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Do Compensation Committee Members Perceive Changing CEO Incentive Performance Targets Mid-Cycle to be Fair?

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Abstract We examine the influences of social capital, source credibility, and fairness perceptions on the judgments of experienced compensation committee (CC) members who are considering a proposal to reduce management's performance targets in the middle of a compensation cycle due to difficult circumstances. Eighty-nine U.S. public company CC members participated in a 2 × 2 experiment with social capital and source credibility each manipulated as low or high, and outcome fairness to management, process fairness to shareholders, and outcome fairness to shareholders included as measured variables. While social capital and source credibility are not significant, we find that outcome fairness to the CEO and outcome fairness to shareholders are significantly related to CC members' support for reducing performance targets during a compensation cycle. In addition, we find that more experienced CC members are less supportive of changing the performance targets. The significant interactions include one between outcome fairness to shareholders and process fairness to shareholders, which suggests that CC member support for the proposal relies on *both* process and outcome fairness being present. Finally, the participants' qualitative responses reflect arguments both *for* and *against* adjusting performance targets. Overall, the results highlight the important roles of fairness and director experience in boardroom decisions and provide important insights into factors affecting CC judgments.

Keywords Compensation committee · Decision making · Executive compensation · Fairness · Performance targets

Introduction

The compensation committee (CC) is responsible for determining the compensation of the CEO, but there has been little research determining what actually goes on in the boardroom as executive pay is determined. To gain insight into CC judgment processes, we examine CC member support for changing CEO performance targets mid-compensation cycle. Our setting is inspired in part by a public company's shareholder proxy statement that includes discussion of the effects of significantly greater than anticipated expenses related to a reduction in the workforce and the closing of underperforming stores. Adjustment of performance targets can be viewed by investors, government regulators, and the public as unfair or even as evidence that the CC is unduly under the influence of the CEO, and we seek to determine if fairness considerations impact CC support for changing the targets.

Agency theory would suggest that the CC, consistent with its monitoring role, would design and execute the CEO compensation contract to align the interests of the

"When measuring top executives' performance for pay purposes, the company [Walmart] says it makes various "adjustments" to its recorded financial results. In 2014, those adjustments resulted in better performance than reported in the audited statements. That enhanced performance meant higher incentive pay for executives" (Morgenson 2014).

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CEO and shareholders (Matsumura and Shin 2005). However, companies persist in adjusting their financial results when evaluating CEO performance for incentive pay (Morgenson 2014), usually resulting in increased CEO pay. These adjustments are occurring in spite of efforts to increase CC accountability for CEO pay and company performance by increasing executive compensation annual disclosure requirements (Securities & Exchange Commission (SEC) 2009) and the corporate governance provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd–Frank Act 2010). Indeed, Rodgers and Gago (2003, p. 198) suggest that "corporate law does relatively little as a governance matter for executive compensation".

Specifically, using a 2 × 2 experiment with three additional measured variables, we investigate the influences of social capital[1] (high or low social capital between the CC member and the CEO), source credibility (high or low source credibility based on whether the change in targets was suggested by the CEO [low] or another CC member [high]), and three measured variables (outcome fairness to management, process fairness to shareholders, and outcome fairness to shareholders) on CC members' decisions. On average, we find little support for changing the targets mid-cycle, but we do find considerable variability in responses. While social capital and source credibility are not significant, we find that outcome fairness to the CEO and outcome fairness to shareholders are significantly related to CC members' support for reducing performance targets during a compensation cycle. In addition, more experienced CC members are less supportive of changing the performance targets. We do not find that social capital, source credibility, or process fairness to shareholders significantly influence CC member support for the executive compensation proposal.[2]

In additional analyses, we also find three significant interactions. There is a significant interaction between outcome fairness to shareholders and process fairness to shareholders; CC members' support for the proposal was highest in the presence of both process and outcome fairness to shareholders. This interaction suggests that CC members' support for the proposal relies on *both* process and outcome fairness being present, consistent with Blader and Chen (2011). Additionally, there is a significant interaction between the social capital of the CC member and the CEO and outcome fairness to the CEO. The effect of outcome fairness to the CEO is less pronounced in the high social capital group than in the low social capital group. Lastly, we find a significant interaction between outcome fairness to shareholders and CC members' experience with changing performance targets in the past, whereby the effect of outcome fairness to shareholders is less pronounced when the participants had actual experience in the domain.

Analysis of the participants' qualitative responses to our support and fairness questions reveals four themes that provide insights into the reasoning of CC members for their judgments. Two themes reflect arguments *against* adjusting performance targets: not extraordinary/stick with the plan, and pay for performance/shareholders suffering. The other two themes reflect arguments *for* adjusting performance targets: retain and motivate management/focus on long-term, and CC and board discretion.

The next section presents background information and develops the hypotheses. The following sections describe the method, results, and conclusion.

Background and Hypotheses

At the essence of the focus on executive compensation judgments and overall fairness considerations is the CC of the board, which is responsible for establishing and overseeing the executive compensation system (e.g., Reda et al. 2007). According to financial market observers, the role of the CC has become more complex and demanding in recent years (Howe 2010; Reda et al. 2007). Increasingly, CCs must justify their decisions to shareholders, Congress, and the media, and they may face shareholder "say on pay"[3] votes and recommendations from shareholder advisory firms such as Institutional Shareholder Services (ISS) (Coleman and Lurie 2010; Howe 2010; Shorter 2009). Some CCs have been blamed 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).

Even though CCs' judgments are challenging in this environment, the academic literature examining CCs is limited. Research has primarily examined the association between CC characteristics and various compensation outcomes, such as level or type of executive compensation, disclosures related to executive compensation, and stock option backdating (e.g., Bebchuk et al. 2010; Collins et al. 2009; Laksmana 2008; Nelson et al. 2010; Sapp 2008; Sun

[1] We define social capital consistent with Lin (2001, p. 30) as "an investment in social relations with expected returns."

[2] In the Results section, we note that process fairness to shareholders is significant if the outcome fairness variables are excluded from the model, suggesting that process fairness is subordinate to outcome fairness (i.e., individuals consider the fairness of the process only when the outcome of the judgment is deemed unfair; see Lind et al. 2001).

[3] The Dodd–Frank Act requires periodic, non-binding shareholder votes on executive pay of the CEO and CFO and three other most highly paid executives as part of the proxy process.

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and Cahan 2009; Sun et al. 2009), rather than the CC process and influences on CC member judgments.

Consistent with agency theory, one of the main purposes of the CC would be aligning shareholder interests with the self-interest of the CEO through the CEO compensation contract (Matsumura and Shin 2005). However, Hermanson et al. (2012) find that CC members experience tension between resource dependence theory, being fair to management by paying competitive compensation, and agency theory, which emphasizes pay for performance and fairness to shareholders in their judgments. Others find that CEO influence has led to exorbitant compensation, as well as weakening the value of incentive-based compensation or even incentivizing decisions that are not in the long-term interest of shareholders, which is more indicative of managerial hegemony theory (Bebchuk and Fried 2006), and consistent with the widespread public belief that CEOs have significant influence in setting their own pay. Indeed, Harris (2009, p. 150) suggests the process of determining CEO compensation as it stands is inherently unfair: "There are certainly troubling indications that CEO selection and pay determination are far from open, arm's length processes."

Given the mixed findings in corporate governance and executive compensation research and the continued public and regulator concern about CEO pay for performance or lack thereof, even after extensive regulatory efforts, we believe that CC members adjusting targets mid-cycle may be using discretion, similar to the studies of manager–subordinate performance evaluation decision making (e.g., Bol 2011; Bol and Smith 2011), which find supervisors use their discretion in performance evaluations to adjust upward (but not downward) for events outside the control of the employee, in the interest of fairness. In addition, Bol et al. (2010) find that managers provide easier performance targets to "higher status" individuals to reduce potential conflict. Both of these biases potentially affect CC judgments. This line of reasoning leads to our overarching research question: What are the factors, including social capital, source credibility, and fairness considerations, that may influence CC members to adjust CEO compensation targets mid-cycle?

Influences on CC Member Judgments

Tosi et al. (2000), in a meta-analysis, study the relationship between CEO pay, firm size, and company performance. They find that more than 40 percent of the variance in CEO compensation is related to firm size and only five percent to firm performance. In fact, pay for performance, or lack thereof, has been the subject of much controversy (e.g., Bebchuk and Fried 2006).

In addition, the Economic Policy Institute (Mishel and Sabadish 2012, p. 2) reports, "from 1978 to 2011, CEO compensation increased more than 725 %, a rise substantially greater than stock market growth and the painfully slow 5.7 % growth in worker compensation over the same period."[4] The widening pay gap has raised pay fairness as an issue. In fact, the Dodd–Frank Act (2010) requires the SEC to amend shareholder proxy rules to require companies to disclose their internal pay equity. In contrast, Nichols and Subramaniam (2001) find comparisons between CEO pay and others are insufficient to evaluate the appropriateness of CEO pay due to the unique and valuable skill set needed to be an effective CEO.

Even in this challenging environment for CCs, Glater (2009) and Morgenson (2011, 2014) report that some companies reduce performance goals when their CEOs have difficulty meeting the targets. In addition, Lublin (2010) reports that a growing number of companies are replacing their annual incentive targets with targets that are reset twice per year to allow companies to react quickly to changes in economic conditions. Similarly, the majority of the 20 public company CC members interviewed by Hermanson et al. (2012) cite instances in which the board revised previously established performance targets in the middle of a compensation cycle. The justifications for the change include loss of 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, although in some cases such rationales might be cited merely to provide justification and cover for the CC members.

Social Capital

In the current environment, there is intense scrutiny of CCs, as well as concerns about CC members and management being too friendly. For example, Bebchuk and Fried (2006,pp. 11–12) assert:

> Many independent directors have some prior social connection to, or are even friends with, a company's CEO or other senior executives… With such a background, directors often start serving with a reservoir of good will toward the CEO, which will contribute to a tendency to favor the CEO in setting her pay. This kind of reciprocity is expected and observed in many social and professional contexts.

[4] The Economic Policy Institute compensation amounts are presented in 2011 dollars.

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Likewise, Kaplan et al. (2015) find less shareholder support for executive compensation judgments in the presence of social ties between the CEO and CC members, indicating that shareholders are also concerned about the influence of social capital on executive compensation judgments.

Despite concerns over the effects of social ties, Fama and Jensen (1983) find that directors place value on their reputation as effective monitors and receive benefits in the form of other directorships, compensation, etc. for their human capital. In addition, ineffective monitors experience sanctions with the loss of directorships and committee assignments (Srinivasan 2005). In fact, Masulis and Mobbs (2014) find that directors with prestigious directorships are more willing to terminate the CEO for poor company performance, thus engaging in conflict to protect their human capital as effective monitors. In contrast, Adams et al. (2010) find successful CEOs have bargaining power with the directors and are able to achieve a less independent board of directors with less effective monitoring. Given the tension between social ties and director human capital/reputation preservation, it is important to understand what role "social capital" between the CC members and the CEO plays in CC members' decisions. Our research defines social capital consistent with Lin (2001, p. 30), "The premise behind the notion of social capital is rather simple and straightforward: investment in social relations with expected returns."

Consistent with Bebchuk and Fried's assertion above, research indicates that board members often have prior social or professional affiliations with the CEO, and these affiliations may have facilitated their identification as a board nominee (e.g., Beasley et al. 2009; Clune et al. 2014; Hermanson et al. 2012; Westphal 1999). While prior social or professional affiliations may increase the collegiality of the board and facilitate the board's provision of expert counsel to management (Stevenson 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. 2014). For example, Hwang and Kim (2009) find that social ties between directors and the CEO are associated with higher CEO pay and a weaker link between CEO pay and performance.

Consistent with the results of Hwang and Kim (2009) and with the notion that social capital is an "investment in social relations with expected returns" (Lin 2001, p. 30), we expect CC members with high social capital with the CEO to be more supportive of an executive pay proposal to reduce financial performance targets in mid-cycle. The CC member benefitted from the CEO's identification of the CC member as a board candidate, and now the CC member can provide a return to the CEO by reducing the performance targets. Stated formally:

H1 The presence of high social capital between the CEO and CC member will lead to higher CC member support for reducing financial performance targets in mid-cycle than will the presence of low social capital between the CEO and CC member.

Source Credibility

Another relevant factor to consider is the credibility of the source making the executive compensation proposal. In an audit committee setting, DeZoort et al. (2003a) find that directors provide greater support to the auditor (as opposed to management) in an accounting disagreement when the issue involves annual reporting (as opposed to interim reporting, when the auditor has done much less work and lacks the same level of credibility as in an annual audit setting) and when the auditor consistently argues his/her position (as opposed to relenting to management preferences and appearing less resolute). These findings are consistent with directors considering the credibility of the source making a recommendation; auditors have greater credibility than management when the auditor has larger information set (annual audit setting) and when the auditor is unwavering in support of an adjustment.

Therefore, the second influence we examine in the CC setting 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). Of greatest relevance to the present study is the role of potential bias, as the CEO typically would benefit from a proposal to reduce targets mid-cycle (i.e., the CEO is biased toward a favorable outcome), but a CC member would not directly benefit from the proposal and would likely be less biased.

In their interviews of CC members, Hermanson et al. (2012) find that, if the company had revised performance targets mid-cycle, management often was the initiator of the proposal to revise the targets (either management alone, or management working with a CC member). The CEO may justify the request as providing motivation for senior management through the rest of the performance period, but the CC members may view the CEO proposal as self-serving, seeking additional pay for services already negotiated and expected. Likewise, the CC member may be less inclined to agree with a proposal when the CEO receives monetary benefit, while other stakeholders, including shareholders, are suffering losses. Since CC members may view compensation proposals initiated by the CEO as less

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credible (as the CEO has a direct financial interest in the outcome) than proposals initiated by independent directors (who do not have a direct financial stake in the outcome), we expect to find less support from CC members for executive compensation proposals initiated by the CEO. Considering the source credibility perspective, CC members may find CEO initiated executive pay proposals to be biased and accordingly have less credibility; therefore, CEO initiation (low source credibility) of the proposed reduction in performance targets mid-cycle is expected to result in lower CC member support for the change (i.e., high source credibility will result in higher support for the change).[5] Stated formally:

H2 The initiation of the proposed reduction in performance targets mid-cycle by a party with low source credibility will lead to lower CC member support for the change than the initiation of the proposed reduction by a party with high source credibility.

Fairness

A recurring theme in corporate governance is the focus on fairness to shareholders. For example, Bierstaker et al. (2012) find that fairness to shareholders plays a key role in audit committee members' evaluation of an auditor-proposed adjustment. Likewise, Schwartz et al. (2005) and Schweitzer and Gibson (2008) highlight the importance of fairness in ethical decision making. In addition, Hermanson et al. (2012) find that CC members report feeling pressure to strike a balance between paying enough to retain high performing executive talent versus creating value for shareholders by keeping executive compensation more modest, attempting to be fair to both shareholders and management. A NYSE CC member describes the process in Hermanson et al. (2012, p. 666):

> …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….

Accordingly, the third influence we examine is CC members' assessments of the process fairness to shareholders and outcome fairness to shareholders and management of their executive compensation judgments. Outcome fairness refers to the distribution of resources, while process fairness refers to the process of reaching the decision. While the discussion above primarily relates to outcome fairness to shareholders, process fairness to shareholders also is of concern given allegations that the manner by which executive compensation is established is not always arm's length or transparent (e.g., Bebchuk and Fried 2006).

Under the resource dependence perspective, a key role of the board is to attract and retain management talent, thus making fair treatment of management a prime consideration (Boyd 1990; Cohen et al. 2008; Dalton and Daily 1999). Likewise, Bol and Smith (2011) find that supervisors use their discretion in performance evaluation for uncontrollable events that would decrease subordinate pay, but not for uncontrollable events that would increase pay. Bol et al. (2010) also find that supervisors will provide easier sales targets to those subordinates with a higher status within the organization. Finally, Bol (2011) finds that leniency bias in performance evaluations does not necessarily harm future performance, but may improve fairness perceptions of employees and thereby motivation. As a result, we expect a relation between perceived outcome fairness to the CEO and CC members' support for the proposal to reduce performance targets mid-cycle whereby, if the members believe that it is unfair to the CEO *not* to reduce the targets, then we expect them to exhibit greater support for the proposal. Process fairness to management is not considered in this study, as management has substantial influence over the compensation process compared to shareholders. Both outcome and process 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 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, we expect that CC members who perceive outcome or process fairness to shareholders to be 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). Stated formally our fairness hypotheses are:

H3 CC members with lower assessments of outcome fairness to the CEO (if the change is *not* made) will have more support for reducing the performance targets mid-cycle than CC members with higher assessments of outcome fairness to the CEO.

H4 CC members with lower assessments of process fairness to shareholders will have less support for reducing

[5] As discussed below, our model includes an interaction term (SOCIAL CAPITAL x SOURCE CREDIBILITY), but we do not have a theoretical basis to predict such an interaction. Also, we conduct additional analyses to identify other possible interactions among independent variables.

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the performance targets mid-cycle than CC members with higher assessments of process fairness to shareholders.

H5 CC members with lower assessments of outcome fairness to shareholders will have less support for reducing the performance targets mid-cycle than CC members with higher assessments of outcome fairness to shareholders.

Method

Experimental Design

Public company CC members participated in an experiment that included a hypothetical case inspired in part by an actual large cap retailer's discussion of its performance targets.[6] The case was pre-tested for readability, understandability, and relevance by several academic researchers and one public company CC 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 for the consultant's assessment of the case's realism and relevance. Any recommendations of the above parties were carefully evaluated, and appropriate revisions were made before the final case was mailed to CC members.

The case (see the Appendix) first provided background information about the company and industry. The company is a mid-size publicly traded retail company in the consumer products industry, with prior year annual revenues of $650 million. This was followed by information about the company's executive compensation plan and compensation philosophy. Next, the case described the CC and then presented an executive compensation proposal to revise the management'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.

In the experiment, the CC members were randomly assigned to one of two social capital conditions and one of two source credibility conditions (each high or low), a 2 × 2 experimental design. In the discussion of the CC, social capital was manipulated by whether the CEO (high social capital condition) or an independent search firm (low social capital condition) nominated the CC members to the board of directors. In the discussion of the compensation proposal, source credibility was manipulated by whether a CC member (high source credibility condition) or the CEO (low source credibility condition) suggested the change in performance targets.

After they read the case, we asked the participants how likely they were to support (SUPPORT, 0 = not likely to support revising targets downward and 100 = very likely to support revising targets downward) the proposal to reduce performance targets mid-cycle. In addition to indicating their level of support for a decision to revise the short-term executive performance targets downward, members were asked about outcome fairness to the CEO (OUTFAIRCEO), on a scale ranging from 0 (very unfair) to 100 (very fair), if the decision to adjust the targets was *not* made. We also asked about process fairness to shareholders (PROCFAIRSHARE) and outcome fairness to shareholders (OUTFAIRSHARE), measured on a scale ranging from 0 (very unfair) to 100 (very fair), if the decision to revise the targets downward was made.[7]

We asked two manipulation check questions to assess the participants' understanding of the social capital and source credibility conditions. The remainder of the case asked members to assess how realistic, understandable, and challenging the case was, and presented demographic and governance experience questions. We include some of these items as control variables, as described below.

Model

Based on the above discussion, we use the following ANCOVA model to test H1–H5:

$$\begin{aligned}\text{SUPPORT} = \text{f}\ (&\text{SOCIAL CAPITAL [H1], SOURCE CREDIBILITY [H2], SOCIAL CAPITAL} \\ &\times \text{SOURCE CREDIBILITY, OUTFAIRCEO [H3], PROCFAIRSHARE} \\ &\text{[H4], OUTFAIRSHARE [H5], EVERCONSIDER, CCEXP, CEOEXP).}\end{aligned}$$

In addition to the dependent variable and independent test variables described above, we include three additional variables in our model. EVERCONSIDER is a dummy variable indicating whether the participant has actual experience as a CC member considering a proposal to adjust incentive compensation performance targets mid-compensation cycle (=1 if had prior experience, otherwise 0). Bierstaker et al. (2012) find, in an audit committee context, that participants having prior experience with an accounting issue have different views than those without such

[6] A limited portion of the case language is from earlier work (Bierstaker et al. 2012), as well as a few actual public companies' compensation-related disclosures. Some case questions are from earlier work (e.g., Bierstaker et al. 2012).

[7] The variables (SUPPORT, OUTFAIRCEO, PROCFAIRSHARE, and OUTFAIRSHARE) were, consistent with Bierstaker et al. (2012), measured by having the participants place a slash on an unnumbered scale with labeled endpoints (e.g., not likely and very likely, very unfair and very fair), and we convert the slashes to 0-100 values.

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experience. CCEXP is the log of the years of experience as a member of a public company CC, and CEOEXP is a dummy variable indicating if the participant has prior experience as a CEO (=1 if had prior experience as a CEO, otherwise 0). In an audit committee context, member experience has been a significant control variable in certain studies (e.g., Bierstaker et al. 2012). Also, it is possible that CC members with CEO experience may respond differently than those without such experience.

Participants

We solicited CC members in two ways. First, we used the *Audit Analytics* database to identify CC members who were appointed or reappointed from 1/1/2007 to 31/12/2010 to serve companies in retail, wholesale, and light manufacturing industries[8] with revenues from greater than \$0 up to less than \$2 billion.[9] We eliminated the CC members with principal addresses in non-English speaking countries. Using websites such as zabasearch.com, whitepages.com, peoplefinders.com, and intellius.com, combined with the biographical information in the company's shareholder proxy statement, we were able to locate the primary business or home address of the CC members. We mailed the case materials via USPS priority mail to 366 target CC members. Following Dillman (2000), our case materials used personalized letters, color letterhead, and hand-stamped return envelopes. No financial incentives were offered to participate in the research.

Twenty-six (7 %) packages were returned for incomplete or inaccurate addresses. We were able to obtain better addresses for all but seven and resent the package with the revised address. Second requests were mailed approximately three weeks after the first request mailing. We received a total of 104 responses from this effort, for a response rate of 29 %.[10] In addition, we used a convenience sample of six CC members (identified through our contacts) to supplement the *Audit Analytics* data, for a full sample of 110 CC members.

Results

Manipulation Checks

We used two multiple-choice questions to evaluate the effectiveness of the manipulations in the case instrument. Specifically, we asked the 110 participants (104 from *Audit Analytics* and 6 from a convenience sample) about who suggested their nomination to the board of directors (a search firm or the CEO) and who suggested the performance targets be adjusted downward (the CEO or another CC member). After excluding the 14 participants (12.7 %) who failed one or both manipulation checks and an additional seven (6.4 %) eliminated due to incomplete responses, 89 participants are left for analysis.[11]

Participants' Perceptions of the Case

The participants assessed the case to be realistic (mean of REALISTIC = 76.51, SD = 19.04 on a 0–100 scale from "not at all realistic" to "very realistic") and understandable (mean of UNDERSTANDABLE = 83.08, SD = 16.18 on a 0–100 scale from "not at all understandable" to "very understandable"). Both of these means are significantly greater than the scale midpoint of 50 ($p < 0.001$). Also, the participants indicated that they would find the decision somewhat challenging if they faced it in practice ($n = 88$; mean of CHALLENGING = 44.59, SD = 27.58 on a 0–100 scale from "not at all challenging" to "very challenging"). This mean is marginally different from the scale midpoint of 50 ($p = 0.069$). Based on one-way ANOVAs, there are no significant differences in REALISTIC, UNDERSTANDABLE, or CHALLENGING across the four case versions ($p \geq 0.24$ in all cases).[12]

Demographics

Table 1 presents the demographic information for the 89 participants. Most participants are male (92.1 %), well educated (79.8 % have some form of a graduate degree), and older (69.7 % are 60 or older). Most have experience with similar judgments regarding revising executive incentive performance targets mid-compensation cycle (75.3 %). Twenty-seven (30.3 %) have served as a public company CEO, and 42 (47.7 %) currently serve on the CC of a

[8] We narrowed our sample of potential compensation committee members to those serving in retail, wholesale, and light manufacturing industries, as those industries are most similar to the industry in the background information of our experimental case.

[9] We used a three-year sample period ending December 2010 in Audit Analytics to identify potential public company compensation committee members. We used a three-year period, as most public company boards appoint members to three-year terms, and we wanted to avoid duplications in our sample. We ended our period in December 2010, in an effort to avoid having participants who were very recently appointed to the board/CC and may not have actually participated in a CC meeting.

[10] This response rate is far above some other recent director studies (e.g., Bierstaker et al. 2012) that did not use Internet searches to find the primary business or home address of directors.

[11] In addition, we ran the ANCOVA model including participants who failed the manipulation check but had complete responses ($n = 100$). The results are qualitatively similar to those presented in Table 3. Specifically, OUTFAIRCEO has $p < 0.001$, OUTFAIRSHARE has $p = 0.084$, and CCEXP has $p = 0.016$.

[12] In addition, we ran the ANCOVA model adding the variables UNDERSTANDABLE, REALISTIC, and CHALLENGING. None of these variables is significant.

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Table 1 Participant demographics ($n = 89$)

	Number	Percentage
Gender		
Male	82	92.1
Female	7	7.9
Highest education		
Bachelors	18	20.2
Master	50	56.2
Juris Doctor	11	12.4
Ph.D.	10	11.2
Age		
Under 50	8	9.0
50–59	19	21.3
60–69	47	52.8
Over 70	15	16.9
Experience with similar judgment in the past		
Yes	67	75.3
CEO experience		
Yes	27	30.3
Annual revenue of largest company served ($n = 88$)		
Under $250 million	15	17.0
$250–500 million	15	17.0
$501 million–$1 billion	16	18.2
Over $1 billion	42	47.7
CPA certification		
Yes	17	19.1
	Mean	**SD**
Experience		
Number of current public company CCs served	1.54	0.85
Number of total public company CCs ever served	2.90	2.11
Number of years of service on a public company CC	8.04	6.44
Number of current public company Audit Committees served	0.93	1.06
Number of current public company Nominating and Governance Committees served	1.15	0.89

company with annual revenues over $1 billion. Seventeen (19.1 %) are certified public accountants (CPA). In addition, the participants have extensive experience in public company governance. On average, the participants serve on 1.54 CCs currently and 2.90 total CCs ever. Total years of CC service averages 8.04 years. Also, the participants currently serve on an average of 0.93 audit committees and 1.15 nominating and governance committees.[13]

Descriptive Statistics

Table 2 presents descriptive statistics for the dependent variable and the measured independent variables. Based on one-way ANOVAs, there are no significant differences across experimental conditions for any of the four variables ($p \geq 0.10$ in all cases). Overall, the participants tend toward not supporting the reduction of the executive compensation performance targets mid-compensation cycle (mean of SUPPORT = 30.66 on a scale of 0 = "not likely to support" and 100 = "very likely to support"), although there is considerable variation in responses (S.D. = 26.27; range = 0–97). The mean of 30.66 is significantly lower than the scale midpoint of 50 ($p < 0.001$).

The participants perceive ***not*** making the adjustment as fair to the CEO (mean of OUTFAIRCEO = 74.02, SD = 20.55 on a scale of 0 = "very unfair to the CEO" and 100 = "very fair to the CEO"). They perceive revising the performance targets downward in the moderate range in terms of fairness to the shareholders (mean of PROCFAIRSHARE = 47.37, SD = 31.46, and mean of OUTFAIRSHARE = 38.90, SD = 29.39; both variables are based on a scale of 0 = "very unfair to shareholders" and 100 = "very fair to shareholders"). The means of OUTFAIRCEO and OUTFAIRSHARE are significantly different from the scale midpoint of 50 ($p \leq 0.001$ in both cases; not tabulated).

The three measured independent variables (outcome fairness to the CEO, process fairness to shareholders, and outcome fairness to shareholders) are significantly correlated (not tabulated). PROCFAIRSHARE and OUTFAIRSHARE have $r = 0.755$, while OUTFAIRCEO is negatively related to PROCFAIRSHARE ($r = -0.579$) and OUTFAIRSHARE (-0.753).[14] The dependent variable, SUPPORT, is negatively associated with fairness to the CEO ($r = -0.690$) and is positively associated with fairness to shareholders ($r = 0.532$ for process fairness, and $r = 0.662$ for outcome fairness).

ANCOVA Results

The ANCOVA results are shown in Table 3. The model is significant ($F = 11.99$, $p < 0.001$, Adjusted

[13] When added (one at a time) to the model in Table 3, controls for age, gender, education, CPA status, audit committee service, nominating and governance committee service, company revenue (largest public company currently served), and regulated industry (largest public company currently served) are not significant. Also, five participants do not currently serve on a CC, but have served on several public company CCs in the recent past (1, 2, 3, 3, and 10 total committees ever served, respectively). These participants can be deleted from the sample with results consistent with those in Table 3 (OUTFAIRCEO has $p < 0.001$, OUTFAIRSHARE has $p = 0.037$, and CCEXP has $p = 0.011$).

[14] Despite the significant correlations, if we use a regression approach, the Variance Inflation Factors (VIFs) on all the variables are 3.8 or below, indicating that multicollinearity is not an issue.

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Table 2 Descriptive statistics ($n = 89$)

	Low social capital/low source credibility $n = 20$ Mean (SD)	Low social capital/high source credibility $n = 27$ Mean (SD)	High social capital/low source credibility $n = 18$ Mean (SD)	High social capital/high source credibility $n = 24$ Mean (SD)	Total $n = 89$ Mean (SD)
SUPPORT	37.85 (28.88)	27.04 (24.09)	28.78 (23.57)	30.17 (28.67)	30.66 (26.27)
OUTFAIRCEO (of *not* making adjustment)	67.90 (27.30)	77.44 (17.14)	69.06 (23.07)	79.00 (13.52)	74.02 (20.55)
PROCFAIRSHARE	62.55 (34.00)	41.15 (27.35)	44.67 (31.05)	43.75 (31.75)	47.37 (31.46)
OUTFAIRSHARE	49.90 (32.27)	34.07 (25.80)	38.28 (31.36)	35.63 (28.64)	38.90 (29.39)

SOCIAL CAPITAL = 1 for high and = 0 for low

SOURCE CREDIBILITY = 1 for high and = 0 for low

SUPPORT is CC 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

OUTFAIRCEO is perceived outcome fairness to CEO if adjustment is not made; scale from very unfair = 0 to very fair = 100

PROCFAIRSHARE is perceived process fairness to shareholders if adjustment is made; scale from very unfair = 0 to very fair = 100

OUTFAIRSHARE is perceived outcome fairness to shareholders if adjustment is made; scale from very unfair = 0 to very fair = 100

We did not include the p values of the differences between the means and the scale midpoints of our measured variables in Table 2

Table 3 ANCOVA results DV = SUPPORT ($n = 89$)

Variable	Hypothesis	Df	Mean Square	F value	P value (two-tailed)
Model		9	3896.99	11.99	<0.001
SOCIAL CAPITAL	(H1)	1	27.42	0.08	0.772
SOURCE CREDIBILITY	(H2)	1	177.02	0.54	0.463
SOCIAL CAPITAL × SOURCE CREDIBILITY		1	365.93	1.13	0.292
OUTFAIRCEO	(H3)	1	5217.13	16.06	<0.001
PROCFAIRSHARE	(H4)	1	11.99	0.04	0.848
OUTFAIRSHARE	(H5)	1	1604.32	4.94	0.029
EVERCONSIDER		1	41.88	0.13	0.721
CCEXP		1	1977.20	6.09	0.016
CEOEXP		1	44.81	0.14	0.711
Error		79	324.90		

Adjusted $R^2 = 0.529$. See Table 2 for other variable definitions

EVERCONSIDER = 1 if participant has actually considered a mid-compensation cycle incentive performance target change; otherwise = 0. CCEXP = log of the years of experience as a member of a public company CC. CEOEXP = 1 if had prior experience as a CEO, otherwise 0

$R^2 = 52.9\ \%$).[15] Based on this model, there is no support for H1 (SOCIAL CAPITAL, $p = 0.772$), H2 (SOURCE CREDIBILITY, $p = 0.463$), or H4 (PROCFAIRSHARE, $p = 0.848$), but there is support for H3 (OUTFAIRCEO, $p < 0.001$) and H5 (OUTFAIRSHARE, $p = 0.029$).[16] Support for adjusting the performance targets downward is greater when CC members perceive that (a) ***not*** making the adjustment is less fair to the CEO, and (b) making the adjustment is fairer to shareholders, both of which are focused on outcome fairness.[17] Thus, outcome fairness appears to be the primary consideration in the CC members' judgments regarding the proposal to reduce performance targets mid-cycle.[18]

[15] Due to the presence of heteroskedasticity ($p = 0.036$ using Breusch-Pagan/Cook-Weisberg test), we ran a sensitivity test using the ranks of SUPPORT as the dependent variable (Conover and Iman 1982; Shirley 1981). The results are similar using ranks as the dependent variable (OUTFAIRCEO has $p = 0.001$, OUTFAIRSHARE has $p = 0.095$, and CCEXP has $p = 0.018$).

[16] We report all p-values related to the ANCOVA as two-tailed.

[17] OUTFAIRCEO has a coefficient of −0.595, and OUTFAIRSHARE has a coefficient of 0.282.

[18] We 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 ANOVA models (Fairness variable = f (SOCIAL CAPITAL, SOURCE CREDIBILITY, SOCIAL CAPITAL

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While process fairness (PROCFAIRSHARE) has an insignificant coefficient (H4), we further explored this variable (not tabulated). We find that PROCFAIRSHARE is significantly positive ($p < 0.001$) without the two outcome fairness variables in the model (i.e., excluding OUTFAIRSHARE and OUTFAIRCEO from the model); however, the control variable CCEXP is no longer significant ($p = 0.208$). Thus, there is support for H4 if outcome fairness is not considered, which is consistent with prior research indicating that individuals consider the fairness of the process only when the outcome of the judgment is deemed unfair (e.g., Lind et al. 2001).

In terms of the additional variables, the coefficient on EVERCONSIDER is not significant. CCEXP, log of the number of years participants have served on public company CCs, is significant ($p = 0.016$) and negative[19], indicating that the CC members with more years of experience are less likely to support revising incentive performance targets mid-compensation cycle than those with less experience.[20] Thus, more experienced CC members appear to focus more on shareholder protection (agency theory perspective) than on the needs of management (resource dependence perspective). Finally, CEOEXP, a dummy variable indicating whether CC members have ever served as a public company CEO, is not significant.[21]

Exploratory Analysis of Interactions

We conducted an exploratory analysis for significant interactions and found three such interactions. First, as shown in Fig. 1, there is a significant interaction between PROCFAIRSHARE and OUTFAIRSHARE ($p = 0.02$). The mean of SUPPORT is 49.40 if both process and outcome fairness are high ($\geq$median value), versus <27 in the other cells. If CC participants perceived that changing targets mid-cycle was fair to shareholders both in process and outcome, their support for the change rose substantially. This result suggests, similar to Blader and Chen (2011) and Chen et al. (2003), that higher status individuals, such as public company CC members, expect *both* high process and outcome fairness. Although some prior studies, such as Lind et al. (2001) and Tyler and Blader (2000), find the presence of *either* high outcome fairness or high process fairness to be generally sufficient to foster trust, those studies focus solely on lower status individuals' evaluation of a higher status individual's judgment.

Second, there is a significant interaction between SOCIAL CAPITAL and OUTFAIRCEO ($p = 0.04$). As shown in Fig. 2, the means of SUPPORT suggest that the effect of OUTFAIRCEO is stronger in the low (<median) SOCIAL CAPITAL condition (mean of 48.95 when OUTFAIRCEO is low versus mean of 17.65 when OUTFAIRCEO is high—a difference in these means of 31.30) than in the high ($\geq$median) SOCIAL CAPITAL condition (mean of 40.15 when OUTFAIRCEO is low versus mean of 19.95 when OUTFAIRCEO is high—a smaller difference in these means of only 20.20). In other words, when SOCIAL CAPITAL is high the difference in means between the low versus high OUTFAIRCEO groups is smaller, indicating that the effect of OUTFAIRCEO is less pronounced when SOCIAL CAPITAL is high.[22] Thus, the CC member participants appear to be more heavily influenced by outcome fairness to the CEO when social capital with the CEO is low, possibly suggesting that CC members are aware that social capital between the CEO and the member may be perceived by others as a conflict of interest and unfair.

Lastly, there is a significant interaction between OUTFAIRSHARE and CC participant's actual experience with similar judgments in the past ($p = 0.01$). As shown in Fig. 3, the means of SUPPORT suggest that the effect of OUTFAIRSHARE is stronger when the CC member participant has no experience with changing performance targets (mean of 10.38 when OUTFAIRSHARE is low as compared with the mean of 77.50 when OUTFAIRSHARE is high—a difference in means of 67.12) than when the CC member has experience in changing targets (mean of 20.00 when OUTFAIRSHARE is low as compared to the mean of 38.49 when OUTFAIRSHARE is high—a much smaller difference in means of 18.49); we caution that the mean of 77.50 above has $n = 6$. Thus, CC members who had considered changing performance targets in the past had a smaller difference in the means of support for changing the CEO's targets mid-cycle, indicating that the effect of OUTFAIRSHARE is less pronounced when the participants had actual experience in the domain.

Footnote 18 continued
x SOURCE CREDIBILITY). None of the three models is significant ($p \geq 0.10$ in each case).

[19] The coefficient for CCEXP is −16.029.

[20] If we measure experience as the log of the number of CCs ever served in the participant's career, then this variable has $p = 0.037$. If we measure experience as the number of CCs currently served, then this variable is not significant ($p = 0.168$).

[21] We also ran the model without the insignificant control variables (EVERCONSIDER and CEOEXP), and the results are similar to those in Table 3. Specifically, OUTFAIRCEO has $p < 0.001$, OUTFAIRSHARE has $p = 0.032$, and CCEXP has $p = 0.007$.

[22] We performed a *t* test to determine if the means of SUPPORT are different between the low social capital and high social capital groups when OUTFAIRCEO is low (<median of 80). There is not a significant difference between groups ($p = 0.320$).

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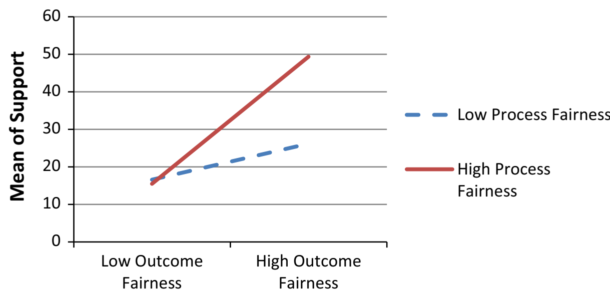

Fig. 1 PROCFAIRSHARE*OUTFAIRSHARE ($p = 0.02$)

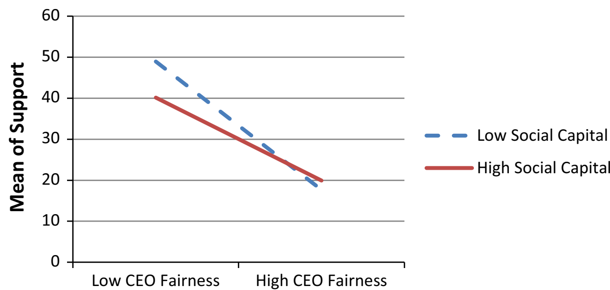

Fig. 2 SOCIAL CAPITAL*OUTFAIRCEO ($p = 0.04$)

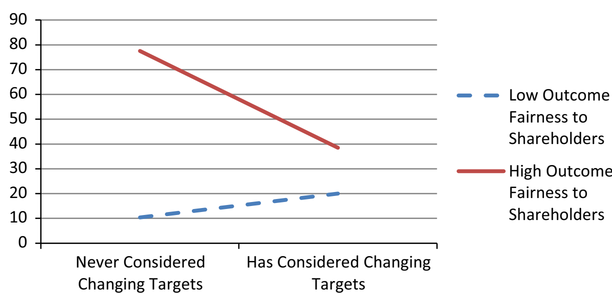

Fig. 3 OUTFAIRSHARE*EVERCONSIDERED ($p = 0.01$)

Themes Identified in Open-Ended Questions

In completing the case materials, the participants were asked to provide their reasoning behind each key judgment and to comment on the primary advantages or disadvantages of adjusting the performance targets downward. Eighty-four (94 %) of the participants provided qualitative responses. We analyzed their responses to determine key themes in the thought processes of those supportive of the change and those against it. Although there was little overall support for changing CEO performance targets in the situation outlined in this experimental case, there was a high degree of variability in the responses (range of 0–97, SD = 26.27).

Each of the three coauthors independently analyzed the qualitative responses to all the questions in the case materials by focusing on key words/phrases and identifying key quotes reflecting those themes in order to determine the rationale behind the CC members' judgments in this case.[23] Approximately 250 quotes were identified in total by the three coauthors, and 55 of those quotes were specifically identified as notable quotes by more than one coauthor. Next, one coauthor analyzed the quotes and determined that over 75 % of the quotes were reflected in one of the four major themes: two reflecting arguments *against* adjusting performance targets mid-cycle (the first two themes) and two reflecting arguments *favoring* such adjustments (the last two themes).[24] These themes reflect, among other issues, a focus on fairness to shareholders and fairness to management. We then selected key relevant quotes (all of these key quotes presented below were identified by two or more of the coauthors) reflecting the identified themes to include in the paper.

Theme #1: Not extraordinary/Stick with the Plan

The first theme apparent in the qualitative responses relates to the notion that the situation in the case is not extraordinary, management has a responsibility to forecast accurately, and the company should stick with the original plan and targets so as not to set a bad precedent. One participant wrote:

> This is not an extraordinary event and not beyond management control.

Similarly, a second argued:

> Contracts are contracts–why should they be adjusted?! Shareholders expect us to manage their money, so it is slightly uncomfortable to give away more money than contractually established.

Theme #2: Pay for Performance/Shareholders Suffering

The second theme deals with pay for performance and the idea that shareholders have suffered so the management should suffer as well. One participant wrote:

> The compensation committee is not an insurance policy against low pay for performance.

[23] This effort to identify key themes is a higher-level (i.e., more global) analysis than performing detailed coding of responses to each individual question and tabulating frequencies and inter-rater agreement. Our purpose was to provide evidence of the "main messages" contained in the qualitative responses, considering the open-ended questions collectively. Our approach is consistent with qualitative studies (e.g., Hermanson et al. 2012) that focus on major themes emerging from the data.

[24] The quotes fit into the themes as follows: theme #1 (23 %), theme #2 (20 %), theme #3 (28 %), and theme #4 (5 %). The other quotes do not fit into one of the four themes.

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Another pointed out that the CEO would not argue to increase targets in other situations:

> Live by the sword, die by the sword. [The CEO] would not be asking to give money back if he were to over perform.

Several participants mentioned shareholders. For example, one wrote:

> Fairness—other stakeholders including shareholders don't get to 're-set' once the game is started.

Theme #3: Retain and Motivate Management/Focus on Long-Term

Moving to arguments in support of adjusting the targets, the third theme relates to the importance of retaining and motivating management, including removing any barriers to management making decisions in the long-term interests of shareholders. One participant wrote:

> Very fair if you keep a top rated management group. Only unfair if you do it for the wrong reason.

Another offered an explanation as to why changing CEO performance targets mid-cycle would benefit shareholders:

> In the grand scheme, effects of CEO bonus have little effect on EPS and generating earnings and presumed share price. If critical to CEO 'happiness,' could be worthwhile to keep him or her and thus benefit shareholders in the long-term.

With respect to management incentives, several participants pointed to the importance of not penalizing good long-term decisions. One participant wrote:

> This restructuring is good for the shareholder, and I don't want the CEO to be penalized for doing it.

Overall, a number of participants focused on retaining and properly motivating management.

Theme #4: CC and Board Discretion

Finally, some participants provided responses consistent with the fourth theme, which addresses the appropriateness of the CC and board using discretion and judgment in executive compensation decisions. One participant wrote:

> Directors are employed to exercise their best business judgment for the company. If they have done that, weighed all factors, and come to the conclusion that the targets should be adjusted, that is fair to the shareholders because the directors have done their job…

Across the four main themes, notions of fairness are prominent. For example, changing targets in mid-cycle appeared to strike some participants as an unfair process that potentially could result in an unfair outcome if management is rewarded for low performance when shareholders have suffered. Others viewed the adjustment of targets as a fair process and a fair outcome for dealing with management in the presence of uncontrollable circumstances, and also ultimately as a fair outcome for shareholders given the importance of retaining management. Finally, some participants asserted that the role of the CC is to use professional judgment, pointing to the fairness of processes and outcomes that incorporate director discretion.

Conclusion

This study provides insights into judgments of CC members relative to a proposal to reduce management's performance targets mid-compensation cycle due to a greater than anticipated reduction in workforce and store closing costs. Overall, we find that public company CC members have little support for adjusting executive incentive performance targets mid-compensation cycle, although most have actual experience considering revisions to executive performance targets during a compensation cycle.

We find no evidence that social capital between the CEO and CC member and source credibility (based on who initiates an executive pay proposal) influences the judgments of CC members, and more research is needed regarding the effects of these manipulated variables. Perhaps the manipulation of social capital through nomination to the board was not strong enough in the experimental setting and did not capture the nuances of social capital in actual settings. Likewise, some CC members in the qualitative responses to the support question indicated that the case setting was not extraordinary, thus not warranting mid-cycle incentive performance changes, and that the CEO was responsible for accurate budget forecasting. Thus, the tension within the case instrument may not have been strong enough to detect any effects of social capital or source credibility. Further research should examine the effect of the intensity of the dilemma on the relation of social capital and source credibility with CC decisions.

The manipulation of source credibility also may have been affected by the domain knowledge of CC members. Specifically, Hermanson et al. (2012) found that even when a CC member suggested an executive pay proposal, it often was in conjunction with management. Thus, it is possible that some participants in the high source credibility condition may have perceived that the CEO was behind the CC member's proposal to reduce targets.

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We find that outcome fairness to the CEO and outcome fairness to shareholders are significantly related to CC members' support for reducing performance targets during a compensation cycle. This appears to reflect the inherent conflict in executive compensation decisions between the board of directors' duty to protect shareholders from potential exploitation from executive management and the duty to attract and retain executive talent, as well as the use of discretion in compensation judgments for fairness perceptions. Further, we find that more experienced CC members are less likely to support the compensation proposal.

In additional analyses, we find three significant interactions among the independent variables. The first is the interaction between outcome fairness to shareholders and process fairness to shareholders, with support for the executive compensation proposal highest in the presence of higher process fairness and outcome fairness. This interaction suggests that support for the executive compensation proposal relies on *both* process and outcome fairness being present. The second interaction is social capital between the CC member and the CEO and outcome fairness to the CEO. We find CC members with high social capital are less influenced by outcome fairness to the CEO. We suggest the high social capital CC member may, in the interest of fairness, be compensating for the perception by shareholders that social capital between board members and the CEO would enable the CEO to unduly influence the committee. We encourage further research on this potential effect. Lastly, we find a significant interaction between outcome fairness to shareholders and CC members' experience with changing performance targets in the past, whereby those CC members with prior experience are less influenced by outcome fairness to shareholders.

In terms of the CC members' qualitative responses, many CC members indicated that closing underperforming stores was a part of continuing operations and not an extraordinary item warranting downward revision of CEO incentive performance targets. Many CC members indicated that management had a role in setting the targets and the company budget; therefore, management was responsible for the failure to meet the targets. We also find that many CC members are cognizant of the risk of losing valuable executive talent or creating disincentives for executives to operate in the long-term interest of the shareholders. This is consistent with Hermanson et al. (2012), who find that CC members identified loss of executive talent as a significant risk faced by their committee. Interestingly, many CC members indicate in their responses a belief that making these executive compensation decisions is their responsibility and that they have the knowledge and information to make the most objective decisions even if the outcome may be perceived by other stakeholders as unfair.

Our study has three primary implications. First, our findings highlight the importance of fairness considerations in CC members' decisions, consistent with the notions of fairness revealed in the CC member interview studies by Hermanson et al. (2012) and Malsch et al. (2012), as well as with evidence from audit committee research on the role of fairness in shaping directors' judgments (Bierstaker et al. 2012). Based on our results, outcome fairness to the shareholders and outcome fairness to the CEO are important considerations in CC members' judgments, underscoring the tension felt by CC members to balance the demands of shareholders and management. In addition, outcome fairness appears to be more important than process fairness, although CC member support for the proposal was highest in the presence of both process and outcome fairness to shareholders. We also find evidence that some CC members appear to exhibit biases in performance evaluation, such as leniency and asymmetric uncontrollability effects, similar to managers performing subordinate performance evaluations (e.g., Bol 2011; Bol and Smith 2011). We suggest CC members be aware of such biases and that they be trained to mitigate them as needed.

Second, several studies have examined the relation between director experience (years of service) and judgments. In the audit committee arena, the evidence is somewhat mixed. For example, Bierstaker et al. (2012) find audit committee member experience to be negatively related to member support for the auditor in an auditor–management accounting disagreement, while DeZoort et al. (2008) find the opposite, a positive relation between audit committee experience and support for the auditor. We find evidence that more experienced CC members are less supportive of adjusting management performance targets mid-cycle, thus favoring a shareholder protection perspective (agency theory) than a focus on management's needs (a resource dependence perspective). We encourage additional research on the relation between director tenure and board committee-level judgments.

Finally, although we find most CC members are not supportive of changing targets mid-cycle, some members indicate that retaining and motivating a high-performing CEO may justify such a change and actually be in the best interest of the company. This may potentially explain why changing targets mid-cycle is still being justified by CCs despite intensive regulation and public scrutiny. We encourage future research to determine the justification of executive compensation judgments which may be perceived as unfair to shareholders and other stakeholders.

We recognize a number of limitations that may provide avenues for future research. Fairness has multiple components, which often interact with each other. While we examine only process and outcome fairness, there are calls for more research to use a global construct of fairness to capture

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these interactions (Ambrose and Schminke 2009; Nicklin et al. 2011). In addition, our participant sample, while reflecting high-level individuals, does have limitations. First, we use an experimental research design, which limits the results to those who were willing to participate, and second, our participants typically were CC members of fairly large public companies. Perhaps there would be different results for members from smaller public companies. Also, the scales used in the experiment for the participants to indicate their responses to our dependent variable and measured variables did not have an explicit midpoint indicator, which may possibly have introduced measurement error in the midrange of the scale. Finally, we examine individual decision making, while CC decisions are made in a group setting. Future research should examine the group dynamics in reaching an executive pay decision.

Despite these limitations, we complement recent interview-based studies (Hermanson et al. 2012; Malsch et al. 2012), as well as experimental work addressing audit committee member judgments (e.g., Bierstaker et al. 2012; DeZoort et al. 2003a, b, 2008). Based on this emerging body of research, it appears that notions of fairness are significant influences on many boardroom decisions.

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Appendix

Excerpt of Case Materials

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 compensations 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. All of the Committee members were identified as nominees for the Board by **an independent search firm** [***the Company's CEO***].

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Current Year Executive Compensation Issue

Five months into the current year, **another Compensation Committee member similar in experience to you [*the CEO of Lessco*] met with the Compensation Committee Chair** about the Company's expected annual performance. The Compensation Committee member [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 Compensation Committee member [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 Compensation Committee member [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 **the Compensation Committee member's [*the CEO'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.

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