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Fourth Annual Research Excellence Awards*

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The Case of Additions and Deletions to the Calvert Social Index***

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Stephen A. Stumpf, Villanova University

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**DOES THE MARKET RESPOND TO INSTITUTIONAL ENDORSEMENT OF
SOCIAL RESPONSIBILITY?
THE CASE OF ADDITIONS AND DELETIONS TO THE CALVERT SOCIAL INDEX**

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**DOES THE MARKET RESPOND TO INSTITUTIONAL ENDORSEMENT OF
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THE CASE OF ADDITIONS AND DELETIONS TO THE CALVERT SOCIAL INDEX**

Corporate citizenship, social responsibility, and governance have emerged as major issues in the deliberations of policymakers, managers, and shareholders. This interest has generated questions about the relationship between positive corporate behavior and firm value. Scholarly theoretical and empirical literature regarding the relationship between corporate social performance (CSP), corporate governance (CG) and corporate financial performance (CFP) has followed. Many recent studies have addressed these questions in an attempt to determine if firms that are well-governed and socially responsible outperform those that are not. While the results of individual studies are mixed, when taken in aggregate, a consistent conclusion emerges: “virtuous” firms are not punished – and are more likely to be rewarded – by the market for being good corporate citizens.¹

There is also evidence that investors are increasingly interested in socially responsible investing (SRI). According to the Social Investment Forum (2003), assets in socially screened portfolios grew to \$2.14 trillion in 2003, a seven percent growth rate from the end of 2001. In contrast, assets in professionally managed portfolios fell by four percent over that same time period. Socially responsible mutual funds numbered 200 in 2003, up from 139 in 1997. According to Lipper, these socially responsible mutual funds had net inflows of \$1.5 billion in 2002 alone while other diversified equity funds had net outflows of almost \$1.05 billion that same year. These statistics appear to reflect the growing importance of SRI in financial markets.

As SRI becomes an increasingly important trend in the financial markets, greater numbers of investors are paying closer attention to firms with socially responsible behavior. However, it is sometimes difficult for investors to measure and observe what is or is not socially responsible. As a consequence, the opinion of experts may influence investors’ perceptions. Several institutions currently evaluate the social responsibility of public firms, including KLD, the Calvert Group, and others.

The purpose of this study is to extend research by exploring the role of an institutional endorsement of corporate responsibility (and conversely, the withdrawal of such an institutional endorsement) and its effects on shareholder wealth. One of the most well-known institutions that screens firms on both social responsibility and corporate

¹ Orlitzky M, Schmidt F, Rynes S. 2003. Corporate social and financial performance: a meta-analysis. *Organization Studies* 24(3): 403-441.

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governance is the Calvert Group. Calvert maintains a widely referenced social index (SI) - the Calvert Social Index (CSI) - that includes firms that conform to strict criteria for social responsibility and corporate governance. We use the CSI to test the question of whether changes in the firms included in the CSI are associated with the market and operating performance of the firms involved.

THEORETICAL BACKGROUND AND HYPOTHESES DEVELOPMENT

The importance of inclusion in or exclusion from a social index has roots in two distinct areas of research. One area of relevant research relates to the institutional and stakeholder pressures on firms to pursue socially responsible actions, including corporate governance, the impact of these pressures on the actions of firms and their reputation, and the consequences of those actions and firm reputation on firm performance. The second literature stream, drawn from finance research, relates more specifically to how changes in various market indexes affect investor perceptions of firms, and how these perceptions result in market reactions.

Institutions constrain and enable behavior. Stakeholders are individuals or groups with whom the corporation interacts and who have a stake or vested interest in it, such as employees, consumers, suppliers, and local communities within which corporations operate.² The way corporations treat their stakeholders depends on the institutions within which they operate.³ The study of institutions is the study of norm-governed behavior and as such, it can be used to inform instances in which firms respond to pressures to adopt corporate responsibility policies. In their classic 1983 article, DiMaggio and Powell observe homogeneity among organization forms and practices and explore why this similarity exists and persists.⁴ They argue that the state and the professions exert significant influence over the parameters of organizational behavior and that once a set of organizations emerges as a field, rational actors make their organizations increasingly similar even as they try to change them.

To analyze this convergence, DiMaggio and Powell explored the phenomenon of isomorphism: the tendency of one unit in a population to resemble others. DiMaggio and Powell and other institutional theorists have focused on three principal mechanisms by which isomorphic pressures manifest: coercive, mimetic, and normative. Here we argue that consideration as a socially responsible firm, and inclusion in a socially responsible index, constitutes a specific type of legitimization. We can see how coercive, mimetic, and normative pressures could all contribute to pressures – and preferences – for firms to

² Freeman RE. 1984. *Strategic Management: A Stakeholder Approach*. Pittman: Boston MA.

³ Fligstein N, Freeland R. 1995. Theoretical and comparative perspectives on corporate organization. *Annual Review of Sociology* **21**: 21-40.

⁴ DiMaggio PJ, Powell WW. 1983. The iron cage revisited: institutional isomorphism and collective rationality in organizational fields. *American Sociological Review* **48**(2): 147-60.

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behave in a socially responsible manner. Intermediaries, such as socially responsible mutual funds, serve as institutional mediators that signal legitimacy to both institutional and individual investors.

The second main area of research that is related to our study is literature on the impact of index changes on firm value. This research has examined the impact of additions and deletions to various indexes and theorized – and tested for – various antecedents of those effects. In general, the majority of studies that examine inclusion in an index find that the announcement of inclusion is associated with a positive price reaction from the market. Most of the studies that examine exclusion of a firm from an index find that the market reacts negatively to this announcement.

A third research area that is important to our study is the link between corporate social performance and financial performance. Orlitzky, Schmidt, and Rynes undertook a comprehensive meta-analysis of the relationship of corporate social performance and financial performance. They find that corporate virtue in the form of social responsibility and to a lesser extent, environmental responsibility, is likely to pay off, although alternate operationalizations of corporate social performance and corporate financial performance moderate the positive association. Further, their study suggests that the path through which CSP leads to CFP is via reputation effects rather than eco-efficiencies or other operational influences.

METHODS

In this paper, we look at firm inclusion and exclusion from a socially responsible investment index and examine the market reaction to the change. Based on the growing importance of SRI in our society and financial markets today and the link between social performance and financial performance, we hypothesize that an expert endorsement (or removal of an endorsement) of good social behavior conveyed to investors through changes in a social responsibility index will positively (negatively) affect the stock price of the endorsed firm. In order to have an impact on stock price, the announcement of a change in the index must change the markets estimate of either future cash flows or the risk of these cash flows. Our hypotheses are as follows:

H1a: There is a positive wealth effect associated with a firm's inclusion in a SI.

H1b: There is a negative wealth effect associated with a firm's deletion from a SI.

H2: Firms that are added to a SI will have superior operating performance in the period prior to the index change when compared to their deleted peers.

H3: The announcement day reaction to additions to and deletions from a SI will be inversely related to the operating performance in the period prior to the announcement.

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Using LexisNexis, we identify all announcements of changes in the CSI and record the reasons given by Calvert for the change. We define the event date as the earliest date that an index change is announced in the financial press. We found announcements of 56 additions and 65 deletions over the sample period. We calculated several measures of financial performance and risk in the period prior to the announcement of an index change for each firm in the sample. Tobin's q has been used to measure the marginal impact of governance and social responsibility. We include two different measures of operating performance based on their frequency of use in previous studies and on the strength of their relation to social performance. The return on assets (ROA) and operating income to total assets ratios are calculated for each firm in the last full year prior to the announcement. The change in each of these measures in the period preceding the index change is calculated by subtracting the measure in year -3 to -1.

We measure the impact of index change announcements on short-term stock prices using market model event study methodology. Using the announcement day as the event day, we use standard event study methodology to find the stock price reaction of firms when an announcement of an index change is made.

We test the significance of the stock price reaction using two separate methods. The parametric approach tests if mean abnormal returns are significantly different from zero using a t-test. The non-parametric statistic tests the hypothesis that the returns are ranked as expected. We use a signed rank test to calculate the non-parametric statistic. We use OLS regressions to test Hypothesis 3. We use two-day standardized abnormal returns as the dependent variable in our regressions. These returns are calculated by dividing the abnormal return on day 0 and the abnormal return on day +1 by the standard error. The result is then summed and that sum is divided by the square root of two to create a two-day standardized abnormal return.

RESULTS

The results of this study show that firms that are added to the CSI do not stimulate market reactions in the period immediate following the addition announcement. Deletions are met with a significant three day decline in stock price of over 1.5% on average. A closer inspection of the added and deleted firms reveals that the added firms have significantly better operating performance in the year leading up to the index change than their deleted counterparts. The strong performance prior to the addition appears to mute or partly mitigate the surprise related to the addition announcement.

In a cross-sectional regression, the announcement day reaction for deleted firms is more negative for small, high book to market firms with relatively good performance as measured by ROA. These are firms for which the announcement of a deletion would prove to be the biggest surprise. For added firms, the announcement day return is likely

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to be more positive for smaller firms and firms with deteriorating performance as measured by operating income, firms for which the information asymmetry is largest. The positive relation between operating income and deletion announcement returns and the marginal positive relation between ROA and addition announcement returns is unexplained.

Overall, the results suggest that membership in the CSI is important to investors but that investors anticipate additions and deletions to this index. The results also suggest that investors reward CSP and punish firms when an endorsement of good CSP is removed. Socially responsible mutual funds serve as an important institutional mediator of information, a role that appears only likely to grow in the coming decades. While CSR is often advanced as a normative component of the social contract between business and society, our study provides additional support that CSR does not impose costs on firms and appears to have a positive strategic effect by improving the relative financial position of firms that are judged to subscribe to its principles.

Regression of two day standardized abnormal returns (Day 0 and +1)

<i>Variable</i>	<i>Parameter</i>	<i>t-statistic</i>
Market value of assets to book value of assets	-0.157	-2.01**
Log of firm size	0.341	3.83***
Return on Assets	-6.170	-2.68***
Change in Return on assets (year -3 to -1)	-2.894	-2.86***
Operating income/Total assets	8.378	3.73***
Change in Operating income/Total assets	1.651	2.11**
Addition Dummy	3.998	3.01***
<i>Addition Dummy interaction terms:</i>		
Market value of assets to book value of assets	0.146	0.80
Log of firm size	-0.350	-2.40**
Return on Assets	2.412	0.29
Change in Return on assets (year -3 to -1)	7.498	2.09**
Operating income/Total assets	-6.749	-1.39
Change in Operating income/Total assets	-6.889	-1.67*
F for model	2.550***	
Adjusted R²	0.160	

* p-value < 0.10

** p-value < 0.05

*** p-value < 0.01

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**A SIMULATION OF MORAL BEHAVIOR WITHIN MARKETING
EXCHANGE RELATIONSHIPS**

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**A SIMULATION OF MORAL BEHAVIOR WITHIN MARKETING
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SUMMARY OF FINDINGS

This simulation examined business-to-business exchanges between sales agents, companies, and industries. Employing a version of the Iterative Prisoner's Dilemma, different contexts were created with variations in personal moral philosophies, firm ethical cultures, payoffs, and decision-making heuristics. Findings from unitary moral philosophies show the long-term benefits of altruism over egoism on simulated financial performance. Companies made up of altruists earned significantly more income than companies containing egoists. This conclusion is corroborated by the results from the first imbalanced simulations where individual morality also was allowed to dictate firm behavior. These runs demonstrate that economic success declined in perfect order from the most altruistic (i.e., True Altruists) to the least altruistic (i.e., True Egoists).

The more complex simulations include firm ethical paradigms that emphasized altruism, egoism, and/or monetary achievement. Both the balanced and imbalanced runs confirm that simulated organizational cultures caused a marked shift of sales agent morality in the appropriate directions, while the neutral paradigm ended with a more diverse sales agent population. These simulations also reveal that total revenue across the balanced and imbalanced runs was significantly higher for the True Altruists within Ethical Paradigms than for True Egoists within Unethical Paradigms. Taken together, our findings suggest synergies between individual and collective factors on the success of simulated companies as well as the composite industries. Finally, sensitivity analyses involving payoffs and decision-making heuristics show that results remain robust except under extraordinary circumstances that over-reward egoists relative to altruists or hide their selfishness from view for an extended period of time.

DISCUSSION AND IMPLICATIONS

The potential contributions of this study are partially a function of the underlying assumptions and operational details of the IPD as a simulation of a business-to-business sales environment. At the center of our model is marketing as exchange and the possible impact of individual moral philosophies and organizational ethical cultures on sales transactions. There is much research support for the proposition that personal morality significantly influences professional behavior (see Singhapakdi, Vitell, and Franke 1999), and that various forms of other-centered activities defined as altruistic and self-centered actions defined as egoistic play an important role (Watkins and Hill 2005). Research also concludes that dynamic elements of institutional culture are capable of guiding behavior in ethical or unethical directions (Kelley and Elm 2003).

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Therefore the characteristics of our simulation seem representative of important aspects of sales/marketing transactions, and our attention now focuses on the outcomes of these exchange relationships. The use of 1000 runs for each study simulation allows for discovery that imitates a lengthy time horizon and considerable firm and industry experience. Initial income distribution may favor selfishness in the face of selflessness (described here as defection), but results demonstrate that maintaining this perspective performs less well as negative experiences among potential customers or their firms accumulate. Over time, cooperative transactions based on trust provide the greatest return, consistent with the basic tenets of good marketing practice.

In his treatise on the natural roots and virtues and values of capitalism, Klein (2003, p. 394) asks: “Since it is uppermost in the minds of businesspeople to survive and preferably survive well, will not moral business activity put businesspeople at a competitive disadvantage?” Implicit to this question is the belief that customers, including business-to-business trading partners, are so incredibly naïve or other-centered that they are easy prey for the unscrupulous. However, assumptions imposed during our sensitivity analyses indicate that immorality only serves marketers who exchange with ill-informed customers or who receive unusually high compensation for their actions. Instead, our findings suggest that sales agents as well as others occupying boundary-spanning positions are more likely to gain and sustain financial success through cooperative and altruistic endeavors.

Assumptions of our model also support research that contends the ethical nature of corporations influences individual morality and economic achievement. For example, organizational ethical postures resulted in changes to personal moral positions, causing increasing consonance with the dominant corporate culture over time. Additionally, our capitalistic “value-neutral” perspective based on income maximization produced a mixed assortment of sales agents and organizational productivity that was akin to the Unethical Paradigm. Along with this negative impact on individuals or their organizations, our findings show that mean income for industries as a whole is diminished under these conditions. In the final analysis, our results support the larger societal dictates that require individuals, corporations, and industries to adhere to strict ethical guidelines.

These insights notwithstanding, limitations of our study provide opportunities for other investigations of morality in marketing. Expanding the independent and dependent variables explored is an important next step. Causal factors that may affect morality include previous experiences, self-efficacy, gender, religiosity, extroversion versus introversion, and professional commitment. Further, moral behavior may drive, in part, emotional well-being, absenteeism and turnover, job satisfaction, and professional outlook. In order to examine such a wide range of possibilities, a variety of study settings and methods must be employed that utilize similar conceptualizations of individual

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morality and organizational ethics. The goal of this research stream is to enrich our understanding of the causes and consequences of ethical marketing practice.

CONCLUDING COMMENTS

Of course, simulations are much better at predicting particular types of behavior and proclivities rather than the actions of specific individuals in unique situations. For example, a salesperson facing intense pressure to perform in the very short run may succumb to egoistic behavior even if her or his normal ethical posture or the corporate culture suggests otherwise. As a consequence, our model may best capture impact on exchanges over time rather than at a discrete point or for a specific transaction. However, the longer-term view has real importance at the firm as well as the macro level. Ethical marketing is built on mutual trust that exchange partners value each other's satisfaction, leading to financial success. Additionally, the finding that moral choices enhanced industry performance has important societal and public policy implications.

Pragmatically, salespeople and sales managers may view exchange relationships from a different perspective. They are more likely to articulate tactics of themselves or their exchange partners as "cooperative," "competitive," or "predatory." Cooperative actions are consonant with our discussion of altruism and the ideal of communal sharing; competitive actions are most similar to tit-for-tat and the individuality of equality matching; and predatory actions suggest egoism and objectification or commoditization of others that is inherent in market pricing. Regardless of these monikers, the potential effects on firm profitability and industry revenues require serious consideration by marketers and policy makers. Such findings also support the value of mutual trust and consideration within exchanges, which are the cornerstones of relationship marketing.

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**THE IMPACT OF POSITIVE AND NEGATIVE AFFECT ON
AUDITORS' COGNITIVE AND ETHICAL JUDGMENTS**

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**THE IMPACT OF POSITIVE AND NEGATIVE AFFECT ON
AUDITORS' COGNITIVE AND ETHICAL JUDGMENTS**

Researchers, particularly in psychology, are increasingly acknowledging the importance of affect on decision-making (e.g. Beach 1990; Beach & Mitchell 1987; Finucane et al. 2000; Mellers 2000). In fact, several researchers contend that a consideration of affect's role in decision-making is necessary to gain a better understanding of the decision-making process (Keren 1996; Kida & Smith 1995; Lowenstein 1996; Strack & Neumann 1996). The growing body of evidence on the influence of affect increases the relevance of several important, long-standing questions about the role of affect in decision-making (cf. Janis and Mann 1977). For example, under what conditions will affect improve or impair judgment?

PURPOSE OF THE STUDY

This paper examines the effects of positive or negative affect on auditors' cognitive and ethical judgments.¹ The purpose of this study is to provide evidence on the effects of affect on two different tasks commonly encountered by auditors. Prior psychology studies show that affect affects judgment and performance differently depending on the nature of the task (Au et al. 2003; Creyer and Kozup 2003). This suggests that affect can have a functional effect on performance of certain tasks but a dysfunctional effect on other types of tasks. Given recent concerns about potential ethical lapses involving professional auditors, this paper examines whether affect, a pervasive environmental factor, can contribute to these lapses.

COGNITIVE vs. ETHICAL TASKS

In this paper, cognitive tasks are defined as relatively structured and familiar or practiced tasks that require domain specific knowledge to complete. For instance, a staff auditor could be required to generate explanations for a fluctuation in gross margin or an inventory turnover ratio. Ethical tasks, on the other hand, may require truthful reporting of information that affects the auditors' private circumstances (self-focused), or reporting of information that affects the public's circumstances (public-focused). For example, a staff auditor may be required to indicate the time he or she spent on confirming receivables, relative to a time budget, which may impact their performance evaluation by their superiors. Identification of this task as an ethical task is consistent with prior

¹ Concepts such as affect, mood, and emotion are often used interchangeably. The term "affect" refers to a range of reactions including emotions and moods. Moods are differentiated from emotions in that they are less intense, of longer duration, and are not directed at a specific target (Frijda, 1993; Forgas and George, 2001). In this paper, we use the term "affect" and make little distinction between emotions and moods because their boundaries are "unsharp" (Frijda, 1986, p.60).

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research that has identified underreporting, in particular, as an unethical behavior that auditors engage in (e.g., Ponemon 1992; Dirsmith & Covalleski 1985). Similarly, an auditor may be confronted with a decision involving the write-off of inventory – a decision that affects the earnings per share (EPS) that investors observe and use to make their investment decisions.

AUDITORS' RESPONSIBILITIES

An auditors' professional creed requires alliance to public service and professional skepticism when confronted with pressure from client management to comply with a client-preferred method of accounting. Auditors are trained to consider themselves as professionals (Jamal 1997) with responsibilities to financial statement users, as highlighted in the U.S. by the AICPA *Code of Ethics*. Rules 101 and 102 of the *Code of Ethics* require auditors to be unbiased and impartial, and staff auditors should not subordinate their judgments to those of their superiors (Louwers et al. 2007, 541-546). Therefore, auditors' adherence to their code of ethics when confronted with pressure from management to, for instance, avoid a write off inventory may be viewed as an ethical decision that affects the public.

PSYCHOLOGY RESEARCH

Prior psychology research has produced mixed findings on the impact of affective states on judgment. Some research suggests decision makers in a positive affective state will suffer from a variety of cognitive biases that result from the use of heuristics, the simplification of problem definitions, or immature acceptance of solutions based on heuristics (Schwartz & Clore 1983; Wyer et al. 1999). However, people in a negative affect state process information more systematically, effortfully, and efficiently (Forgas 1995), are more influenced by central rather than peripheral cues (Worth & Mackie 1987), and are more immune to a variety of biases (Taylor & Brown 1988). Theoretical work on the affect-ethical decision relation suggests that positive affect will lead to more ethical decision making but that the negative affect-ethical decision relation is complex and not straightforward.

One explanation for these mixed findings is that the nature of the task may lead to different effects of affect on judgment. Based on theory relating to the asymmetric effect of positive and negative affect, it is hypothesized that negative affect will improve technical task performance but impair ethical task performance (i.e., lead to less truth telling). It is also predicted that positive affect will impair technical task performance but will enhance ethical task performance.

METHODS

To test our predictions, fifty-four auditors were assigned to one of three conditions – positive, negative, or neutral affect. Each participant read a series of affect-

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laden statements to produce a negative, positive, or neutral affect state. Then participants were asked to complete a cognitive task (involving the generation of explanations for fluctuations in gross margin and inventory turnover ratios) and two ethical judgments (a self-focused one involving the reporting of audit work and a public-focused one involving writing off inventory obsolescence).

RESULTS

In the cognitive task, consistent with expectations, auditors in the negative (compared to positive) affect condition generated more correct explanations for fluctuations in the gross margin and inventory turnover ratios than those in the positive affect condition. Also consistent with expectations, in the ethical tasks, auditors in the negative (compared to positive) affect condition made less ethical judgments on both the self-focused ethical task and on the public-focused ethical task.

Overall, these results show that negative affect, which has a functional effect on technical performance, can have an unintended deleterious effect on ethical judgments. These findings may be particularly of concern given current auditor workloads in the post Sarbanes-Oxley environment, and recent criticism of the auditing profession. These results should increase awareness that negative affect can have both positive and deleterious effects and that appropriate debriefing after a negative-affect generating event must be in place to minimize the deleterious effects. Likewise, systematic processing-enhancing debriefing should accompany events eliciting positive affect, such as a positive performance evaluation or a recent job promotion.

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**SETTING BALANCED SCORECARD TARGETS AND WEIGHTS IN A
COLLABORATIVE SETTING USING TWO- PARTY NEGOTIATION MODELS**

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**SETTING BALANCED SCORECARD TARGETS AND WEIGHTS IN A
COLLABORATIVE SETTING USING TWO- PARTY NEGOTIATION MODELS**

The balanced scorecard (BSC) is one of the most extensively researched topics in management accounting. The balanced scorecard (BSC) model provides a framework for selecting multiple performance measures related to strategic goals. By integrating the financial, customer, internal and learning and growth perspectives, the BSC can be used as an organizing framework for a strategic management system (Kaplan and Norton 1996). A fundamental principle in the balanced scorecard model is to align the organization to the strategy. The firm's strategy is formulated at the top of the organization, and it is cascaded downward so that goals, measurements and targets are used throughout the organization to implement strategy.

While the model encompasses planning and control functions, most BSC research has focused on the control aspects. These papers typically have considered issues related to the use of BSC measures in evaluating managers. An important control issue in the performance evaluation process is whether managers effectively use strategically linked performance measures or is there a bias towards using non-linked measures (common measures) such as financial measures that are common to all strategic business unit (SBU) managers. If there is a bias towards common measures, the result may be interpreted as undermining the BSC's major espoused benefit of uniquely capturing business strategy. The role of BSC in planning at the strategic level is the focus of this paper. In the planning process, BSC targets and weights must be determined. We present a model for setting BSC targets and weights that could be used by organizations that desire to enhance cooperative behavior.

We argue for a contemporary participative approach for the joint selection of BSC variables and weights using collaborative decision analysis models. These joint decision models are ideal for planning and implementing organizational strategy using the BSC where manager's openness and truthfulness identify integrative benefits to the organization. This contrasts with agency models that focus on competitive behavior. We present a negotiation model (summarized below) for developing targets and approximate weights through joint selection for the various dimensions in the firm's BSC. Weights are important in directing the actors attention among the goals when actions lead to the need to make trade-offs among alternatives actions. Our paper makes several contributions. Our negotiation model takes preferences of two parties into consideration and jointly determines the BSC targets and weights. We consider both manager's preferences and information in our approach, which enhances cooperative behavior. It avoids the extreme posturing of a competitive environment and offers a starting point for discussion that has the parties focusing on the appropriate solution. We argue that our model enhances the possibility that managers will effectively use strategically linked performance measures

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in the planning and control and minimizes a bias towards using non-linked (common) measures.

Negotiations in practice create a tension between claiming action designed to obtain a larger share of the pie and creating actions aimed at building a bigger pie. In the first case, the basic problem deals with *claiming or two party distributive negotiations*. Distributive negotiations are basically a win-lose type negotiation where the aim of both parties is to get a bigger piece for oneself. In the second case, the problem involves *creating or two party integrative negotiations*. Integrative means integrating parties capabilities and resources to generate more value, which is win-win type situation. In this article, we deal with only two party integrative negotiations that is the hallmark of cooperative decision-making. We apply a negotiation analysis formulated by Raiffa. The two parties have to determine the best alternative to a negotiated agreement (BATNA), which can be used to determine the threshold value to each party. These threshold values are called the *reservation values* (RV), and they represent the very minimum value for each party.

In integrative negotiations, the two parties will collaborate to maximize joint gains. This is similar to deal making which present opportunities for joint gains in contrast to disputes, which have to be resolved. From a behavioral point negotiation involving deal making is more collaborative than those involving settlement of disputes. A deal is usually made if the parties believe that there is significance value in joining forces. Typically, there will be a lot of issues to be resolved. Take for example, a potential deal such as a merger between two companies. There is significant value in the merger and would involve negotiating numerous issues on production, finance, governance, distribution, profit sharing and contingencies to name a few. In addition to the list of issues to be resolved, for each issue, the two parties should also list the set of possible resolutions (contracts).

The two parties should jointly construct a *template* for their negotiations, which include the list of issues that they need to resolve. For each of these issues, the parties need to compile a list of potential resolutions. Analytical minded parties can quantitatively score the template and establish numerical reservation values that will specify the minimum value that will be acceptable in his or her negotiations. For each issue, the parties should rank order their preferences for the different issues (between-issue qualitative analysis) and follow with this rank ordering the importance of different resolutions (with-in issue qualitative analysis). Negotiation analysis can be understood by investigating the *fair-division problem*, which is a good starting point for more general problems such as two party negotiations with multiple issues and many party negotiations.

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The fair division problem deals with how to divide n items between two parties in a FOTE manner. The template of this problem is simple such that each issue corresponds to an item to allocate to either one of the parties. The fair-division problem can be modeled and solved as a mathematical programming problem. The idea is to find the best contract from the *extreme efficient contracts* that is equitable. The set of extreme efficient contracts can be found using the critical ratio method. The natural question then is what constitutes equity or fairness? In choosing an equitable outcome among the extremely efficient points, there are three possibilities: (a) maximizing the sum of the payoffs; (b) maximizing the product of the excesses and; (c) maximizing the minimum proportion of potential. The two parties can agree on a pure or mixed (randomized) strategy. Our paper illustrates the application of the three possibilities.

Our two party negotiation model can be used to enhance cooperation in setting balanced scorecard targets and weights. We argue that our model is attractive to firms seeking to develop or maintain a culture of responsible leadership and governance. The model includes between-issue qualitative analysis, which involves weighting by the parties and utilizes manager's preferences and information in our approach. Our paper contributes to the BSC and negotiation literatures through the development of an analytical model for joint selection of BSC weights. It avoids the extreme posturing of a competitive environment and offers a starting point for discussion that has the parties focusing on the appropriate solution. In using the model, the CEO and SBU managers would agree upon rules.

Our research also addresses reliability and credibility issue of unique performance measures. While the role of BSC in planning at the strategic level is the focus of this paper, the targets and weights would be used in the performance measurement process. Recent studies in the BSC literature report on the superiors' performance evaluations being biased toward using common measures and biased against using unique measures; but one study suggests that managers who have detailed strategy information will rely on more on strategically linked performance measures and less on non-linked measures, as compared to managers with less knowledge. We argue that the two party negotiation models presented in this paper reduce the weighting bias against unique measures. Using the negotiation model should be a positive factor in enhancing managers' knowledge of strategic linkages and enhancing reliability of data. We submit that the discipline and structure in the negotiation model enhances cooperation in setting balanced scorecard targets and weights and reduces BSC implementation issues.

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**DOES GOVERNANCE STRUCTURE IMPACT THE OUTCOME OF
SHAREHOLDER PROPOSALS TO REMOVE TAKEOVER DEFENSES?**

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**DOES GOVERNANCE STRUCTURE IMPACT THE OUTCOME OF
SHAREHOLDER PROPOSALS TO REMOVE TAKEOVER DEFENSES?**

"What's really needed is a change in mindset – one that fosters not only a culture of compliance but also a company-wide environment that fosters ethical behavior and decision-making."

William H. Donaldson, SEC Chairman (2004)

The end of the twentieth century witnessed some of the largest corporate scandals (e.g. Enron, WorldCom, Tyco, Global Crossing, and the New York Stock Exchange) in this country's history, highlighting a wave of managerial abuses of shareholder trust that resulted in extensive financial and social damage. The ensuing public outcry for increased accountability and ethical behavior has led to amplified emphasis on corporate governance as a mechanism to bring about desired managerial behavior. Passage of the 2002 Sarbanes-Oxley legislation is a well-known attempt to provide legal conformity, corporate oversight, and to foster ethical behavior among the firm's top managers. The intent of Sarbanes-Oxley is to positively impact corporate behavior and, hopefully, lead to improved ethical behavior on the part of top level managers.

Arjoon (2005)¹ concludes that legislating ethical behavior is unrealistic and cites Donaldson (2003),² who indicates that ethical obligation on the part of the firm, cannot be achieved through legislation. Therefore, Sarbanes-Oxley may not be enough to lead managers to act ethically. One form of managerial action not addressed in Sarbanes-Oxley is the incentive managers have to entrench themselves or, more specifically, to protect their jobs through the process of fighting potential value creating takeovers. Managers can use takeover defenses such as classified boards and poison pills to avoid being taken over, thereby reducing the chance that they will lose their jobs. However, the rationale for using takeover defenses is not always clear. Managers generally argue that they use the defenses in an ethical manner since takeover defenses imbue them with bargaining leverage to obtain a higher price for shareholders in the event of a takeover. The opposing argument is that takeover defenses entrench managers by not allowing exposure to the market for corporate control, leaving them less accountable to shareholders.

The earliest studies of the wealth effects of takeover defenses and the determinants of adopting these measures were completed following the 1980s merger wave with no clear conclusion as to their effect on managerial behavior or the

¹ Arjoon, Surendra, 2005. "Corporate Governance: An Ethical Perspective." *Journal of Business Ethics* 61, 343-352.

² Donaldson, William H., 2003, "Corporate Governance." *Business Economics* 38, 16-21.

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relationship between managers and shareholders. More recent research has focused more on poison pills and classified boards in the broader context of corporate governance, and criticized the existence of these measures and concluded that strong takeover defenses are used unethically and are likely to entrench managers and destroy shareholder wealth.

Additionally, managers can use classified boards and poison pills unethically to shield themselves from the market for corporate control at the expense of shareholders. In light of recent events, shareholders are more aware than ever that managers may be acting unethically by trying to protect their own interests instead of taking action in shareholders' best interests. Therefore, shareholders of many firms have made proposals at the annual meeting to remove poison pills and classified board provisions. Since the defenses are sometimes value destroying it seems imperative that managers act ethically and remove them in the case where the majority of shareholders themselves vote for the removal of the takeover defenses. The purpose of this study is to examine the governance structure of firms whose shareholders vote to remove the takeover defenses and determine if this structure is related to the probability that management ultimately acquiesces to shareholder wishes.³

The focus of this study is to determine the role of governance structure in the responsiveness of management with respect to shareholder wishes. Since managers are not bound to act on shareholder proposals to remove takeover defenses, many firms in our sample act unethically and choose to not remove takeover defenses even in the face of overwhelming shareholder sentiment to do so. The results of this study will provide evidence on how different governance structures affect the responsiveness of management with respect to the shareholders of the firm. We will examine two main aspects of governance, the composition, structure, and leadership of the board and the ownership structure of the firm to determine how these important governance mechanisms impact the probability that managers respond ethically to shareholder votes to rescind classified board and poison pill takeover defenses.

This study focuses on two specific forms of takeover defenses. Poison pills represent a class of shareholder rights plans that make it prohibitively costly for a firm to be taken over without managerial approval. Poison pill rights offerings do *not* require shareholder approval for adoption. An antitakeover charter amendment known as a classified board election is the second type of takeover defense. The charter amendment *does* require shareholder approval for adoption. Classified board elections make the process of taking over a company through a proxy fight a much lengthier procedure due to the small numbers of board members elected in any one year. This study focuses on votes to rescind poison pills and the classified board elections. These two types of

³ Rechner, Sundaramurthy, and Dalton (1993) find that governance plays a role in the likelihood of adoption of antitakeover measures.

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takeover defenses dominate the shareholder proposals to rescind over the time period of the study and are most likely to be passed yet not implemented.

Corporate governance mechanisms are meant to mediate the agency problems between managers and shareholders. Governance quality focuses on two main areas, board strength and ownership structure. The structure and composition of the board has been found to impact their ability to operate as champions for shareholder rights. A well-functioning board oversees management and insures they operate in the best interest of shareholders. Firms with strong boards should be more likely to act on the wishes of shareholders. Part of our hypotheses and empirical tests look at whether the presence of specific attributes, found to be characteristics of a well-functioning board, is related to the likelihood that the proposals to rescind the antitakeover amendments are enacted. These attributes include board size, CEO/Chairman duality, % of outside directors on the board, tenure of outside directors, and the number of directorships held by outside directors.

The second main focus of corporate governance research focuses on the ownership structure of the firm as this has also been shown in prior research to have an impact on the agency relationship between managers and shareholders. Additional hypotheses and tests that relate to ownership structure and the likelihood to rescind the antitakeover amendment include the % of shares owned by large blockholders, the % of shares owned by the CEO, and the % of shares owned by inside and outside directors. We also examine whether the passage of Sarbanes-Oxley has increased the likelihood of proposals being rescinded.

We perform univariate, non-parametric statistical analysis to determine whether there is a difference in medians of the governance variables described below using a Wilcoxon test. We also perform a logistic regression to model the relation between the independent variables related to board and ownership structure and the probability that the firm will remove the takeover defense once shareholders have voted to rescind the defense. In this model the dependent variable is the dummy variable measuring the implementation of the passed proposals. The fact that the dependent variable is binary leads to the use of the logistic model. We also model the potential interaction of some of the independent variables and the possibility that the relation between the dependent variable and independent variables may be non-linear in some cases.

The univariate analysis provides evidence of striking differences between the governance structure of the firms that implement passed proposals and those that do not. The firms that fail to implement passed proposals have significantly higher levels of CEO ownership, lower levels of blockholder and outsider ownership, more outsiders on the board, outsiders with less tenure, and more directorships per outside director than firms that implement passed proposals. All of the differences are significant at greater than the

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.01 level except for outside ownership which is significant at the .05 level. These results are largely consistent with the general hypothesis that well-governed firms are more likely to implement passed proposals than poorly governed firms. The only univariate result that is not consistent with this hypothesis is the fact that firms that fail to implement have a significantly higher percentage of outsiders on their board. Both types of firms have outside representation in excess of 70%, so this result could be a manifestation of the non-linear relation between outside representation and governance.

The results of the logistic model estimation presented in the table below provide more insight into how the governance terms interact to determine the likelihood of implementation of passed proposals. The parameter estimates for the model represent the effect the independent variable has on the probability of implementation. The Chi-square for the model is significant at more than the 0.0001 level which indicates that the independent variables in the model explain a significant portion of the probability of implementation of passed proposals.

The parameter estimate for the CEO ownership variable is negative and significant at the 0.05 level indicating that the probability of implementation is inversely related to the level of ownership of the firm's CEO. We also find that the estimate for insider ownership is positive and significant. The only other significant ownership variable is the interaction term between blockholder ownership and the insider control dummy which means that blockholder ownership is only important in the implementation decision when the board is dominated by insiders.

The remainder of the independent variables measure board structure. We find that firms whose boards are dominated by insiders are less likely to implement passed shareholder proposals than those that are dominated by outsiders. In contrast, our results indicate that firms whose boards have a very high level of outside representation are most likely to implement passed proposals. Firms with larger boards are more likely to implement passed proposals. The results show that smaller, outside dominated boards are more likely to implement passed proposals than larger outside dominated boards, and firms with outside directors that hold a large number of other directorships are less likely to implement passed proposals than firms with more focused outside directors. A final result indicates an observed increase in implemented proposals since Sarbanes-Oxley was passed.

Our findings suggest that the governance structure of a firm can have powerful implications on the relationship between management and shareholders. In the case of shareholder proposals that shareholders approve, managers should accede to the wishes of the firm's owners. Management works for the owners and these votes represent an explicit manifestation of a directive by the shareholders. The fact that some managers

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fail to implement passed shareholder proposals to remove a mechanism that impacts shareholder wealth is unethical.

Our study provides clear evidence that board structure does impact the behavior of managers vis-à-vis shareholders and does mitigate the agency problem that exists in organizations in which managers run firms for a diverse set of owners. In this study, the firm's owners have made their desires clearly known to management but some managers, namely those of poorly governed firms, still ignore these desires. Both quality governance and government policy have effectively lowered the probability that managers will continue the unethical behavior of ignoring the stated wishes of their shareholders.

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Table. Logistic Regression Results.

<i>Variable</i>	<i>Parameter Estimate</i>	<i>Chi-Square</i>	
CEO ownership %	-19.061	6.169	**
Insider ownership %	18.759	3.829	*
Outsider ownership %	4.005	1.126	
Outside ownership %* Outside control dummy	689.900	1.127	
Blockholder ownership%	0.778	0.561	
Blockholder ownership % * Inside control dummy	19.725	3.058	*
Inside control dummy	-4.521	4.900	**
Outsider domination dummy	3.744	3.984	**
Board size	0.341	7.663	***
Board size*Outside domination dummy	-0.412	5.763	**
Average tenure of inside directors	-0.048	1.664	
Average tenure of outside directors	0.107	2.147	
Directorships per outside director	-1.173	28.836	***
Classified board dummy	-0.943	4.147	**
Sarbanes-Oxley dummy	1.659	6.653	***
Model Chi-Square		117.905	***

* p-value < 0.10

** p-value < 0.05

***p-value < 0.01

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**USING STAKEHOLDER ASSESSMENTS FOR PERFORMANCE MANAGEMENT
AND PREDICTING CAREER SUCCESS IN PROFESSIONAL SERVICE FIRMS¹**

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**USING STAKEHOLDER ASSESSMENTS FOR PERFORMANCE MANAGEMENT
AND PREDICTING CAREER SUCCESS IN PROFESSIONAL SERVICE FIRMS**

Professional service firms (PSFs) are facing significant profitability challenges due to the costs associated with globalization, consolidation within their industries, and client demands for more differentiated and value-added services. PSF professionals (such as business consultants, certified public accountants, investment bankers, lawyers, and public relations/advertising executives) must satisfy the increasing demands of their clients, the often changing demands of their leaders, and the developmental needs of their staff. The increased pressure to competently serve many diverse stakeholders has led to 70-80 hour work weeks, a sense of irresolvable conflicts among some stakeholders, and feelings of being overwhelmed. The majority of new PSF professionals change their career within a few years; many PSFs report retention rates of less than 10% after 7 years. PSFs are responding to the pressures they have placed on their professionals, in part, through enhanced performance management systems that use of multisource feedback (MSF) for both performance assessment and professional development purposes. An MSF instrument developed specifically for PSFs is discussed along with an examination of how different stakeholder assessments of and feedback on PSF professionals' work-related performances can assist in performance management and contribute to one's career success.

A career in a PSF can be very rewarding – personally, financially, and professionally – particularly if one survives to become a partner or managing director. With up-or-out selection-to-partner rates below 5% at many of the most prestigious PSFs, young professionals must continuously examine their career potential and current success – from the points of view of their clients, partners, peers, and teams. Since these stakeholders often have differing goals, and frequently have different expectations for the competencies and performance of young professional service professionals (PSPs), the burden of career development must be shared by the PSF and the individual.

The work in PSFs is project or program oriented, serving the needs of the external client organization (or customer) more so than internal management. Terms used to describe this project work are engagements, deals, cases, and campaigns. Because project work is often interdisciplinary and complex, it may require a team of PSPs to work together for several weeks. The work is often done at a client's site for easy access to key information sources -- the client's employees and physical records. The research and problem solving associated with completing the work creates opportunities to identify additional opportunities either directly or related to current work, or to extend that work based on facts and situations discovered during the project. Upon completion of a project, the engagement or case team is disbanded and its members are considered

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for other projects. PSPs may be reassigned immediately or left unassigned (not billable) until suitable work is found.

The importance of stakeholders to both individual and organizational success (and failure) is well established. People that have a stake in what others do may act in a supportive or in a destructive manner towards these individuals. The relationships that individuals have with their salient stakeholders may be career enhancing or damaging, depending upon how these stakeholders view and value their work-related performances. Performance can be viewed as the level of effectiveness and skill exhibited on work-related activities as perceived by different stakeholders.

The *Relationship Management Survey (RMS)* was developed over two years by a sponsoring professional service firm (PSF) in conjunction with faculty members at two universities and two industrial/organizational (I/O) psychology consulting firms. The impetus for the *RMS* came out of a change in the sponsoring firm's strategy, followed by a complete revision of its performance management system. Table 1 lists the competency items contained in the *RMS*. Table 2 summarizes the hypothesized relationship of the six *RMS* dimensions with career success (L=low, M=medium, and H=high expected relationships)

Table 1. *RMS* Items Clustered into Six Dimensions

- 1. Leadership**
 - 1.1 Challenges the Situation
 - 1.2 Inspires a Shared Vision
 - 1.3 Empowers Others
 - 1.4 Models Effective Behavior
 - 1.5 Celebrates Achievements
- 2. Building Relationships**
 - 2.1 Understands Others
 - 2.2 Can Take Others' Perspective
 - 2.3 Puts Others at Ease
 - 2.4 Shows Concern for Others
 - 2.5 Respects Others
- 3. Trust**
 - 3.1 Generates Confidence
 - 3.2 Engenders Mutual Trust
 - 3.3 Is Dependable
 - 3.4 Is Open to and with Others
- 4. Collaboration**
 - 4.1 Communicates Well Across Boundaries
 - 4.2 Learns from Others

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4.3 Creates Synergies Across Boundaries

4.4 Seeks Win-Win Outcomes

4.5 Shares Useful Expertise

5. Coaching

5.1 Doesn't Dwell on Failures

5.2 Encourages Others to Take Reasonable Risks

5.4 Rewards Achievement

6. Relationship Outcomes

6.1 Achieves Impact

6.2 Builds Client Relationships

6.3 Develops Team Relationships

6.4 Collaborates Well with Clients

6.5 Fosters Information Sharing that Leads to Results

6.6 Develops Personal Relationships

**Table 2. Hypothesized Strength of Relationship with Career Success Measures
By Stakeholder Constituency**

<i>Skill Dimension</i>	Self	Direct Reports	Peers	Partners	Clients
<i>Leadership</i>	L	H	M	L	L
<i>Building Relationships</i>	M	L	H	H	H
<i>Trust</i>	M	L	M	H	H
<i>Collaboration</i>	L	M	H	M	M
<i>Coaching</i>	M	M	L	L	L
<i>Relationship Outcomes</i>	L	M	M	H	H

The ideas proposed herein are that stakeholders' assessments can be used as valued input into a PSFs performance management system, and might also be used to predict later career success. Both uses have implications for incorporating feedback from stakeholders in one's career management. Research supporting these hypotheses would be particularly relevant for identifying high potential professionals and determining whether stakeholder judgments are indicators of advancement. Research exploring these hypotheses will determine differences among stakeholder groups in predicting career success and whether selected performance dimensions from different stakeholders are more or less important to future career success. This has both theoretical and practical relevance. It will advance our understanding of how stakeholders' perceptions affect later judgments of those making personnel decisions. Such research can inform the design of succession management and career development programs. They may lead to stakeholder training in evaluating high potential professionals and to target PSPs improved use of stakeholder ratings in shaping their career plans.

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Research exploring these hypotheses should contribute to the stakeholder research literature and the professional development literature on MSF practices in several ways. It can:

(1) provide an enhanced understanding of what different stakeholder groups value in the PSP's behaviors, thereby supporting the importance of involving stakeholders in organizational issues.

(2) add an alternative perspective with respect to measurement issues in MSF whereby different stakeholder assessments are expected to correlate (converge) as a sign of construct validity. Statistical independence (low correlations) among different stakeholder assessments may be a more meaningful sign of validity than their co-variation.

(3) provide individuals receiving MSF with guidance on what different assessments by different stakeholders may mean with respect to their career success, and suggest how to interpret differences in these assessments as function of the likely importance of a competency to the stakeholder.

(4) provide work organizations, particularly the human resource function, with more information on which to base their design MSF surveys and from whom to solicit feedback on which MSF items/dimensions.

(5) provide PSFs with a better idea of what performance competencies really matter to their stakeholders as these competencies relate to the future success of their leaders and other professionals.