is unsatisfactory, as well as recruiting and retaining executives and managing shareholder expectations (Randolph-Williams, 2010). These objectives are not always aligned, thus causing tension. Hermanson et al. (2011), in interviews with 20 public company compensation members, found that notions of balance and being fair to management and shareholders reflected the overall dominant theme of their interviews.

The role of the compensation committee has become more complex and demanding in recent years (Howe, 2010). Increasingly, compensation committees have to justify their decisions to shareholders, Congress, and the media, and they must deal with shareholder “say on pay” proposals and recommendations from shareholder advisory firms such as RiskMetrics Group (Coleman and Lurie, 2010; Howe, 2010).¹

Compensation committees have even been held responsible for playing a role in the recent financial crisis by encouraging excessive risk taking with their executive compensation plans (Ferracone and Gershkowitz, 2010; Keller and Stocker, 2008). In response, compensation committees have faced increased disclosure requirements from additional regulations issued by the SEC and as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) (Lajoux, 2010).²

Even in this difficult environment for compensation committees, *The New York Times* (Glater, 2009) reported that some companies were reducing performance goals when their CEOs had difficulty meeting their targets. In addition, *The Wall Street Journal* (Lublin, 2010) reported that a growing number of companies are replacing their annual incentive targets with targets that are reset twice a year to allow companies to react quickly to economic conditions. Hermanson et al. (2011) reported that a majority of compensation committee members interviewed had changed performance targets mid-compensation cycle. The reasons used to justify the change included losing a patent, impairment of an asset, or a tough economic environment. In essence, the committee was attempting to maintain fairness to the executives in the presence of unforeseen and arguably uncontrollable circumstances.

¹ Committee on Oversight and Governance Reform (March 7, 2008).

² <http://www.sec.gov/news/press/2009/2009-268.htm>

Thus, it appears that some companies may adjust performance targets mid-cycle based on a view that extraordinary circumstances are present; however, U.S. Generally Accepted Accounting Principles (FASB ASC 225-20) require “extraordinary” items to be both infrequent and unusual in the environment in which the company operates; specifically excluded from the definition of extraordinary items are write-downs of assets, disposals of business segments, and the effects of a strike.³ Investors, similar to accounting standard setters, may perceive that such events may be infrequent but are part of normal business operations and should be expected from time to time. Thus, investors may perceive that certain changes to performance targets are not warranted. Coleman and Lurie (2010) highlight the importance of communication to shareholders when revising performance targets. Coleman and Lurie note that revising a performance target may be prudent for the company, but if not properly communicated, it may be misinterpreted as a way to exploit the system to the CEO’s advantage.

There has been limited academic research on compensation committees. Most of the research is archival and documents associations between certain publicly available governance and compensation committee characteristics and compensation-related outputs.⁴ For example, Bebchuk et al. (2010) found opportunistic timing of stock option grants was associated with higher CEO compensation from sources other than options, a majority of inside directors, and no shareholders with significant stock ownership on the compensation committee. Collins et al. (2009) found opportunistic timing of stock option grants to CEOs was associated with weaker governance structures such as a higher proportion of inside or gray (not directly employed by the company but has some

³ Executive compensation decisions are not required to be in conformity with GAAP; however, GAAP provides a useful definition of an extraordinary event.

⁴ All studies discussed below are U.S. focused unless noted otherwise.

economic relationship) directors, a higher incidence of independent directors being appointed by the incumbent CEO, and a higher likelihood that the CEO was also the Board Chair.

Likewise, Sun and Cahan (2009) found the quality of the compensation committee (based on six characteristics: CEO appointed directors, senior directors, CEO directors, director shareholdings, additional directorships, and committee size) was associated with the alignment of CEO cash compensation and company accounting earnings. Sapp (2008), in a study of over 400 publicly listed Canadian firms from 2000 to 2005, also found that CEO pay was related to governance characteristics. Boards with more directors, busy directors, and longtime board members were associated with higher CEO compensation, while boards with controlling shareholders and large equity positions were related to lower executive compensation. Lastly, Conyon and He (2004), using a sample of IPO firms, found CEO pay was lower when there were shareholders with large equity interests on the compensation committee.

Prior academic compensation committee research does not provide an understanding of the actual influences on judgments of compensation committee members, an important gap in the literature. My research uses experimental methods to directly examine three potential influences on actual compensation committee judgments: social capital, source credibility, and fairness, as well as the potential role of compensation committee member experience.

Social Capital Hypothesis

My research defines social capital consistent with Lin (2001, 30), “The premise behind the notion of social capital is rather simple and straightforward: investment in social relations with expected returns.” Consistent with this definition is reciprocity. Fehr

and Gachter (2000) found individuals will respond favorably to acts of kindness in a reciprocal manner. Thus, board members who have significant social capital with the CEO may be hesitant to exercise independent judgment, or they may allow their conflicts of interest to bias their decision making.

Social capital between the board and the CEO can have both positive and negative implications. Westphal (1999) found social ties between the board and the CEO increased the sharing of advice and counsel between the CEO and outside board members while not decreasing monitoring. However, Westphal (1998) suggests when independent directors are appointed in an effort to increase board power to protect shareholders, the CEO mediates the independence by using social influence to build social relationships with the independent board members. Consistent with Westphal's (1998) findings, recent work by Hwang and Kim (2009) found a high incidence of non-independent audit committee members being replaced post-Sarbanes-Oxley Act of 2002 (post-SOX) with socially affiliated, but technically independent, audit committee members.

The Dodd-Frank Act, passed in 2010, requires compensation committee members to be independent. Independence was defined in the Act as a function of compensation involving the Company or entities controlled by the company, other than director fees. The definition of independence used by the Dodd-Frank Act is similar to that used in SOX for audit committee members. However, in recent research on audit committees post-SOX, Carcello et al. (2011) found that CEO involvement in the selection of audit committee members destroyed the benefits of a financially expert (and independent) audit committee. Thus, it appears that CEO influence can reduce directors' true substantive independence or focus on monitoring. In addition, Cohen et al. (2010), in interviews with

Big 4 audit partners and managers, found that even in the post-SOX era when all audit committee members are economically independent from company management, approximately 50 percent of the audit partners and managers did not perceive the audit committee as effective in resolving accounting disagreements between management and the external auditor. Lastly, Hwang and Kim (2009) found increases in earnings manipulations and higher CEO bonuses when there were social ties between the CEO and audit committee members, and Krishnan et al. (2011) found that social ties between the CEO/CFO and the board of directors lowered financial reporting quality. However, Krishnan et al. (2011) also found reduced earnings management in firms with socially connected board members post-SOX, indicating there was a positive governance behavioral change associated with the implementation of SOX. Based on the above studies, even in the post-SOX area, it appears that the independence of the board of directors, and in particular audit committee members, can be compromised through social ties.

This research on audit committees and boards of directors suggests the economic independence requirements of the Dodd-Frank Act may not achieve greater focus on shareholder interests by the compensation committee, as both economic and social independence between boards and management may affect the quality of monitoring and judgments of the board of directors. For example, Main et al. (1995) found that CEOs involved in the nominating process of boards had significantly higher compensation, and Collins et al. (2009) found more evidence of stock option backdating when the CEO identified nominees as board members. CEOs continue to have significant input in the director nomination process. Clune et al. (2011) interviewed 20 nominating and

governance committee members and found, on average, that, in general, the CEO had a moderate influence on the director nomination process, but that there was high variability across companies. In addition, Clune et al. (2011) found that CEO-identified director candidates were included in the pool of potential nominees 50 percent of the time and were the actual director nominee 36 percent of the time. Thus, it appears even post-SOX, the CEO continues to have influence on the selection of new board members.

The presence of high social capital between the CEO and compensation committee members may result in tension between the need for transparency and pay for performance versus the desire to maintain committee members' influence and social relationship with the CEO. The desire to maintain influence may result in a committee member's support for CEO opportunistic behavior (e.g., executive compensation proposals that are favorable to the CEO). Collectively, the prior literature leads to the following directional hypothesis. I posit that the presence of high social capital between the CEO and compensation committee member will increase compensation committee member support for reducing financial performance targets in mid-cycle. Stated formally:

H1: The presence of high social capital between the CEO and compensation committee member will increase compensation committee member support for reducing financial performance targets in mid-cycle.

Source Credibility Hypothesis

The second issue I examine is source credibility. Birnbaum and Stegner (1979) found source credibility had two main components: expertise and bias. They found bias is reflected when conditions exist that influence the decision maker to doubt the motives of the other party. Management has self-interest in the outcome of executive compensation

decisions; therefore, compensation committee members may doubt the CEO's motives when the CEO suggests executive pay proposals.

Prior auditing and accounting research demonstrates that source credibility has been shown to influence judgments. Beaulieu (1994) found source credibility affected commercial loan officers' lending decisions. He found that lenders use character information about the borrower to assess borrower credibility, particularly when positive information about the loan was presented. Alexander (2003) examined the effects of source credibility and expertise on review procedures in tax consulting engagements. She found that tax managers' perceptions of the credibility of individuals requesting the tax consulting (client versus firm) impacted the review hours and diligence of the tax manager. DeZoort et al. (2003) examined source credibility and audit committee member support for proposed audit adjustments. They found that audit committee members were more likely to support audit adjustments when the auditors had consistently advocated that the adjustments be made.

Hermanson et al. (2011) found CEOs often are the initiators of proposals to change incentive performance targets during the compensation cycle. Thus, the CEO is communicating to the compensation committee members the justification for the downward revision of the incentive performance targets. Source credibility plays a role in the believability of communication (Birnbaum and Stegner, 1979). Source credibility can be compromised if the recipient of the message believes that the individual delivering the message has an interest in or benefits from the outcome of the decision. When the CEO initiates the proposal and benefits from the change, the compensation committee

members may view the CEO's rationale for revision as less credible, resulting in less support for the change.

As source credibility has been shown to influence judgments in accounting and auditing, I expect a similar result with compensation committees. My directional hypothesis predicts compensation committee members may find CEO initiated executive pay proposals biased and less credible; therefore, the committee members will have less support for these proposals than for proposals initiated by compensation committee members. Thus, CEO initiation of the proposed reduction (low source credibility) in performance targets mid-cycle is expected to decrease compensation committee member support for the change (i.e., high source credibility will increase compensation committee member support for the change). Stated formally:

H2: CEO initiation of the proposed reduction (low source credibility) in performance targets mid-cycle will decrease compensation committee member support for the change (i.e., high source credibility will increase compensation committee member support for the change).

Fairness Hypotheses

Organizational justice research has shown organization employees are more likely to support a decision if the participants feel the outcome is fair (Leventhal, 1976; Adams, 1965; Homans, 1961) and/or the process is fair (Leventhal, 1980; Thibaut et al., 1974). Outcome fairness refers to the distribution of resources, while procedural fairness refers to the process of reaching the decision. Outcome and procedural fairness have been shown in economics, management, and psychology research to have positive organizational outcomes in areas such as organizational commitment (Cohen-Charash and Spector, 2001); attitude (Folger and Konovsky, 1989); extra role behavior such as altruism, courtesy, conscientiousness, sportsmanship, and civic virtue (Moorman, 1991);

and support (Kahneman et al., 1986). In addition to the direct impact of outcome or procedural fairness perceptions on participants' support for the decision and its positive organizational outcome, there is recent research that indicates outcome and process fairness may interact with each other reducing positive behavior when both outcome fairness and procedural fairness as assessed as high (Brockner and Wiesenfeld, 1996). Thus, the positive behaviors that generally result when participants perceive high process fairness are diminished if the participants also perceive the outcome was fair.

Referent cognitions theory (RCT) describes the process by which individuals assess the fairness of an action (Folger, 1986). Folger found individuals perceive judgments as unfair when there could have and should have been an alternative judgment with a more favorable outcome. In subsequent work, Folger and Cropanzano (2001, 1998) refined RCT and introduced fairness theory, which added a responsibility dimension to RCT. Thus, an individual held less responsible for an unfavorable outcome will be less accountable. However, individuals may not be in a position to have all the information necessary to reach a judgment about responsibility for the unfavorable outcome of the judgment. Lind et al. (2001) found that under this condition of uncertainty, individuals will use their assessment of the fairness of the process (procedural fairness) to determine their degree of support for the decision.

Process fairness includes an element of bias suppression (Leventhal, 1980), which indicates that personal self-interest should not be part of an allocation decision. Information about the propriety of a decision in organizations is obtained through the decision makers' justification (Bies, 1987). Compensation committees provide justification to shareholders for their executive pay decisions in the annual executive

compensation discussion and analysis (CD&A) report. Committee members may perceive that compensation proposals advantageous to the CEO will be harder to justify to shareholders; therefore, my expectation is that the committee members who assess procedural fairness lower will have less support for reducing performance targets mid-cycle. I examine this in the following hypothesis:

H3: Compensation committee members who assess procedural fairness to shareholders lower (if the targets are reduced) will have less support for reducing the performance targets mid-cycle (i.e., higher procedural fairness to shareholders will lead to higher support for reducing the targets).

Outcome fairness has been shown in the accounting literature to reduce self-interested behavior (Cohen et al., 2007) and increase support for external auditors in auditor-management disagreements (Bierstaker et al., 2011), yet outcome fairness perceptions have not been widely studied in governance research. If the compensation committee members assess outcome fairness to shareholders lower, they will have less support for reducing the incentive performance targets mid-cycle. Stated formally:

H4: Compensation committee members who assess outcome fairness to shareholders lower (if the targets are reduced) will have less support for reducing the performance targets mid-cycle (i.e., higher outcome fairness to shareholders will lead to higher support for reducing the targets).

Hermanson et al. (2011) found compensation committee members identified underpayment of executive compensation leading to loss of executive talent as the single greatest risk faced by their committee. If the committee did not meet the CEO's executive compensation expectations, the members risk CEO dissatisfaction and the possible loss of executive talent, which may be difficult to replace. Therefore, the committee members' concern with outcome fairness to management may represent a greater organizational risk than outcome fairness to shareholders. Compensation committee members who assess

outcome fairness to CEO lower (of not making the change) are expected to be more likely to support the reduction of incentive performance targets mid-cycle. Formally stated:

H5: Compensation committee members who assess outcome fairness to the CEO (if the targets are not reduced) lower will have more support for reducing the performance targets mid-cycle.

METHODOLOGY

I randomly assigned the compensation committee member participants to two social capital and source credibility conditions (each high or low), which results in a 2 X 2 experimental case design (social capital and source credibility are my manipulated independent variables). In addition, I use three measured independent variables, process fairness to shareholders and outcome fairness to shareholders and management. The dependent variable reflects how likely the participants were to support (SUPPORT, range from 0-100) an executive compensation proposal to revise the CEO's incentive performance targets downward mid-compensation cycle due to significantly greater than anticipated expenses related to a reduction in workforce and the closing of several underperforming stores. The hypothetical company in the case is a mid-size publicly traded retail company in the consumer products industry, with prior year annual revenues of \$650 million.

The case instrument was developed using a scenario described in a large cap retail consumer products company's annual compensation discussion and analysis, which is included in the company's annual proxy statement to their shareholders. The case was pre-tested for readability, understandability, and relevance by several academic researchers and one public company compensation committee member. In addition, the

case was reviewed by an executive compensation consultant for any potential conflicts between the case and SEC regulations, as well as the consultant's assessment of the case's realism and relevance. Any recommendations of the above advisors were carefully evaluated, and appropriate revisions were made before the final case was mailed to compensation committee members. See Appendix A for a complete copy of the case materials.

Instrument

The case provided to the compensation committee members describes the background of the company and industry, executive compensation philosophy and objectives, as well as information about the composition and operation of the compensation committee. Within the case instrument, members are placed into a high or low social capital position and a high or low source credibility position (four possible conditions). Social capital is manipulated by the manner in which the member was nominated to the board, either identified by an independent search firm or by the CEO. Source credibility is manipulated by the initiator of the executive compensation proposal, either the CEO or compensation committee member.

In addition to their support of a decision to revise the short-term executive performance targets, members were asked about process fairness to shareholders (PROCESS FAIRNESS SHAREHOLDERS), outcome fairness to shareholders (OUTCOME FAIRNESS SHAREHOLDERS), and outcome fairness to the CEO (OUTCOME FAIRNESS CEO), all measured on a scale ranging from 0 (very unfair) to 100 (very fair) if the decision was made.⁵

⁵ Although marketing and management research designs seek to generate data to test relationships among several constructs measured with multi-item scales, accounting experimental research targeting high-level

I asked two manipulation check questions to assess whether the participants understood the social capital and source credibility conditions of their case instrument. The remainder of the case asked members to assess how realistic, understandable, and challenging the case was, and asked demographic and governance experience questions. Some of these items are included in the model below as control variables, as described below.

Model and Control Variables

Based on the discussion above, I use the following OLS regression model to test my hypotheses:

$$\begin{aligned} \text{SUPPORT} = & \alpha_1(\text{SOCIAL CAPITAL}) + \alpha_2(\text{SOURCE CREDIBILITY}) + \\ & \alpha_3(\text{PROCESS FAIRNESS SHAREHOLDERS}) + \\ & \alpha_4(\text{OUTCOME FAIRNESS SHAREHOLDERS}) + \\ & \alpha_5(\text{OUTCOME FAIRNESS CEO}) + \alpha_6(\text{PRIOR TARGET CHANGE}) + \\ & \alpha_7(\text{EXPCCMEM}) + \alpha_8(\text{CEOEXP}). \end{aligned}$$

In addition to the dependent variable and independent test variables described above, I include three control variables in my full model. *PRIOR TARGET CHANGE* is a dummy variable indicating whether the participant had actual experience as a compensation committee member considering a proposal to adjust incentive

professionals often uses single-item constructs (Rose and Rose, 2010; Coram et al., 2009; DeZoort et al., 2001). In addition, there is recent management and marketing research highlighting the need for making measurement more efficient by using single-item measures (Fuchs and Diamantopoulos, 2009; Bergkvist and Rossiter, 2007). Kwon and Trail (2005) noted the advantages of single-item measures including simplicity, ease of use, and global measurement. My dependent variable *SUPPORT* is a concrete measure, one dimension, and clearly understandable, which is acceptable for a one-item construct (Rossiter, 2002). My fairness variables are extremely complex global constructs requiring the need to directly ask the participant the direct question (Fuchs and Diamantopoulos, 2009; De Boer et al., 2004; Sloan et al., 2002 p. 481; Scarpello and Campbell, 1983), i.e., “what is your assessment of outcome fairness to shareholders?”, which is similar to “what is your assessment of your job satisfaction?”. Therefore, I determined that one-item constructs would be effective in this research involving compensation committee members.

compensation financial performance targets mid-compensation cycle (= 1 if had prior experience, otherwise 0). Consistent with Bierstaker et al.'s (2011) results in an audit committee context, I expect that participants who have experienced a particular type of decision in the past possess relevant domain expertise (Bedard and Biggs, 1991) and will therefore be more supportive of the proposal. EXPCCMEM is the log of the years of experience as a member of a public company compensation committee, and CEOEXP is a dummy variable indicating if the participant had prior experience as a CEO (= 1 if had prior experience as a CEO, otherwise 0). Both are exploratory control variables, and as such I do not have an expected sign. See Table 1, shown below, for the variable definitions.

Participants

One hundred one (101) U.S. public company compensation committee members participated in the study. I solicited compensation committee members in two ways. First, I used *Audit Analytics* to identify compensation committee members who were appointed or reappointed from 1/1/2007 to 12/31/2010 to serve companies in retail, wholesale, and light manufacturing industries with revenues greater than \$0 but less than \$2 billion. I eliminated the compensation committee members with principal addresses in non-English speaking countries. Using Internet websites such as zabasearch.com, whitepages.com, peoplefinders.com, and intellius.com combined with the biographical information in the company's shareholder proxy statement, I was able to locate the primary business or home address of the compensation committee members. I mailed the case materials via USPS priority mail to 366 target compensation committee members. Following Dillman (2000), my case materials used personalized letters, color letterhead,

TABLE 1
Variable Definitions

Variable Name	Expected Sign	Description
SUPPORT		compensation committee member support for changing the performance targets mid-compensation cycle measured on a scale anchored 0 = not likely to support revising targets downward and 100 = very likely to support revising targets downward
SOCIAL CAPITAL	+	= 1 if high, 0 if low
SOURCE CREDIBILITY	+	= 1 if high, 0 if low
PROCESS FAIRNESS SHAREHOLDERS	+	perceived process fairness to shareholders if adjustment is made; scale from very unfair = 0 to very fair = 100
OUTCOME FAIRNESS SHAREHOLDERS	+	perceived outcome fairness to shareholders if adjustment is made; scale from very unfair = 0 to very fair = 100
OUTCOME FAIRNESS CEO	-	perceived outcome fairness to CEO if adjustment is <u>not</u> made; scale from very unfair = 0 to very fair = 100
PRIOR TARGET CHANGE	+	= 1 if participant has actually considered a mid-compensation cycle incentive performance target change; otherwise = 0 ⁶
EXPCCMEMBER	?	log of total number of years served on a public company compensation committee
CEOEXP	?	= 1 if prior experience as a CEO of a public company; otherwise = 0

and hand stamped return envelopes. Twenty-three (6%) were returned for incomplete or inaccurate addresses. I was able to obtain better addresses on all but four and resent the package with the revised address. Second requests were mailed approximately three weeks after the first request mailing. As of October 20, 2011, I received a total of 95 responses from this effort, for a response rate of 26%.⁷ In addition, I supplemented the *Audit Analytics* data with a convenience sample of 6 compensation committee members

⁶ In my sample, almost no one had actually changed a target in real life; therefore, I focus on whether a target change had been considered.

⁷ This response rate is far above some other recent director studies (e.g., Bierstaker et al. 2011) that did not use Internet searches to find the primary business or home address of directors.

obtained through professional contacts.⁸ I calculated the effect size of my sample (Cohen's $f^2 = 1.19$), which indicates a high effect size and an adequate sample size.

DATA ANALYSIS AND FINDINGS

Manipulation Checks

I use two multiple-choice questions to evaluate the effectiveness of the manipulations in the case instrument. Specifically, I ask the 101 participants (95 from Audit Analytics and 6 from a convenience sample) about who suggested their nomination to the board of directors and who suggested the performance targets be adjusted downward. After excluding the 14 participants (13.9%)⁹ who failed one or both manipulation checks and an additional 6 (5.9%) eliminated due to incomplete responses, 81 participants were left for analysis.¹⁰

Participants' Perceptions of the Case

The participants found the case to be realistic (mean of REALISTIC = 76.94, SD = 18.83 on a 0-100 scale anchored "not at all realistic" and "very realistic") and understandable (mean of UNDERSTANDABLE = 82.70, SD = 16.69 on a 0-100 scale anchored "not at all understandable" and "very understandable"). Both of these means are significantly greater than the scale midpoint of 50 ($p < 0.001$ in both cases). Also, the participants indicated that they would find the decision somewhat challenging if they faced it in practice (mean of CHALLENGING = 44.69, SD = 27.83 on a 0-100 scale anchored "not at all challenging" and "very challenging"). This mean is not significantly

⁸ Supplemental analysis reveals no evidence of early/late response differences. Also, since the replies were anonymous, I cannot specifically identify the 6 convenience sample responses.

⁹ This rate of manipulation check failures is far below that seen in audit committee member studies (e.g., DeZoort et al. 2003, 2008).

¹⁰ In addition, I ran the full OLS model including participants who failed the manipulation check or had incomplete responses. The results ($n = 92$) are consistent with those presented in Table 7.

different from the scale midpoint of 50 ($p = 0.09$). One-way ANOVAs indicate no significant differences in REALISTIC, UNDERSTANDABLE, or CHALLENGING across the four case versions ($p > 0.30$ in all cases).¹¹

Demographics

Table 2 (shown below) presents the demographic information for the 81 participants. Most participants are male (92.6 percent), well educated (80.2 percent have some form of a graduate degree), and older (69.1 percent were 60 or older). Most have experienced similar judgments regarding revising executive incentive performance targets mid-compensation cycle (76.5 percent). Twenty-four (29.6 percent) have served as a public company CEO, and 36 (45.0 percent) currently serve on compensation committees of companies with annual revenues in excess of \$1 billion. Seventeen (21 percent) are certified public accountants (CPA).¹²

In addition, the participants have extensive experience in public company governance. Thirty-nine of the participants currently serve on more than one public company compensation committee (mean of 1.56, $SD = .87$), and 61 have served at some point in their career on additional public company compensation committees (mean of 2.93 total committees served, $SD = 2.16$). Total years of compensation committee service range from 1 year (1 participant) to 30 years (2 participants); however, approximately half of the participants have between 2 and 5 total years of compensation committee

¹¹ In addition, I ran the full OLS model, adding the variables UNDERSTANDABLE, REALISTIC, and CHALLENGING. None of these variables is significant.

¹² I also test whether CPA certification is a significant control variable in my full model. The variable is not significant.

TABLE 2
Demographics
(n = 81)

		<u>Number</u>	<u>Percentage</u>
Gender	Male	75	92.6 %
	Female	6	7.4 %
Highest Education	Bachelors	16	19.8 %
	Masters	44	54.3 %
	JD	11	13.6 %
	Ph.D.	10	12.3 %
Age	Under 50	8	9.9 %
	50-59	17	21.0 %
	60-69	41	50.6 %
	Over 70	15	18.5 %
Experience with Similar Judgment in the Past	Yes	62	76.5 %
	No		
CEO Experience	Yes	24	29.6 %
Annual Revenue of Largest Company Served ¹³	Under \$250 million	14	17.5 %
	\$250 - 500 million	15	18.8 %
	\$501 million - \$1 billion	15	18.7 %
	Over \$1 billion	36	45.0 %
CPA Certification	Yes	17	21.0 %
	No		
		<u>Mean</u>	<u>S.D.</u>
Experience	Number of current public company Compensation Committees	1.56	.87
	Number of total public company Compensation Committees ever served	2.93	2.16
	Number of years of service on a public company Compensation Committee	8.14	6.63
	Number of current public company Audit Committees	.95	1.09
	Number of current public company Nominating and Governance Committees	1.12	.86

¹³ One participant did not indicate the annual revenue of largest company served.

service (mean of 8.1 years, SD = 6.63). In addition, 48 (mean of 0.95 audit committees per participant, SD = 1.09) serve on public company audit committees, and 63 serve on nominating and governance committees (mean of 1.12 nominating and governance committees per participant, SD = .86).¹⁴

Descriptive Statistics

Table 3 (shown below) presents the study's descriptive statistics for the dependent variable and the test variables. One-way ANOVAs reveal no significant differences across experimental conditions for any of the four variables ($p > 0.10$ in all cases).

Overall, the participants tend toward not supporting the reduction of the executive compensation performance targets mid-compensation cycle (mean of SUPPORT = 31.33 on a scale of 0 = "not likely to support" and 100 = "very likely to support"), although there is considerable variation in responses (S.D. = 26.33; range = 0 – 97). This mean is significantly lower than the scale midpoint of 50 ($p < 0.001$).

The participants perceive revising the performance targets downward in the moderate range of fairness to the shareholders (mean of PROCESS FAIRNESS TO SHAREHOLDERS = 48.40, SD = 30.92 and OUTCOME FAIRNESS TO SHAREHOLDERS = 39.21, SD = 28.69; both variables are based on a scale of 0 = "very unfair to shareholders" and 100 = "very fair to shareholders"). They perceive *not* making the adjustment as fair to the CEO (mean of OUTCOME FAIRNESS TO

¹⁴ Four participants do not currently serve on a compensation committee but have served on several public company compensation committees in the recent past (2, 3, 3, and 10 total committees ever served, respectively)

TABLE 3
Descriptive Statistics
 (n = 81)

	Low Social Capital/Low Source Credibility n = 20	Low Social Capital/High Source Credibility n = 24	High Social Capital/Low Source Credibility n = 16	High Social Capital/High Source Credibility n = 21	Total n = 81
	Mean (S.D.)	Mean (S.D.)	Mean (S.D.)	Mean (S.D.)	Mean (S.D.)
SUPPORT	37.85 (28.88)	26.96 (24.56)	27.50 (21.22)	33.05 (29.46)	31.33 (26.33)
PROCESS FAIRNESS TO SHAREHOLDERS	62.55 (34.00)	41.04 (26.10)	45.25 (30.43)	45.71 (31.10)	48.40 (30.92)
OUTCOME FAIRNESS TO SHAREHOLDERS	49.9 (32.27)	33.54 (23.95)	38.13 (30.76)	36.33 (27.76)	39.21 (28.69)
OUTCOME FAIRNESS TO MANAGEMENT (of not making adjustment)	67.90 (27.31)	78.63 (17.26)	70.31 (20.61)	78.95 (12.69)	74.42 (20.18)

MANAGEMENT = 74.42, SD = 20.18 on a scale of 0 = “very unfair to the CEO” and 100 = “very fair to the CEO”). The means of OUTCOME FAIRNESS TO SHAREHOLDERS and OUTCOME FAIRNESS TO MANAGEMENT are significantly different from the scale midpoint of 50 ($p < 0.001$ in both cases).

Table 4 presents a correlation matrix for the dependent variables and test variables. All three main independent variables (process fairness to shareholders, outcome fairness to shareholders, and outcome fairness to management) are significantly correlated. SUPPORT is negatively associated with fairness to shareholders and positively associated with fairness to management. Despite the significant correlations,

the VIF scores on all the variables are 3.22 or below, indicating multicollinearity is not an issue.

TABLE 4
Correlations
(n = 81)

	1	2	3
1. SUPPORT			
2. PROCESS FAIRNESS SHAREHOLDERS	.513**	--	--
3. OUTCOME FAIRNESS SHAREHOLDERS	.665**	.722**	--
4. OUTCOME FAIRNESS MANAGEMENT	-.689**	-.550**	-.738**

** Indicates significance < 0.01 level (1-tailed).

To present the regression results and provide maximum information, I build up to the full model, first examining the manipulated variables alone, then adding the fairness variables, and finally adding the control variables. The regression results of the most basic regression model are presented in Table 5.¹⁵ This model shows predictors SOCIAL CAPITAL and SOURCE CREDIBILITY with SUPPORT as the dependent variable. The model is not significant, $F = 0.19$, $p = 0.83$. There is no evidence that higher social capital or higher source credibility increases participants' support for adjusting executive incentive performance targets mid-compensation cycle.

Next, I consider the influence of fairness perceptions on participant support by adding the fairness variables to the regression model shown Table 5 above (see Table 6). The model is significant ($F = 17.65$, $p < 0.001$), and the adjusted R^2 is 51.0 percent. The coefficients SOCIAL CAPITAL and SOURCE CREDIBILITY remain insignificant

¹⁵ The participant data was examined using casewise diagnostics for outliers over 3 standard deviations. Only one outlier was identified, and the results are significantly the same if the outlier is included or excluded. Therefore, I include the outlier observation in the regressions.

(SOURCE CREDIBILITY has $p = 0.09$), and the coefficient on process fairness to shareholders is not significant.¹⁶ The coefficient on outcome fairness to shareholders is significant and positive ($p = 0.019$), indicating that the participants who perceive that revising the performance targets downward as more fair to shareholders are more likely to favor the revision. The coefficient on outcome fairness to management is significant and negative ($p < 0.001$), indicating that compensation committee members are more

TABLE 5
Regression Results (Manipulated Variables)
DV= SUPPORT

Variable	Predicted Sign	Coeff.	t-stat	P-value
Intercept	?	33.78	6.55	<0.001
SOCIAL CAPITAL	+ (H1)	-1.18	-0.20	0.842
SOURCE CREDIBILITY	+ (H2)	-3.42	-0.58	0.567

Note: P-values are one-tailed if sign is in expected direction, two-tailed otherwise.

TABLE 6
Regression Results (Manipulated Variables and Fairness Variables)
DV= SUPPORT

Variable	Predicted Sign	Coeff.	t-stat	P-value
Intercept	?	59.02	3.90	<0.001**
SOCIAL CAPITAL	+ (H1)	0.85	0.21	0.419
SOURCE CREDIBILITY	+ (H2)	5.76	1.35	0.090
PROCESS FAIRNESS TO SHAREHOLDERS	+ (H3)	0.06	0.60	0.274
OUTCOME FAIRNESS TO SHAREHOLDERS	+ (H4)	0.27	2.10	0.019**
OUTCOME FAIRNESS TO CEO	- (H5)	-0.60	-3.91	<0.001**

Note: P-values are one-tailed if sign is in expected direction, two-tailed otherwise.

** Significant p-values, $n = 81$.

¹⁶ Process fairness to shareholder is significantly positive ($p < 0.001$) without the two outcome fairness variables in the model. Thus, there is support for H3 if outcome fairness is not considered, which is consistent with process fairness being subsidiary to outcome fairness (e.g., Lind et al., 2001).

supportive of revising incentive performance targets downward when they perceive the outcome (if the targets are not revised) as less fair to the CEO.

In addition to the main variables described above, I consider three control variables, which are exploratory in nature. The full model is shown below in Table 7 and is significant ($F = 12.89$, $p < 0.001$, adjusted $R^2 = 54.3$ percent).¹⁷ Based on this full model, there is no support for H1, H2, or H3, but there is support for H4 and H5.¹⁸

In terms of the control variables, the coefficient on TARGET CHANGE is not significant, so prior experience adjusting incentive performance targets mid-compensation cycle is not supported as influencing a compensation committee member's support of an adjustment of the target. EXPCCMEM, log of the number of years participants has served on public company compensation committees, is significant ($p < 0.01$) and negative, indicating that the compensation committee members with more years of experience are less likely to support revising incentive performance targets mid-compensation cycle than those with less experience. Lastly, CEOEXP, a dummy variable indicating whether compensation committee members have ever served as a public company CEO, is not significant, indicating that prior experience as a public company CEO is not a significant influence in determining support of the compensation proposal.

Exploratory Analysis of Potential Interactions

I analyzed the data for significant interactions and found three such interactions. First, there is a significant interaction between SOCIAL CAPITAL and OUTCOME

¹⁷ The VIF scores for all the variables are ≤ 3.34 indicating that multicollinearity is not an issue. Also, there is no evidence of heteroskedasticity.

¹⁸ I also test whether the three fairness variables are affected by the two manipulated variables (e.g., does process fairness to shareholders vary depending on the level of social capital and source credibility?), using three regression models (fairness variable = f (SOCIAL CAPITAL, SOURCE CREDIBILITY)). None of the three models are significant at the 0.05 level.

TABLE 7
Regression Results (Full Model)
 DV = SUPPORT

Variable	Predicted Sign	Coeff.	t-stat	P-value
Intercept	?	75.65	4.72	<0.001**
SOCIAL CAPITAL	+ (H1)	-0.44	-0.11	0.914
SOURCE CREDIBILITY	+ (H2)	4.93	1.19	0.118
PROCESS FAIRNESS TO SHAREHOLDERS	+ (H3)	0.02	0.23	0.409
OUTCOME FAIRNESS TO SHAREHOLDERS	+ (H4)	0.30	2.38	0.010**
OUTCOME FAIRNESS TO CEO	- (H5)	-0.60	-3.96	<0.001**
TARGET CHANGE	+	-0.58	-0.12	0.904
EXPCCMEM	?	-18.61	-2.73	0.008**
CEOEXP	?	1.17	0.24	0.811

Note: P-values are one-tailed if sign is in expected direction, two-tailed otherwise.

** Significant p-values, n = 81.

FAIRNESS TO CEO ($p < 0.02$); see means of SUPPORT in Table 8- Panel A below (the cells in Table 8 are based on median splits for continuous variables). The means of SUPPORT reveal that the effect of OUTCOME FAIRNESS TO CEO is stronger in the low SOCIAL CAPITAL condition. Interestingly, the compensation committee member participants appear to be more heavily influenced by outcome fairness to the CEO when social capital with the CEO is low.

Second, there is a significant ($p < 0.02$) interaction between SOCIAL CAPITAL and the EXPCCMEM; see Table 8- Panel B below. The means reveal that the effect of committee member experience is greater in the low SOCIAL CAPITAL condition, consistent with the pattern in the first interaction above.

Finally, there is a significant interaction between PROCESS FAIRNESS TO SHAREHOLDERS and OUTCOME FAIRNESS TO SHAREHOLDERS ($p < 0.01$); see Table 8- Panel C below. The means reveal that the effect of OUTCOME FAIRNESS TO SHAREHOLDERS is much stronger for participants with high PROCESS FAIRNESS

TO SHAREHOLDERS. This result shows, similar to Blader and Chen (2011) and Chen et al. (2003), higher status individuals, such as public company compensation committee members, expect *both* high process and outcome fairness (the mean of SUPPORT is

TABLE 8 – Panel A
Descriptive Statistics for SUPPORT
 SOCIAL CAPITAL * OUTCOME FAIRNESS TO CEO ($p < 0.02$)

		Low Outcome Fairness FAIRNESS < 80	High Outcome Fairness FAIRNESS \geq 80
Low Social Capital	Mean	52.50	17.65
	SD	27.69	14.24
	N	18	26
High Social Capital	Mean	40.17	21.63
	SD	27.01	22.13
	N	18	19

TABLE 8 – Panel B
Descriptive Statistics for SUPPORT
 SOCIAL CAPITAL * EXPCCMEM ($p < 0.02$)

		Low Experience EXPCCMEM < 0.70	High Experience EXPCCMEM \geq 0.70
Low Social Capital	Mean	44.24	24.15
	SD	27.41	23.85
	N	17	27
High Social Capital	Mean	35.69	27.92
	SD	30.00	23.86
	N	13	24

TABLE 8 – Panel C
Descriptive Statistics for SUPPORT
 PROCESS FAIRNESS TO SHAREHOLDERS * OUTCOME FAIRNESS TO
 SHAREHOLDERS ($p < 0.01$)

		Low Outcome Fairness FAIRNESS < 27	High Outcome Fairness FAIRNESS \geq 27
Low Process Fairness FAIRNESS < 49	Mean	17.17	29.50
	SD	17.57	22.15
	N	30	10
High Process Fairness FAIRNESS \geq 49	Mean	17.50	50.10
	SD	13.38	26.82
	N	10	31

50.10 if both process and outcome fairness are high, versus < 30 in the other cells). In this study, with higher status individuals, one type of fairness does not fully compensate for the other in promoting support for the adjustment; although some prior research such as Lind (2001) and Tyler and Blader (2000) found the presence of *either* high outcome fairness or high process fairness was generally sufficient to foster trust, these studies focused solely on lower status individuals' evaluation of a higher status individual's judgment.

Qualitative Analysis

To complement the quantitative analyses above, I reviewed the comments the compensation committee members included as a basis for their SUPPORT judgments. I separated the responses by the mean of SUPPORT (above or below the mean value of SUPPORT).¹⁹ A graduate assistant and I independently reviewed the comments and coded the responses. Only minor differences were observed, which were resolved.

Table 9 below presents the major patterns identified in the responses from compensation committee members, sorted by the relevance of the key variables in the model. The compensation committee members with less than average support for revising the incentive performance targets acknowledge the committee's right to revise performance targets but indicate fairness to shareholders, pay for performance and CEO responsibility as influences on their decision. The members with greater than average support for revising the incentive performance targets state the revision will incentivize management to do the right thing for long-term shareholder value. Thus, regardless of whether the compensation committee members have above average support or below

¹⁹ The mean of SUPPORT is 31.33. The median is 24, and only 12 observations have SUPPORT from 24 to 31.

TABLE 9
*Summary of Insights from Compensation Committee Members Regarding Their
 SUPPORT Judgments*

	SUPPORT Below Mean < 31.33, n = 53	SUPPORT Above Mean ≥ 31.33, n = 28
Support	The participants did not support revising the performance targets for reasons including: 1) the revision was not a response to an extraordinary situation, 2) philosophically, the compensation committee should adhere to budgets, contracts and targets, 3) the CEO is responsible for the budget and should have predicted workforce size and store performance better, and 4) adjusting performance targets is unfair and negatively impacts shareholders.	The participants provided greater support for revision of the performance targets because the restructuring, which led to the request, was good for the shareholders. Compensation committees should not penalize the CEO for doing the right thing in the long-term interest of the shareholders.
Process fairness to shareholders if performance targets are revised downward	Of the 42 participants who commented, 40% indicated that the compensation committee has the discretion to make changes.	Of the 26 participants who commented, 46% indicated the compensation committee's duty is to be informed and impartial when making executive compensation decisions and no other body has the information necessary to make an informed judgment.
Outcome fairness to shareholders if performance targets are revised downward	Of the 46 participants who commented, 22% indicated that the outcome would not be representative of pay for performance, 24% indicated that shareholders would also be negatively impacted, and 11% indicated that the compensation committee has the discretion to make changes if the committee deems necessary.	Of the 28 participants who commented, 57% indicated the shareholders would benefit long-term if the CEO was incentivized to do the right thing.
Fairness to CEO if performance targets are not revised downward	Of the 51 participants who commented, 35% indicated the CEO is responsible for managing the budget, directing strategy, and financial plans; 27% indicated incentive targets agreed upon should not be changed; and 22% indicated changing performance targets would not reflect pay for performance.	Of the 28 participants who commented, 50% felt these conditions were the CEO's responsibility, and 29% indicated in the long-term, economic conditions would also produce an upward trend in profits.
Advantages of adjusting incentive performance targets	Motivate and retain management.	Retain, incentivize, and motivate management.
Disadvantages of adjusting incentive performance targets	Performance targets can create a moral hazard and, if incentives are misaligned, demotivate management.	Bonuses are seen as a right and assumed by management, thus setting a bad precedent.

average support for adjusting downward the incentive performance targets for the CEO, they typically feel their decision reflects the best interest of the shareholders. The committee members seem to have an agency theory focus – on monitoring and incentivizing management. The members do not indicate that their judgments are under undue influence of management, or even that their decisions favor management more than shareholders.

Additional Analysis

The compensation committee members were also asked to rank (using a scale of 1 = highest priority to 6 = lowest priority) the importance of six influences on their *actual* executive pay decisions.²⁰ Shown below in Table 10 are the mean ranks of the influences (lower mean = stronger influence).

Overall, the compensation committee members indicate that pay for performance and fairness to shareholders are the highest influences on their actual executive pay decisions, while legal and tax compliance and fairness to management are the lowest influences. These responses suggest public company compensation committee members are strongly focused on their monitoring responsibility (consistent with agency theory) and less-so on their responsibility to attract, retain and motivate executive talent (consistent with resource dependency theory). My results are somewhat different than the more even balance between these two perspectives highlighted by Hermanson et al. (2011).

²⁰ I also test whether the influences on participants' actual executive pay decisions are significant control variables in my full model. None of the variables are significant.

TABLE 10
Influences on Participants' Actual Executive Pay Decisions

	Mean	S.D.
Pay for performance	2.321	1.45
Fairness to shareholders	2.852	1.44
Motivating executives through incentives	3.012	1.53
Retaining executive talent	3.370	1.50
Fairness to management	4.025	1.41
Legal and tax compliance	4.691	1.95

CONCLUSION

This study provides insights into decision-making by compensation committee members, an area which has had very limited prior research. Overall, I find that public company compensation committee members have little support for adjusting executive incentive performance targets mid-compensation cycle, although 77 percent have actual experience in considering revisions to executive performance targets during a compensation cycle. I find that social capital between the CEO and compensation committee member and source credibility (based on who initiates an executive pay proposal) have no significant influence on the judgments of the compensation committee members. The compensation committee members who have a higher perception of outcome fairness to the shareholders are less likely to support executive compensation proposals advantageous to the CEO; however, the members who have a higher perception of outcome fairness to the CEO are more likely to support the proposals. This appears to reflect the inherent conflict in executive compensation decisions between the board of directors' duty to protect shareholders from exploitation from executive management and the duty to attract and retain executive talent. Also, I find that more experienced compensation committee members are less likely to support the compensation proposal. Finally, there are a number of significant interactions among the independent variables,

including the interaction between outcome fairness to shareholders and process fairness to shareholders.

In addition, contrary to the perception that compensation committee members are under the influence of the CEO to the detriment of shareholder fairness, I find that compensation committee members' assess pay for performance and fairness to shareholders as the top influences on their actual executive compensation decisions in practice. Overall, although over two-thirds of the compensation committee members have considered an executive pay proposal to revise performance targets mid-compensation cycle, the members have little support for such a proposal in this case.

This study has a number of implications for practice, policy, and research. The process of setting executive compensation is just beginning to be explored. My findings highlight that understanding the influences on committee members' decisions may provide important insights to boards and policy makers to improve their decision making. It appears that contrary to some perceptions, compensation committees are concerned with pay for performance as well as retaining executive talent. Their role will always require a balance between fairness to management and fairness to shareholders, which may result in neither party being completely satisfied with the outcome.

In addition, my research highlights the need for nominating committees of public companies to consider potential compensation committee members who focus on fairness to shareholders, as well as education for committee members on the value of fairness considerations in their judgments. Interestingly, as all parties with a stake in compensation judgments (compensation committee members, executive management, and shareholders) are likely to be higher status individuals, compensation committees

need to ensure that *both* outcome and process fairness perceptions are considered in their judgments. High process fairness alone will not compensate for an outcome perceived as unfair. My research also shows nominating committees that compensation committee members with extensive experience are not necessarily under the influence of the CEO, but in fact are less supportive of adjusting targets during a compensation cycle.

I highlight several limitations of this research, which may affect the interpretation of the results, as well as avenues of further research. I recognize that fairness has multiple components which often interact with each other. In fact, there are calls for more research to use a global construct of fairness to capture these interactions (Nicklin et al., 2011; Ambrose and Schminke, 2009). In addition, my research population has limitations. First, my research uses an experimental research design, which limits the results to those who were willing to participate, and second, my research population was compensation committee members of small to medium size public companies. Perhaps there would be different results for members from much larger public companies.

More research is needed regarding the effects of social capital and source credibility, both of which were not significant in this study. Perhaps the manipulation of social capital through nomination to the board was not strong enough in the experimental setting and failed to capture the nuances of social capital in actual settings. The manipulation of source credibility may have been affected by the domain knowledge of compensation committee members. Specifically, my manipulation of changing the initiator of the proposal between the CEO and a compensation committee member could have been viewed by some participants as somewhat unrealistic. Hermanson et al. (2011) found that even when a compensation committee member suggested an executive pay

proposal; it often was at the request of the CEO. Lastly, I examine individual decision making, while compensation committee decisions are made in a group setting. Future research should examine the group dynamics in reaching an executive pay decision.

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CHAPTER 3 (PAPER 2)- IS THERE AN EXPECTATION GAP BETWEEN NONPROFESSIONAL INVESTORS AND COMPENSATION COMMITTEE MEMBERS ON EXECUTIVE COMPENSATION JUDGMENTS?

INTRODUCTION

This study examines whether an expectation gap exists between nonprofessional investors and compensation committee members with respect to executive compensation judgments. Hermanson et al. (2011) interviewed 20 public company compensation committee members and identified notions of balance and fairness in compensation as the dominant thought process of the committee. However, even though balance and fairness were identified by the compensation committee members as fundamentally important, there continues to be a perception by many stakeholders that compensation committees are under the control of the CEO and are unable to exercise independent judgment (Lajoux, 2010; Dillon, 2009; Bebchuk and Fried, 2003). For example, Bebchuk and Fried (2003) discuss the relationship between managerial power and executive compensation. The authors present a compelling case that executive compensation is higher when a public company CEO has greater power.

Corporate governance perceptions of nonprofessional investors are important to our economy, as corporate governance is designed to protect investors from expropriation of their capital investment in the company (Jensen and Meckling, 1976). Investor protection from expropriation has been shown to positively influence the economy by enhancing savings, thus channeling the savings to real investment, which allows capital to flow to more productive uses, increasing economic growth (La Porta et al., 2000). The

SEC has acknowledged that investor confidence is critical to the success of the U.S. capital market system (Shapiro, 2010; Levitt, 2005). The role of government in the governance process involves the employment of tactics, including laws and regulations, to achieve certain desired results (Stein, 2008). Recent evidence of the reaction of government to corporate governance failures includes the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Act. Continued lack of investor confidence may result in additional legislation, which may erode board discretion in executive pay, or increases in tax rates on CEO compensation (Heineman, 2010; George, 2010; Stewart, 2010; Dillon, 2009). Additional regulation may not be the most efficient way to achieve high quality corporate governance, as Larcker et al. (2011) found stock prices of companies most affected by the issuance of proposed governance regulations declined, suggesting investors felt management and the board rather than the government were best able to determine the appropriate corporate governance mechanisms for their company.

Perhaps the divergence in opinion between board members and nonprofessional investors, on executive compensation judgments, is due to an expectation gap. An expectation gap exists when there are differences of opinion between two or more groups (Porter, 1993). This study examines whether an expectation gap between compensation committee members and nonprofessional investors exists. The study asks participants (nonprofessional investors and compensation committee members) to read a case involving an executive compensation proposal (lightly adapted from Paper 1). The investor and compensation committee version of the case summarize a compensation committee's decision to lower CEO bonus targets mid-compensation cycle due to greater than anticipated expense in the closing of underperforming stores and workforce

reductions. The manipulated variables in the case are social capital with the CEO (the compensation committee members have high or low social capital with the CEO) and source credibility (the party proposing the adjustment to targets has high or low source credibility). Thus, social capital is manipulated by the manner of committee members' nomination to the board, either by the CEO (high social capital) or an independent search firm (low social capital), and source credibility is manipulated by the initiator of the executive compensation proposal, either by a compensation committee member (high credibility) or the CEO (low credibility). These manipulated variables are included in the investor version of the case for comparability with the compensation committee member case (i.e., the need to control for the experimental condition when comparing investors and compensation committee members). The variable of interest is the group variable, indicating investor or compensation committee member.

Both groups of participants (investors and compensation committee members) are asked to assess to what degree the CEO's individual performance contributed to the missed performance targets, their support for a decision to lower the targets, as well as assessments of the process and outcome fairness of the decision to shareholders. I compare the investors and compensation committee member responses to determine if an expectation gap exists between the two groups. Surprisingly, the results indicate that while an expectation gap does exist with respect to CEO responsibility, compensation committee members are *more* likely to blame the CEO for poor financial results. There is no evidence of an expectation gap between compensation committee members and nonprofessional investors in terms of support for the revision of targets or the fairness measures. Consistent with Hermanson et al. (2011), compensation committee members

do not appear to be under the control of the CEO; but are balancing an inherent tension in compensation judgments, striking a balance between paying enough to retain high performing executive talent versus creating value for shareholders by keeping executive compensation more modest (Hermanson et al., 2011; Randolph-Williams, 2010). This balance may require that neither party be fully satisfied with the executive decision outcome.

Further exploratory analyses suggest that nonprofessional investors are influenced by the experimental manipulations of social capital and source credibility in the compensation case, whereas the manipulations have no significant effect on compensation committee members' judgments (in Paper 1). Specifically, nonprofessional investors attribute higher CEO responsibility for the failure to meet executive pay incentive performance targets when there is higher source credibility regarding the initiator of the pay proposal. In addition, the exploratory analyses indicate possible associations between nonprofessional investor support of an executive pay decision and social capital between the CEO and compensation committee members (less support when social capital is higher) and the source credibility of the initiator of the compensation proposal (more support when the source is more credible). This result may indicate nonprofessional investors believe compensation committees are influenced by the CEO more than the members actually appear to be, thus indicating a need for compensation committee members to improve their communications and explanations of executive compensation decisions.

Based on these results, compensation committees may be able to improve investor satisfaction, and thus reduce the need for costly regulation, by more effectively

communicating the rationale behind their executive compensation decisions and their efforts to balance fairness to shareholders with retaining executive talent. Just as compensation committees must balance protection of shareholder interests with retaining and attracting top executive talent for the long-term success of the company, public policymakers need to strike a balance between necessary regulation to protect investors and unnecessarily costly legislation without significant increases in investor protection. If compensation committees voluntarily communicate more effectively to nonprofessional investors their rationale for executive compensation judgments, there may be less need for costly regulation and mandates.

BACKGROUND AND THEORY

Corporate governance academic research has focused on the agency theoretical perspective which views corporate management as self-interested parties who will engage in opportunistic behavior without effective monitoring either by the board, governments or other external or internal parties. While agency theory certainly has its attributes, there is research suggesting individuals do not always look to maximize their individual outcomes. A competing corporate governance theory is the resource dependence theory. The resource dependence theory suggests a board role in managing an organization's scarce resources, which would include human capital such as a chief executive. See Cohen et al. (2008) for a summary of alternative theoretical perspectives on corporate governance.

My research, following Cohen et al. (2008), uses complementary theories of corporate governance behavior to explain outcomes rather than reliance on an exclusive theory. Executive compensation judgments reflect a complex judgment, which may

require complementary governance theoretical perspectives. Indeed, research has shown an inherent tension in executive compensation judgments between agency theory and resource dependence theory (Hermanson et al., 2011). Hermanson et al. (2011) found that many compensation committee members perceive friction in compensation committee judgments, as committee members attempt to balance their agency role of reasonable, but not excessive, executive compensation with a resource dependence role, which focuses on retaining executive talent to implement the company's strategic plan. Yet, even with acknowledgement by compensation committee members that achieving balance and fairness in executive compensation is vitally important, some boards use discretion or mid-compensation cycle financial performance target reductions to reward CEOs and other top executives, even when firm performance is poor by existing standards (Dvorak, 2009; Thornton, 2009; Glater, 2009). Some investors may perceive that such discretion (e.g., adjusting performance targets downward) is evidence of the directors unfairly rewarding the executives, while directors may perceive that they are attempting to adjust the compensation for changed, uncontrollable circumstances (Hermanson et al., 2011). Due to this inherent information asymmetry between an organization's governance bodies and shareholders as to the complete rationale behind executive compensation judgments, an expectation gap may result between directors and shareholders as it relates to compensation committee judgments. Media reports and public dissatisfaction with executive compensation certainly lead one to believe that there is considerable variation between what shareholders and compensation committee members consider appropriate in executive compensation decisions. This research uses social identity and attribution theory to determine if an expectation gap exists between compensation committee

members and nonprofessional investors in executive compensation judgments, and it offers future avenues of research to determine how and why an expectation gap may or may not exist, as well as suggested research on how to reduce misconceptions regarding executive compensation decisions.

EXPECTATION GAP AND HYPOTHESIS DEVELOPMENT

An expectation gap has two elements: 1) reasonableness gap and 2) performance gap (Porter, 1993). The reasonableness gap represents a difference between what is expected and what can reasonably be expected, while a performance gap represents a difference between what can reasonably be expected and actually achieved (Brennan, 2006). An expectation gap may occur in compensation committee judgments due to misunderstanding of the roles of the committee by shareholders, conflicting roles within a compensation judgment, as well as information asymmetry between management and the board or between the organization and its shareholders. My research uses social identity theory and attribution theory to hypothesize an expectation gap in executive compensation decisions.

Social identity theory suggests that individuals classify themselves into groups, such as organization membership (Bamber and Iyer, 2007; Tajfel and Turner, 1985). Such classification results in a social identity with the group, particularly in groups with an associated prestige (Ashforth and Mael, 1989). Once individuals are socially identified with a group, they personalize the successes and failures of the group as a whole (Abrams and Hogg, 1988). Nonprofessional investors will generally have no relationship with company management, so they will not be inclined to form a social identity with the CEO.

Attribution theory suggests that individuals attribute their failures to external causes (such as the economy) and their successes to internal characteristics (superior ability) (Martinko and Gardner, 1987; Gioia and Sims, 1985). Attribution theory has been supported in academic research by Crant and Bateman (1993) who found less blame was attributed when performance was unsatisfactory due to external causes versus internal causes. In addition, Doukas and Petmezas (2007) found a self-attribution bias in managers involved in acquisition deals. They found that managers who were successful in their first acquisition deal attributed that success to their own ability; therefore, they tended to engage in more acquisitions in the future with lower performance. Likewise, Bettman and Weitz (1983), using information from letters to shareholders, found that poor organizational performance was attributed to external factors more often than was good organizational performance.

Attribution theory suggests that whether the perceived cause of a poor outcome, such as an increased expense, is internal or external will result in differences in assigned responsibility. If the perceived cause is external in nature, then the CEO will be held less responsible for (less control over) the poor outcome, since the outcome is seen as a function of the external environment in which the company operates. However, if the perceived cause is internal in nature, then the CEO will be held more responsible in that the performance was under the CEO's control. I adapt the measure used for causal attribution from Kaplan et al. (2007). As in Kaplan et al. (2007), I use a single item measure for the global construct.

Because of the likely difference between compensation committee members and nonprofessional investors in their perception of the cause of the failure to meet

performance targets, an expectation gap may result in executive compensation judgments. My first two hypotheses, consistent with social identity and attribution theories, suggest compensation committee members will form a social identity as a member of the board and thereby personalize the successes or failures of the company. Using attribution theory, when the company fails to achieve financial incentive performance targets, the member will be more likely to attribute the failure to external factors and will be more likely to support the reduction of performance targets than will nonprofessional investors who will be more likely to attribute the failure to achieve performance targets internally to the CEO and will be less likely to support the reduction. Stated formally:

H1: Nonprofessional investors will perceive greater CEO responsibility for the failure to meet targets than will compensation committee members.

H2: Nonprofessional investors' support for reducing financial performance targets in mid-cycle will be lower than that indicated by compensation committee members.

An expectation gap between compensation committee members and nonprofessional investors may also lead to differences in fairness assessments between the two groups regarding compensation committee judgments. Fairness perceptions are important for investor confidence in the U.S. capital market system (Shapiro, 2010). Van den Bos and Lind (2002) found that under conditions of uncertainty, individuals use procedural fairness as a heuristic to assess their outcome satisfaction. Since nonprofessional investors will not have all the information regarding the executive compensation judgment, the nonprofessional investors will be less certain about the appropriateness of the judgment reached, and consistent with Van den Bos and Lind (2002), the nonprofessional investor will look at the fairness of the process used by the

compensation committee members in reaching their judgments as a heuristic to determine their satisfaction with the judgment.

Nonprofessional investors, without all of the information supporting the rationale for the mid-cycle target change, nor perhaps with the knowledge that the committee has the discretion to make the change which may be in the best long-term interest of the shareholders, are expected to look at the process by which the change was approved to ascertain their perception of fairness to shareholders. A mid-cycle target change without an appropriate rationale may appear to shareholders as an exploitation of the governance system by the CEO and a lack of effective monitoring on behalf of the compensation committee (Coleman and Lurie, 2010). This leads to my third directional hypothesis which posits that nonprofessional investors' assessment of procedural fairness to shareholders when incentive performance targets are lowered mid-compensation cycle will be lower than that indicated by compensation committee members. Stated formally, my hypothesis three is:

H3: Nonprofessional investors' assessment of procedural fairness to shareholders (when targets are lowered) will be lower than that indicated by compensation committee members.

In entities where there is a separation between management and owners, such as nonprofessional investors, Jensen and Meckling (1976) identified the monitoring role of the board of directors as important to prevent expropriation of assets by managers. The compensation committee is the committee tasked with oversight of executive compensation. Their monitoring role reflects a tension between incentivizing management to act in the long-term interest of the shareholder (as opposed to management's self-interest) while monitoring management (who has a company

information advantage) to prevent exploitation of the shareholders. If nonprofessional investors assess compensation committee judgments as unfair to shareholders, they may attribute the outcome to ineffective monitoring by the compensation committee that allowed expropriation of rents from their investment by management. Ultimately, if investors are not confident in the board's governance role, they may reduce their participation in the capital market system, resulting in higher prices for investment capital and lower firm performance. Overall, the impact on capital markets may result in lower economic growth (Chen et al., 2009; Bhagat and Bolton, 2008; La Porta et al., 2000).

Building upon the logic underlying H1 and H2 above, if nonprofessional investors place greater blame on the CEO for failing to meet targets and are less supportive of the target change, then they would also view the outcome of reducing performance targets mid-cycle as less fair. In essence, a target reduction would reward the CEO for a failure to meet targets that was more of an internal issue than perceived by the compensation committee members. Consistent with this justification, my directional hypothesis suggests that nonprofessional investors' assessment of outcome fairness to shareholders will be lower than that indicated by compensation committee members when executive incentive performance targets are lowered mid-compensation cycle. Stated formally, my hypothesis four is as follows:

H4: Nonprofessional investors' assessment of outcome fairness to shareholders will be lower (when targets are lowered) than that indicated by compensation committee members.

Methodology

Case Materials

Paper 2 uses a 2 X 2 X 2 between-subjects experimental design (from Paper 1) with two groups, compensation committee members and nonprofessional investors (thus,

the focus on the participant group variable, investors or compensation committee members, results in three independent variables). The manipulated variables are social capital with the CEO (the compensation committee members have high or low social capital with the CEO) and source credibility (the party proposing the adjustment to targets has high or low source credibility). Thus, social capital is manipulated by the manner of committee members' nomination to the board, either by the CEO (high social capital) or an independent search firm (low social capital) and source credibility is manipulated by the initiator of the executive compensation proposal, either by a compensation committee member (high credibility) or the CEO (low credibility). These manipulated variables are included in the investor version of the case for comparability with the compensation committee member case (i.e., the need to control for the experimental condition when comparing investors and compensation committee members). The variable of interest is the group variable, indicating investor or compensation committee member.

The executive compensation case for investors (lightly adapted from Paper 1) summarizes a compensation committee's decision to lower CEO bonus targets mid-compensation cycle due to greater than anticipated expense in the closing of underperforming stores and workforce reductions. Participants are asked to assess to what degree the CEO's individual performance contributed to the missed performance targets, their support of a decision to lower the targets, as well as assessments of the outcome fairness to shareholders and process fairness to shareholders. These assessments are measured on a scale ranging from 0 to 100. (See Appendix A and B for complete copies of the case instruments).

Model

My independent variable of interest (GROUP) is coded 0 for nonprofessional investors and 1 for compensation committee members. The model includes SOCIAL CAPITAL and SOURCE CREDIBILITY, to capture the four experimental conditions, consistent with the compensation committee member case used in Paper 1 (needed to allow for appropriate comparisons between the two participant groups). These variables are coded using dummy variables (0 = low, 1 = high). My four different dependent variables are 1) CEO PERFORMANCE (assessment of CEO responsibility for the failure to meet targets), 2) SUPPORT (support for reducing performance targets), 3) PROCESS FAIRNESS SHAREHOLDERS (an assessment of process fairness to shareholders), and 4) OUTCOME FAIRNESS SHAREHOLDERS (an assessment of outcome fairness to shareholders). Thus, the general model is:

$$DV \text{ (four different ones)} = f(\text{GROUP, SOCIAL CAPITAL, SOURCE CREDIBILITY})^{21}$$

Participants

The participants in Paper 2 include both compensation committee members and nonprofessional investors. A total of 555 cases were mailed to potential participants, 366 to public company compensation members and 189 to nonprofessional investors (clients of an investment advisory firm, as well as MBA students, as discussed below).

I solicited the compensation committee members in two ways (see Paper 1). First, I used *Audit Analytics* to identify compensation committee members who were appointed or reappointed from 1/1/2007 to 12/31/2010 to serve companies in retail, wholesale, and light manufacturing industries with revenues greater \$0 but less than \$2 billion. I

²¹ See below for discussion of first running a MANOVA before examining the four ANOVAs.

eliminated the compensation committee members with principal addresses in non-English speaking countries. Using Internet websites such as zabasearch.com, whitepages.com, peoplefinders.com, and intellius.com with the biographical information in the company's shareholder proxy statement, I was able to locate the primary business or home address of the compensation committee members. In addition, I supplemented the *Audit Analytics* data with a convenience sample of six compensation committee members obtained through professional contacts.

The nonprofessional investors were recruited with the assistance of an independent non-commission based investment advisory firm in the Southeast U.S. The firm mailed the experimental case materials to 118 clients. The MBA students were recruited from two schools also in the Southeast. Elliott et al. (2007) found that MBA students are a good proxy for nonprofessional investors, particularly in tasks that are low in integrative complexity. My experimental case is similar to Elliott et al.'s description of low integrative complexity in that my case describes an executive compensation judgment and asks the participants to assess their support for, and fairness of, the judgment. The case does not require interaction of other subtle variables in the information provided or decisions based on complex financial data. Therefore, MBA students are appropriate participants in addition to the nonprofessional investor group. All recipients were assigned randomly to their experimental case.

Following Dillman (2000), my case materials for the compensation committee members and one school's MBA students used personalized letters, color letterhead, and hand stamped return envelopes. Additional MBA students were recruited from another school as an optional in-class assignment. No extra credit or other compensation was

given to obtain student participation in the optional assignment. The compensation committee member cases were mailed via USPS Priority Mail, and all other mailings were sent first class. In all, 200 participants (101 public company compensation committee members, 65 nonprofessional investors, and 34 MBA students) completed and returned the case materials. Twenty-five mailings (4.5%) were returned for incomplete or inaccurate addresses. I was able to obtain better addresses on all but six and resent the package with the revised address. Second requests were mailed approximately three weeks after the first request mailing.²² I received a total of 200 responses for a response rate of 36%.

DATA ANALYSIS AND FINDINGS

Manipulation Check

I used two multiple-choice questions to evaluate the effectiveness of the manipulations in the case instrument. Specifically, I asked the 200 participants about (a) how the compensation committee members were identified for board service and (b) who suggested the performance targets be adjusted downward. After excluding the 40 participants (20.0%) who failed one or both manipulation checks and an additional 15 (7.5%) eliminated due to incomplete responses, 145 participants (76 compensation committee members and 69 nonprofessional investors [42 investors and 27 MBA students]) were left for analysis.²³

²² Supplemental analysis revealed no evidence of early/late response differences in Table 3, Panel A ($p > 0.60$).

²³ See below for the effect on the Table 3 results when participants failing a manipulation check are included in the analysis.

Participants' Perceptions of the Case

The 145 participants found the case to be realistic (mean of REALISTIC = 77.17, SD = 17.21 on a 0-100 scale anchored “not at all realistic” and “very realistic”) and understandable (mean of UNDERSTANDABLE = 80.28, SD = 16.65 on a 0-100 scale anchored “not at all understandable” and “very understandable”). Both of these means are significantly greater than the scale midpoint of 50 ($p < 0.001$). The participants indicated that they would find the decision somewhat challenging if they faced it in practice (mean of CHALLENGING = 50.48, SD = 29.75 on a 0-100 scale anchored “not at all challenging” and “very challenging”).

Independent sample t-tests indicate no significant differences in REALISTIC ($p > 0.63$) or UNDERSTANDABLE ($p > 0.11$) across the two participant groups, compensation committee members or nonprofessional investors; however, nonprofessional investors found the case significantly more CHALLENGING ($p < 0.01$) than compensation committee members, who would have more experience in executive compensation judgments.

Demographics

The demographics of the compensation committee members and nonprofessional investors (See Table 1) are similar (predominately male and well-educated), with the exception of age. The nonprofessional investors are much younger than the compensation committee members. The compensation committee members have, not surprisingly, more experience with a similar judgment in the past. Most of the nonprofessional investors have moderate investing experience, and CEO compensation typically has little impact on their actual investing decision-making.

TABLE 1
Demographics
 (n = 145)

		Compensation Committee		NPI
Gender	Male	70		59
	Female	6		10
Highest Education	Bachelors	15		26
	Masters	42		27
	JD	9		8
	PhD	10		8
Age	Under 50	8		33
	50-59	16		19
	60-69	39		15
	Over 70	13		2
Experience with Similar Judgment in the Past	Yes	57		14
Investing Experience	None	n/a		2
	Little	n/a		17
	Moderate	n/a		34
	Significant	n/a		16
				<u>Mean</u> <u>S.D.</u>
Influence of CEO Compensation on Stock Purchases where 0 = None, 1 = Little, 2 = Average, and 3 = Significant		n/a		1.04 0.73

Descriptive Statistics

Table 2 (shown below) presents the study's descriptive statistics for the test variables by group. Surprisingly, the compensation committee member participants attribute *more* responsibility ($p = 0.01$) to the CEO for the failure to meet the executive incentive performance targets than do the nonprofessional investors (mean of compensation committee members CEO PERFORMANCE = 64.38 versus mean of nonprofessional investors CEO PERFORMANCE = 54.59 on a scale of 0 = "the CEO's individual performance contributed very little to the unanticipated charges" and 100 =

TABLE 2
Descriptive Statistics
 n = 145

		Low Social Capital/Low Source Credibility		Low Social Capital/High Source Credibility		High Social Capital/Low Source Credibility		High Social Capital/High Source Credibility		Total*	
		n=19	n=14	n=22	n=24	n=16	n=13	n=19	n=18	n=76	n=69
		CC	NPI	CC	NPI	CC	NPI	CC	NPI	CC	NPI
CEO PERFORMANCE	Mean	61.68	46.35	66.95	58.00	59.44	41.62	68.26	65.83	64.38	54.59
	S.D.	26.71	20.61	17.13	20.89	23.63	32.05	15.48	17.93	20.87	23.96
SUPPORT	Mean	38.79	29.71	25.50	48.54	27.50	25.00	28.26	30.06	29.93	35.46
	S.D.	29.36	22.76	23.76	30.33	21.22	26.61	26.65	28.77	25.55	28.95
PROCESS FAIRNESS TO SHAREHOLDERS	Mean	64.79	38.93	38.59	52.21	45.25	30.23	42.00	36.94	47.39	41.39
	S.D.	33.38	30.70	25.63	31.15	30.43	30.83	30.09	29.07	31.01	30.97
OUTCOME FAIRNESS TO SHAREHOLDERS	Mean	51.47	34.79	30.59	44.75	38.13	29.23	32.05	31.17	37.76	36.26
	S.D.	32.36	19.57	22.42	29.98	30.76	29.46	25.45	22.41	28.42	26.42

* For CEO PERFORMANCE, the difference between the CC group (n = 76) and the NPI group (n = 69) is significant at p = 0.01. There are no other significant differences between groups.

“the CEO’s individual performance contributed very much to the unanticipated charges”).²⁴ On average, both the compensation committee members and the nonprofessional investors do not support revising the performance targets, with no significant difference between groups (p = 0.23; mean of compensation committee members SUPPORT = 29.93, while the nonprofessional investors’ mean of SUPPORT = 35.46 on a scale of 0 = “not likely to support” and 100 = “very likely to support”). If performance targets are lowered, the nonprofessional investors and compensation

²⁴ Within the NPI group, there is no significant difference in the mean of CEO PERFORMANCE between investors and MBA students (p > 0.99). As noted below, this is the only variable with a significant difference between NPIs and compensation committee members; therefore, the mixing of NPIs and MBA students does not affect the results. There is a significant difference between NPIs and MBA students with respect to OUTCOME FAIRNESS TO SHAREHOLDERS (p = 0.03), with MBA students having significantly lower assessments of fairness. However, as noted below, there is no evidence of an expectation gap between NPIs and compensation committee members for this variable.

committee members perceive the outcome and the process as moderately fair to the shareholders, with no significant differences between groups ($p > 0.25$ in both cases; mean of compensation committee members' PROCESS FAIRNESS TO SHAREHOLDERS = 47.39 and OUTCOME FAIRNESS TO SHAREHOLDERS = 37.76, while nonprofessional investors have a mean of PROCESS FAIRNESS TO SHAREHOLDERS = 41.39 and OUTCOME FAIRNESS TO SHAREHOLDERS = 36.26; both variables were based on a scale of 0 = "very unfair to shareholders" and 100 = "very fair to shareholders"). However, these comparisons are aggregate results and do not consider the four experimental conditions.

MANOVA Results

My model has multiple dependent variables that are correlated; therefore, I first used MANOVA to assess the group differences across my multiple correlated dependent variables. The MANOVA results are significant at $p < 0.01$ under Roy's greatest characteristic root, Wilks' lambda, Pillai's criterion, and Hotelling's T^2 . Each cell, per group, has more observations than dependent variables and the observed power of the variable respondent is > 0.80 indicating my sample size is adequate. My F-statistic results in the model were robust > 2.62 , suggesting the sample observations are independent, variance-covariance matrices are comparable, and dependent variables are normally distributed (Hair et al., 2010). Individual ANOVAs were used to isolate the cause(s) of the MANOVA model's significance.

ANOVA Results

Table 3 shows the analysis of variance (ANOVA) results for each dependent variable in Hypotheses 1 through 4. As shown in Panel A, GROUP is significantly related

TABLE 3 – Panel A
Results of ANOVA
 DV = CEO PERFORMANCE
 n = 145

	F-statistic	p-value
MODEL	5.89	<0.001**
GROUP (CC or NPI)	8.52	0.004**
SOCIAL CAPITAL	0.08	0.777
SOURCE CREDIBILITY	10.30	0.002**

TABLE 3 – Panel B
Results of ANOVA
 DV = SUPPORT
 n = 145

	F-statistic	p-value
MODEL	1.76	0.158
GROUP (CC or NPI)	1.37	0.244
SOCIAL CAPITAL	3.47	0.064
SOURCE CREDIBILITY	0.25	0.616

TABLE 3 – Panel C
Results of ANOVA
 DV = PROCESS FAIRNESS TO SHAREHOLDERS
 n = 145

	F-statistic	p-value
MODEL	1.90	0.132
GROUP (CC or NPI)	1.31	0.254
SOCIAL CAPITAL	3.91	0.050
SOURCE CREDIBILITY	0.46	0.498

TABLE 3 – Panel D
Results of ANOVA
 DV = OUTCOME FAIRNESS TO SHAREHOLDERS
 n = 145

	F-statistic	p-value
MODEL	1.38	0.252
GROUP (CC or NPI)	0.08	0.779
SOCIAL CAPITAL	3.12	0.079
SOURCE CREDIBILITY	0.98	0.325

** P-value < 0.05

to CEO PERFORMANCE ($p = 0.004$); however, as noted above, the compensation committee members significantly attribute *more* responsibility for failure to meet the incentive performance targets to the CEO. This suggests that compensation committee members do not attribute lower than expected financial performance results of the company to external rather than internal sources. Thus, H1 is not supported, but rather there is a significant difference in the *opposite* direction. In this case, compensation committee members do not appear to be under the influence of the CEO, but appear to be focused on their monitoring role, protecting shareholders from expropriation of profits by executive management.

In addition, SOURCE CREDIBILITY is positively related to CEO PERFORMANCE ($p = 0.002$), indicating that participants in the high source credibility condition attribute more responsibility to the CEO. The source credibility condition is manipulated by the initiator of the proposal to reduce incentive performance targets mid-compensation cycle. In the low condition, the initiator is the CEO, and in the high condition, the initiator is a compensation committee member. It is possible that participants may have viewed the compensation committee member initiation of the proposal as a back-door approach for the CEO to suggest an executive pay proposal through which he or she would personally benefit. The participants may attribute the back-door approach as evidence that the CEO is responsible for the failure to meet performance targets and is attempting to minimize or deflect his or her involvement. In Panels B, C, and D, the overall models are not significant ($p > 0.10$ in all cases); therefore, H2, H3, and H4 are not supported.²⁵

²⁵ If I include participants who failed a manipulation check in the analyses, the results for GROUP and SOURCE CREDIBILITY are consistent with those in Panel A ($n = 189$). In addition, using the full sample

Other Analyses

I performed two additional exploratory analyses. First, I further examined the model in Table 3 - Panel A, adding control variables for gender, age, education, experience with a similar situation, and perceptions of the case's realism, understandability, and level of challenge. None of these variables is significant, and the results for GROUP are unaffected.

Second, I examined the effects of SOCIAL CAPITAL and SOURCE CREDIBILITY using only the NPI sample ($n = 69$) to examine how the investors respond to the two manipulated variables. As shown in Table 4 below, CEO PERFORMANCE is positively related to SOURCE CREDIBILITY ($p = 0.003$), indicating that participants in the high source credibility condition attribute more responsibility to the CEO. The participants may view this approach as a way for the CEO to frame the need to adjust performance targets mid-compensation cycle away from himself/herself. However, by attempting to divert attention from his/her responsibility, the CEO may actually indicate his/her culpability in the need to adjust.

In Panel B, the overall model is significant, and there is marginal evidence ($p \leq 0.07$) that SOCIAL CAPITAL is negatively related to SUPPORT (higher social capital associated with less support for reducing targets) and that SOURCE CREDIBILITY is positively related to SUPPORT (higher source credibility associated with more support for reducing targets).²⁶ Compensation committee members are not influenced by the

($n = 193$), the model using PROCESS FAIRNESS TO SHAREHOLDERS as the dependent variable (Panel C) has model $p = 0.057$, and the GROUP variable has a significant positive coefficient ($p = 0.031$). The compensation committee members assess process fairness to shareholders higher than do the nonprofessional investors, consistent with H3.

²⁶ Considering the collective results in Panels A and B, it is interesting to note that the investor participants in the high source credibility condition place greater blame on the CEO for the poor performance (Panel

TABLE 4 – Panel A
Results of ANOVA- Other Analysis
 DV = CEO PERFORMANCE
 n = 69 NPIs

	F-statistic	p-value
MODEL	4.90	0.010**
SOCIAL CAPITAL	0.27	0.605
SOURCE CREDIBILITY	9.67	0.003**

TABLE 4 – Panel B
Results of ANOVA- Other Analysis
 DV = SUPPORT
 n = 69 NPIs

	F-statistic	p-value
MODEL	3.70	0.030**
SOCIAL CAPITAL	3.72	0.058
SOURCE CREDIBILITY	3.28	0.074

** P-value < 0.05.

social capital or source credibility manipulations (Paper 1); however, the nonprofessional investors appear to respond to the manipulations. This result may indicate nonprofessional investors believe compensation committees are influenced by the CEO more than the members actually appear to be, or perhaps the committee members are more influenced than they indicate in Paper 1. Either way, the results indicate a need for compensation committee members to improve their communications and explanations of executive compensation decisions. Compensation committee members do not appear to be under the influence of the CEO in this experimental study, but they may be not be given credit for their efforts by the nonprofessional investors. Further research is needed to determine if a committee that is more forthright, complete, and objective in its communication of executive compensation decisions will enjoy improved perceptions of

A), but also are more supportive of adjusting the performance targets (Panel B). Thus, the nonprofessional investors' views are somewhat inconsistent across these two variables.

its governance role. The perceptions of nonprofessional investors about corporate governance performance are important to the cost of capital and ultimately to the economy.

Finally, similar models using the fairness variables as the dependent variables are not significant ($p > 0.08$ in both cases).

CONCLUSION

This study examines whether an expectation gap exists between compensation committee members and nonprofessional investors on executive compensation judgments. The study supports the existence of an expectation gap related to CEO responsibility for the failure to meet incentive performance targets but does not support an expectation gap related to support for the executive compensation proposal, process fairness to shareholders, or outcome fairness to shareholders. Unexpectedly, the expectation gap in CEO responsibility showed compensation committee members are not more likely to attribute the cause of the failure to meet incentive performance targets to external rather than internal sources. In fact, the compensation committee members are significantly *more* likely than the nonprofessional investors to attribute failure to meet incentive performance targets as the responsibility of the CEO.

More research is needed to determine why compensation committee members are assigning more responsibility to the CEO. Do they have domain knowledge and experience that the nonprofessional investors are lacking, which would predispose the committee members to assign responsibility to the CEO? Perhaps the criticism of executive pay decisions in the past several years has influenced compensation committee judgments such that compensation committee members are now leaning toward

protection of shareholder interests and away from retaining executive talent. Has the balance between the committee members' duty to protect stakeholders and retain top executive talent shifted towards protection of shareholders, and does that lead to more (or less) value creation in the company? Alternatively, are the compensation committee members unaware of potential influences on their judgments? Each of these issues can be examined in future research.

In addition, exploratory analyses suggest that nonprofessional investors respond to the social capital and source credibility manipulations, whereas the compensation committee members do not (in Paper 1). Specifically, the nonprofessional investors in the high social capital (high source credibility) experimental case conditions are less (more) likely to support the executive compensation proposal to reduce executive incentive performance targets mid-compensation cycle. These findings suggest the need for compensation committee members to communicate more effectively with shareholders the rationale for executive compensation decisions. Even when additional explanation is not legally required, the committee members may view the opportunity to communicate as a way to improve perceptions of their decisions by other stakeholders not involved in the process. Compensation committees with greater transparency and disclosure may be able to improve investor satisfaction with their judgments, and thus reduce the need for costly regulation. One possible communication that may improve investor satisfaction is discussion of the committee's efforts to balance fairness to shareholders with retaining executive talent. Ultimately, nonprofessional investors' confidence in corporate governance is critical to the success of the U.S. capital market system (Shapiro, 2010; Levitt, 2005).

As in all studies, there are limitations that represent opportunities for future research. One such limitation is that fairness has multiple components, such as process, outcome, and interactional fairness that often interact with each other. In fact, there are calls for more justice research to use a global construct of fairness to capture the interaction (Nicklin et al., 2011; Ambrose and Schminke, 2009). Future research could examine whether a global construction of fairness may be a better indicator of outcome satisfaction than a specific dimension of fairness. In addition, my research uses an experimental research design, which limits the results to those who were willing to participate. Future research could use other research designs to determine influences on potential differences between nonprofessional investors and individuals involved in corporate governance. Finally, this research uses primarily small and mid-cap compensation committee members as participants, and further research could determine whether the results hold for the largest public companies.

Although this study did indicate the existence of an expectation gap in CEO responsibility, further research is needed to determine potential causes of this dissatisfaction with executive compensation. For example, executive compensation dissatisfaction may be attributed to media exposure of executive compensation judgments which clearly did not represent pay for performance or shareholder-friendly judgments, or dissatisfaction may be attributable to judgments in larger public companies with powerful CEOs. Without understanding the causes of the stakeholder dissatisfaction, new rules and mandates may result in increased governance costs without corresponding improvements in executive compensation processes.

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Appendix A- Copy of Case Instrument Sent to
Compensation Committee Members



Coles College of Business

RESEARCH STUDY: Decision Making by Compensation Committees

This study is part of my research requirement to earn my Doctorate in Business Administration (DBA). The purpose of the study is to gain insight into the decision-making processes used by Compensation Committee members. This research is intended to help improve our understanding of the challenges faced by Compensation Committees today.

In order to accomplish this, we need your help in completing the enclosed case. Your individual results will not be reported, as results will be reported in the aggregate only.

Thank you for your assistance.

INSTRUCTIONS

1. The pages that follow contain a hypothetical case that includes summary background information and questions for you to answer.
 2. Please complete the materials/pages in the order given without looking ahead through the pages. There are no right or wrong answers, so please answer the questions in a way that reflects your honest opinions and judgments. To ensure a usable response, please complete all of the questions.
 3. Your responses are guaranteed anonymity. No effort will be made to link you to your responses on the following pages, and all data will be reported for the aggregate sample only.
- 

Please review the information below and answer the questions as if you are serving as an experienced Compensation Committee member for the company.

Company and Industry Background

Lessco Products, Inc. is a mid-size publicly-traded retail company in the consumer products industry, with prior year annual revenues of \$650 million. Lessco's primary customers are middle to upper income consumers in the United States. The industry is very competitive, and availability, reliability, price, and customer service are primary competitive factors. Up until last year, the company maintained solid revenue growth of 4-6% per year. Consistent with some others in the consumer products industry, Lessco experienced economic challenges during the first two quarters of last year, which limited revenue growth; however, the economy began to stabilize in the third and fourth quarters of last year, allowing the consumer products industry's (and Lessco's) economic outlook to improve somewhat for the current year.

Compensation Philosophy and Objectives

The Compensation Committee of the Board of Directors is responsible for administering the Company's executive compensation program. The Committee's philosophy emphasizes pay for performance with compensation objectives that support the Company's strategic plan by:

- Providing above average compensation relative to industry peers for above average overall performance and below average compensation relative to industry peers for below average performance.
- Rewarding success in achieving performance goals.
- Ensuring Lessco's reputation as a premier retail organization that demonstrates best practices in business and operations to sustain and enhance our corporate success.

The compensation program for the CEO consists of a competitive base salary, annual incentive bonus, long-term incentives, benefits, and limited perquisites. Lessco's operating results and CEO compensation typically have been comparable to industry averages. Consistent with industry practice, the CEO's compensation is composed of 20% annual salary, 30% performance-based incentive bonus, and 50% long-term incentive pay (including performance-based restricted stock and stock-settled stock appreciation rights). The performance-based bonus is based on achieving operating profit and earnings per share (EPS) targets. These operating profit and EPS performance targets are set before the beginning of the fiscal year. Lessco's other top executives have a similar mix of compensation elements, which consists of a competitive base salary, annual incentive bonus, long-term incentives, benefits, and limited perquisites.

The compensation program is designed to attract, reward, motivate, and retain high-quality talent who share and execute the board's vision for success. Lessco's top management team, which includes the CEO, CFO, and Executive Vice President, has been stable in recent years and has a positive relationship with the Board of Directors.

Your Compensation Committee

Consistent with regulations, the Compensation Committee only has independent directors as members. The Committee is composed of three members, and it meets face-to-face four times per year and holds three conference calls per year.

Table 1 – [Low social capital]
All of the Committee members were identified as nominees for the Board by an independent search firm.
OR
Table 2 – [High social capital]
All of the Committee members were identified as nominees for the Board by the Company’s CEO.

Current Year Executive Compensation Issue

Five months into the current year,

Table 3- [Low source credibility]
the CEO of Lessco met with the Compensation Committee Chair
OR
Table 4– [High source credibility]
another Compensation Committee member similar in experience to you met with the Compensation Committee Chair

about the Company’s expected annual performance. The CEO was concerned that the Company would not meet its current year operating profit and earnings per share performance targets due to significantly greater than anticipated charges related to a reduction in workforce and the closing of several underperforming stores. Some other companies in the industry also reduced their workforce and closed underperforming stores. Several board members are of the opinion that management should analyze workforce size requirements and underperforming stores on an ongoing basis.

The CEO is concerned that unless the operating profit and earnings per share targets are adjusted downward for these additional expenses, his top management team will not be properly motivated to achieve strategic and management goals for the rest of the year. The CEO recommends that the targets be reevaluated (reduced) based on the additional charges. The executive bonus plan allows the Compensation Committee, at its discretion, to adjust (either increase or decrease) its executive bonus performance targets due to extraordinary circumstances.

Decision for the Compensation Committee

The Chair of the Compensation Committee has brought to the Committee **Table 5-** the CEO’s **OR Table 6-** the Compensation Committee member’s request to revise downward the executive bonus performance targets for the current year due to greater than anticipated reduction in workforce and store closing costs.

The questions that follow refer to the proposal to adjust the performance targets downward. Recall, the executive bonus plan allows the Compensation Committee, at its discretion, to adjust (either increase or decrease) its performance targets due to extraordinary circumstances.

Please answer the following questions based on the information in the preceding case. You may refer back to the case information when responding. Recall that you are to review the information and answer the questions as if you are serving as an experienced Compensation Committee member for the company.

1. Based on the information provided, how likely are you **to support** revising the performance targets downward for the CEO? (place a slash on the line below):

Not likely to support revising targets downward	Very likely to support revising targets downward
--	---

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

What factors account for your response to question 1 above?

- a. _____
- b. _____

2. If the performance targets **are not revised** downward, how fair is this outcome to the CEO? (place a slash on the line below):

Very unfair to the CEO	Very fair to the CEO
-------------------------------	-----------------------------

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

What factors account for your response to question 2 above?

- a. _____
- b. _____

3. How comfortable are you that you could **defend to shareholders** the decision **to revise** the performance targets downward? (place a slash on the line below):

Very uncomfortable defending downward revision	Very comfortable defending downward revision
---	---

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

What factors account for your response to question 3 above?

- a. _____
- b. _____

4. If the performance targets **are revised** downward, how fair is this **outcome** to the Lessco **shareholders**? (place a slash on the line below):

**Very unfair
to shareholders**

**Very fair
to shareholders**

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

What factors account for your response to question 4 above?

- a. _____
- b. _____

5. If the performance targets **are revised** downward, how fair is this **decision process** to the Lessco **shareholders**? (place a slash on the line below):

**Very unfair
to shareholders**

**Very fair
to shareholders**

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

What factors account for your response to question 5 above?

- a. _____
- b. _____

6. What are the potential **advantages** of a decision **to adjust** the performance targets downward?

- a. _____
- b. _____

7. What are the potential **disadvantages** of a decision **to adjust** the performance targets downward?

- a. _____
- b. _____

8. To what degree did the **CEO's** individual performance contribute to the significantly greater than anticipated charges related to a reduction in workforce and the closing of several underperforming stores?

**CEO
contributed very
little to charges**

**CEO
contributed very
much to charges**

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

Please answer these questions without referring back to the case materials.

1. In this case, who suggested that the performance targets be adjusted downward (circle one)?
 - a. CEO
 - b. Another Compensation Committee member

2. In this case, who suggested your nomination to the Board (circle one)?
 - a. CEO
 - b. An Independent Search Firm

3. How *realistic* did you find this case?

	- - - - - - - - - - - - - - - - - - - -		- - - - - - - - - - - - - - - - - - - -
	Not at all		Very
	realistic		realistic

4. How *understandable* did you find this case?

	- - - - - - - - - - - - - - - - - - - -		- - - - - - - - - - - - - - - - - - - -
	Not at all		Very
	understandable		understandable

5. How *challenging* would you find this decision if faced with it in practice?

	- - - - - - - - - - - - - - - - - - - -		- - - - - - - - - - - - - - - - - - - -
	Not at all		Very
	challenging		challenging

6. In your **actual** experience as a Compensation Committee member, have you ever considered adjusting incentive performance targets mid-compensation cycle?

Yes ___ No ___

7. If yes, were the CEO incentive performance targets changed mid-compensation cycle?

Yes ___ No ___

8. If applicable, what factors account for your response to question 7 above?
 - a. _____
 - b. _____

9. Please **rank** the priority of the following influences on your **actual Compensation Committee's** CEO and executive compensation decisions, with 1 = highest priority and 6 = lowest priority.

_____	Legal and tax compliance
_____	Retaining executive talent
_____	Fairness to shareholders
_____	Fairness to management
_____	Pay for performance
_____	Motivating executives through incentives

Please respond to the following demographic questions. These will be used only to analyze the results, not to identify any participant.

1. Age _____
2. Gender _____
3. Highest educational degree earned (check one):

Bachelors	_____	JD	_____
Masters	_____	PhD/DBA	_____
3. Professional certifications (e.g., CPA, CFA, etc.):

4. Number of public company **Compensation Committees** you currently serve _____
5. Total number of public company **Compensation Committees** you have ever served _____
6. Total number of years you have served on at least one public company **Compensation Committee** _____
7. Number of public company **Audit Committees** you currently serve _____
8. Number of public company **Nominating and Governance Committees** you currently serve _____
9. Have you ever served as a CEO of a publicly-traded company? Yes ___
No ___
10. If yes, have you ever had your performance targets adjusted mid-compensation cycle?

Yes ___
No ___
11. Approximate annual revenues of largest public company on whose Compensation Committee you currently serve (check one):

< \$250 million	_____
\$250 - \$500 million	_____
\$501 million - \$1 billion	_____
> \$1 billion	_____
12. Industry of largest public company on whose Compensation Committee you currently serve:

If you have any comments on the study, please provide them on the back of this page.

Thank you very much for your participation. If you would like a copy of the study's results, please enclose a business card or email one of the researchers.

Appendix B- Copy of Case Instrument Sent to
Nonprofessional Investors



Coles College of Business

RESEARCH STUDY: Decision Making by Investors

This study is part of my research requirement to earn my Doctorate in Business Administration (DBA). The purpose of this study is to gain insight into the decision-making processes used by investors. This research is intended to help improve our understanding of the challenges faced by investors today. In order to accomplish this, we need your help in completing the enclosed case. Your individual results will not be reported, as results will be reported in the aggregate only.

Thank you for your assistance.

INSTRUCTIONS

1. The pages that follow contain a hypothetical case that includes summary background information and questions for you to answer.
2. Please complete the materials/pages in the order given without looking ahead through the pages. There are no right or wrong answers, so please answer the questions in a way that reflects your honest opinions and judgments. To ensure a usable response, please complete all of the questions.
3. Your responses are guaranteed anonymity. No effort will be made to link you to your responses on the following pages, and all data will be reported for the aggregate sample only.

Please review the information below and answer the questions as if you are a shareholder of the company.

Company and Industry Background

Lessco Products, Inc. is a mid-size publicly-traded retail company in the consumer products industry, with prior year annual revenues of \$650 million. Lessco's primary customers are middle to upper income consumers in the United States. The industry is very competitive, and availability, reliability, price, and customer service are primary competitive factors. Up until last year, the company maintained solid revenue growth of 4-6% per year. Consistent with some others in the consumer products industry, Lessco experienced economic challenges during the first two quarters of last year, which limited revenue growth; however, the economy began to stabilize in the third and fourth quarters of last year, allowing the consumer products industry's (and Lessco's) economic outlook to improve somewhat for the current year.

Compensation Philosophy and Objectives

The Compensation Committee of the Board of Directors is responsible for administering the Company's executive compensation program. The Committee's philosophy emphasizes pay for performance with compensation objectives that support the Company's strategic plan by:

- Providing above average compensation relative to industry peers for above average overall performance and below average compensation relative to industry peers for below average performance.
- Rewarding success in achieving performance goals.
- Ensuring Lessco's reputation as a premier retail organization that demonstrates best practices in business and operations to sustain and enhance our corporate success.

The compensation program for the CEO consists of a competitive base salary, annual incentive bonus, long-term incentives, benefits, and limited perquisites. Lessco's operating results and CEO compensation typically have been comparable to industry averages. Consistent with industry practice, the CEO's compensation is composed of 20% annual salary, 30% performance-based incentive bonus, and 50% long-term incentive pay (including performance-based restricted stock and stock-settled stock appreciation rights). The performance-based bonus is based on achieving operating profit and earnings per share (EPS) targets. These operating profit and EPS performance targets are set before the beginning of the fiscal year. Lessco's other top executives have a similar mix of compensation elements, which consists of a competitive base salary, annual incentive bonus, long-term incentives, benefits, and limited perquisites.

The compensation program is designed to attract, reward, motivate, and retain high-quality talent who share and execute the board's vision for success. Lessco's top management team, which includes the CEO, CFO, and Executive Vice President, has been stable in recent years and has a positive relationship with the Board of Directors.

Compensation Committee

Consistent with regulations, the Compensation Committee only has independent directors as members. The Committee is composed of three members, and it meets face-to-face four times per year and holds three conference calls per year.

Table 1 – [Low social capital]
All of the Committee members were identified as nominees for the Board by an independent search firm.
OR
Table 2 – [High social capital]
All of the Committee members were identified as nominees for the Board by the Company’s CEO.

Shareholder Investment

You invested in Lessco about three years ago. Lessco’s operating results and stock performance during this period have been comparable to industry averages.

Change Approved by Compensation Committee

Today, a credible newspaper indicated that five months into the current year

Table 3- [Low source credibility]
the CEO recommended and the Compensation Committee agreed to
OR
Table 4– [High source credibility]
a Compensation Committee member recommended and the Compensation Committee agreed to

reduce the current year operating profit and earnings per share performance targets for performance-based executive (including the CEO) bonuses. These targets were originally established before the year began and were reported in the annual proxy statement mailed to shareholders earlier this year. The reduction in the performance targets is due to significantly greater than anticipated charges related to a reduction in workforce and the closing of several underperforming stores. Some other companies in the industry also reduced their workforce and closed underperforming stores. Several board members were of the opinion that management should analyze workforce size requirements and underperforming stores on an ongoing basis.

The company justified reducing the performance targets for performance-based executive (including the CEO) bonuses by indicating that the operating profit and earnings per share targets were adjusted downward for these additional expenses to properly motivate the top executive team to achieve strategic and management goals for the rest of the year. The executive bonus plan allows the Compensation Committee, at its discretion, to adjust (either increase or decrease) its executive bonus performance targets due to extraordinary circumstances.

The questions that follow refer to the Compensation Committee’s decision to adjust the performance targets downward. Recall, the executive bonus plan allows the Compensation Committee, at its discretion, to adjust (either increase or decrease) its performance targets due to extraordinary circumstances.

Please answer the following questions based on the information in the preceding case. You may refer back to the case information when responding. Recall that you are to review the information and answer the questions as if you are a shareholder of the company.

2. Based on the information provided, do you **support the Compensation Committee’s decision to revise** the performance targets downward for the CEO? (place a slash on the line below):

Do not support revising targets downward	Strongly support revising targets downward
---	---

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

What factors account for your response to question 1 above?

- a. _____
- b. _____

6. If the performance targets **are not revised** downward, how fair is this outcome to the CEO? (place a slash on the line below):

Very unfair to the CEO	Very fair to the CEO
-----------------------------------	---------------------------------

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

What factors account for your response to question 2 above?

- a. _____
- b. _____

7. How comfortable are you with the company’s justification **to shareholders** for **revising** the performance targets downward? (place a slash on the line below):

Very uncomfortable with justification	Very comfortable with justification
--	--

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

What factors account for your response to question 3 above?

- a. _____
- b. _____

8. If the performance targets **are revised** downward, how fair is this **outcome** to the Lessco **shareholders**? (place a slash on the line below):

**Very unfair
to shareholders**

**Very fair
to shareholders**

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

What factors account for your response to question 4 above?

- a. _____
- b. _____

9. If the performance targets **are revised** downward, how fair is this **decision process** to the Lessco **shareholders**? (place a slash on the line below):

**Very unfair
to shareholders**

**Very fair
to shareholders**

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

What factors account for your response to question 5 above?

- a. _____
- b. _____

6. What are the potential **advantages** of a decision **to adjust** the performance targets downward?

- a. _____
- b. _____

7. What are the potential **disadvantages** of a decision **to adjust** the performance targets downward?

- a. _____
- b. _____

8. To what degree did the **CEO's** individual performance contribute to the significantly greater than anticipated charges related to a reduction in workforce and the closing of several underperforming stores?

**CEO
contributed
very little to
charges**

**CEO
contributed
very much to
charges**

| - - | - - | - - | - - | - - | - - | - - | - - | - - | - - |

Please respond to the following demographic questions. These will be used only to analyze the results, not to identify any participant.

4. Age _____
5. Gender _____
3. Highest educational degree earned (check one):

Bachelors	_____	JD	_____
Masters	_____	PhD/DBA	_____
4. Professional certifications (e.g., CPA, CFA, etc.):

5. How much investing experience do you have (check which level applies)?

None	_____
Little	_____
Moderate	_____
Significant	_____
6. How much influence does CEO compensation have on your decisions to buy or sell stock in a public company?

None	_____
Little	_____
Moderate	_____
Significant	_____
7. What is your current job title? (if retired, list your last job title)

8. What industry are you employed in? (if retired, list the last industry in which you were employed)

9. Do you serve on any public company Compensation Committees? Yes ___
 No ___
10. If yes, how many? _____

If you have any comments on the study, please provide them on the back of this page.

Thank you very much for your participation. If you would like a copy of the study's results, please enclose a business card or email one of the researchers.