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Mark D. Fulford

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GUIDELINES FOR SUBMISSION

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(JLAЕ)

Domain Statement

The Journal of Leadership, Accountability and Ethics is dedicated to the advancement and dissemination of business and management knowledge by publishing, through a blind, refereed process, ongoing results of research in accordance with international scientific or scholarly standards. Articles are written by business leaders, policy analysts and active researchers for an audience of specialists, practitioners and students. Articles of regional interest are welcome, especially those dealing with lessons that may be applied in other regions around the world. Research addressing any of the business functions is encouraged as well as those from the non-profit and governmental sectors.

Focus of the articles should be on applications and implications of management, leadership, ethics, and governance. Theoretical articles are welcome as long as there is an applied nature, which is in keeping with the North American Business Press mandate.

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- Generate an exchange of ideas between scholars, practitioners and industry specialists
- Enhance the development of the management and leadership disciplines
- Acknowledge and disseminate achievement in best business practice and innovative approaches to management, leadership and governance
- Provide an additional outlet for scholars and experts to contribute their ongoing work in the area of management, leadership and ethics

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Articles should be submitted following the American Psychological Association format. Articles should not be more than 30 double-spaced, typed pages in length including all figures, graphs, references, and appendices. Submit two hard copies of manuscript along with a disk typed in MS-Word (preferably).

Make main sections and subsections easily identifiable by inserting appropriate headings and sub-headings. Type all first-level headings flush with the left margin, bold and capitalized. Second-level headings are also typed flush with the left margin but should only be bold. Third-level headings, if any, should also be flush with the left margin and italicized.

Include a title page with manuscript which includes the full names, affiliations, address, phone, fax, and e-mail addresses of all authors and identifies one person as the Primary Contact. Put the submission date on the bottom of the title page. On a separate sheet, include the title and
an abstract of 100 words or less. Do not include authors’ names on this sheet. A final page, “About the authors,” should include a brief biographical sketch of 100 words or less on each author. Include current place of employment and degrees held.

References must be written in APA style. It is the responsibility of the author(s) to ensure that the paper is thoroughly and accurately reviewed for spelling, grammar and referencing.

Review Procedure

Authors will receive an acknowledgement by e-mail including a reference number shortly after receipt of the manuscript. All manuscripts within the general domain of the journal will be sent for at least two reviews, using a double blind format, from members of our Editorial Board or their designated reviewers. In the majority of cases, authors will be notified within 60 days of the result of the review. If reviewers recommend changes, authors will receive a copy of the reviews and a timetable for submitting revisions. Papers and disks will not be returned to authors.

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The SEC requires that all reporting companies test for goodwill impairment once a year. Events may cause a reporting company's goodwill to become impaired during the course of a fiscal year. This article will examine the relationship of GAAP standards governing goodwill impairment and SEC regulations mandating that GAAP standards be followed and analyze a recent decision addressing section 10(b) and rule 10-b5 liability arising from the failure to test goodwill intra-annually.

INTRODUCTION

Whenever my son got a cut or scrape, he immediately called for a Band-Aid. When daughter sneezed she asked for a Kleenex. What they really wanted is an adhesive bandage or a tissue. These brand names, usually trademarked, have inherent value considered part of a company's goodwill. One court has defined goodwill as "the positive reputation a business may enjoy in the eyes of the public that creates a probability that old customers will continue their patronage."

In a corporate acquisition a company's goodwill equals the purchase price, net the expenses, less the fair value of net assets. In other words, it is the intangible value of the business above and beyond its bricks, mortar and equipment. However, in a corporate non-acquisition setting, goodwill may be more difficult to value. Bankruptcy Courts often focus on the value of a company's goodwill, perhaps the most valued asset left.

A company's goodwill could be impaired by an external disaster or a change in customer preferences. Historically, television networks, together with owned and operated stations and affiliates, competed with other television networks. But then came cable, satellite, DVDs, instant streaming and a variety of new forms of competition chasing after the finite pool of advertisers dollars. According to the Nielsen ratings for the week of August 20, 2012, NBC captured the largest audiences of over nine million viewers while cable channels TNT and ESPN each captured over five million viewers. This type of change in industry can be so fundamental and permanent as to result in an impairment to a company's goodwill.

The SEC requires that all reported companies test for goodwill impairment once a year and report it in their 10-K filings. However, events, such as a sudden change in the industry, may cause a reporting company's goodwill to become impaired during the fiscal year, i.e. intra-annually. SFAS 142 requires an intra-annual test for goodwill impairment when events cause a change in circumstances which make it more likely that the book value of a reporting unit exceeds its fair value.

An investor's window into the financial well being of a company is its 10-K and 10-Q statements filed with the SEC. If the valuation of goodwill is materially false, a purchaser of securities has a claim for recompense on the theory that the purchase price was inflated and the price dropped when the truth became known, thereby causing a loss to the stockholder.
This article will examine the relationship of GAAP standards with SEC regulations and a recent decision addressing a section 10(b) and rule 10-b5 (17 C.F.R, § 240.10b–5) action alleging shareholder injury from the failure to test goodwill intra-annually.

**The Plaintiffs' Theory: Res Ipsa?**

In *City of Omaha, Nebraska Civilian Employee’s Retirement System v. CBS Corporation*, the plaintiffs were shareholders of CBS common stock who purchased the shares between April 28, 2008 and October 10, 2008. On October 10, 2008, CBS’s announced a write down of $10 billion to goodwill. Shareholders alleged violations of section 10(b) of the Securities Exchange Act of 1934 and SEC rule 10b-5 due to the Company’s inflated value of goodwill reported on their 10K filing during the first quarter 2008. In essence, they alleged that if the defendant knew the goodwill was impaired by $10 billion on October 10, they knew or should have known it sooner.

In more precise terms, plaintiffs alleged that "CBS knowingly and/or recklessly issued false and misleading financial statements during the Class Period that were not prepared in accordance with GAAP and thus, as a matter of law, violated the Exchange Act by committing securities fraud." Plaintiffs claim defendants “repeatedly and misleadingly highlighted the ‘strong’ and ‘pristine’ nature of CBS’s balance sheet throughout the Class Period, despite strong downward sales trends.” Therefore CBS was materially overstating its income, goodwill and intangible assets.

CBS’ 10-Q statement for the first quarter of 2008 reflected a book value far exceeding the market capitalization, which in the plaintiff’s view was a red flag that goodwill had been impaired. Due to this gap, plaintiffs claimed that the Company should have followed the SFAS 142 28 guidelines and conducted an intra-annual impairment test of goodwill. They claimed that if the test had been performed in early 2008, the Company's goodwill would have been deva lued thereby avoiding a write down in October 2008 causing the stock to plummet 20% in one day. Instead the stock price was artificially inflated and based on the SEC filings mislead purchasers such as the plaintiffs into purchasing the stock.

SEC regulations state that 10K and 10Q reports that are not prepared in accordance with FASB are presumed to be misleading or inaccurate. (SEC Regulation S–X, 17 C.F.R. § 210.4–01(a)(1) The plaintiff alleged that CBS 10Q for the first quarter were not in accordance with FASB standards in that CBS failed to conduct an intra-annual test for goodwill impairment as required and therefore the value of goodwill was materially misleading.

The chart (Table 1) provides the numbers the plaintiff relies on for the theory that the difference between stockholder's equity and market capitalization was ignored by CBS and therefore the basis for the fraud claim.

CBS attributed the decline in market capitalization in the first quarter of 2008 to the lower than expected advertising for Super Bowl XLII and the NCAA Men's Basketball Tournament, as well as the impact of television and radio station divestitures. Similarly its second quarter 10-Q filing reported the negated impact of the June 30, 2008 acquisition of CNET.

On October 10, 2008, CBS announced it had undergone impairment testing due to continued economic slowdown and decline in advertising spending. In Form 10-Q filed on November 4, 2008, CBS reported a non-cash impairment charge to goodwill of $10.99 billion.

The charge represented 48% decrease in goodwill of the Company. As a result of the disclosure of the write down CBS stock price dropped from $10.14 to $8.10. Plaintiffs contended that CBS was aware of the decline in goodwill in early 2008 due to the decreased price in market capitalization and this should have triggered and intra-annual impairment test. The legal theory of *res ipsa loquitur* ("the thing speaks for itself") comes to mind.

Plaintiffs allege that the defendants, including CBS and several of its directors, recklessly disregarded the standards set forth in SFAS 142, which requires interim testing where book value radically exceeds market value. The claim is that the defendants were motivated not to perform the impairment test so as to prevent the trigger of a debt CBS owed.
The Court's View: A Violation of Accounting Rules is Not Necessarily Actionable

The Securities Act and Securities Exchange Act were enacted to maintain public confidence in the marketplace and protect investors against securities fraud. (15 U.S.C.A. §77a, 15 U.S.C.A. §78a et seq) The test for whether a statement is materially misleading under section (b) is “whether the defendants’ representations, taken together and in context would have mislead a reasonable investor.” 

McMahan, (900 F.2d at 579) Plaintiffs’ complaint set forth quotations from defendant’s quarterly reports and other public statements alleged to be were materially false and misleading.

However, a key element to be alleged in the complaint brought section 10(b) and Rule 10b-5, is that the defendant made a false statement or omitted a material fact, with scienter, i.e. a knowledge of the fraud or a reckless disregard of the truth. (San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., 75 F. 3d 801, 808 (2d Cir. 1996) Plaintiff’s alleged that because defendants acted or failed to act despite their knowledge of the gap between the market value and the stockholder's equity, they had adequately alleged scienter.

The district court granted the defendant’s motion to dismiss the Plaintiff’s amended complaint for failure to allege facts supporting their claim with the particularity as required by Rule 9(b) and the Private Securities Law Reform Act of 1995.

The Court concluded that the complaint failed to specify a particular fraudulent concealed event or fact, unknown to the public, which would have prompted a company to test for impairment. The SEC filings as well as the market capitalization numbers were available to the public and therefore the plaintiff's gap theory was never concealed by the defendant. There can be no fraud if the information is public. The court also noted that the plaintiff relies on the difference between the stockholder's equity and market capitalization as a triggering event as articulated in GAAP that necessitates intra-annua l impairment testing. However, the court concluded that GAAP provides guidelines and does not mandate intra-annual testing. The plaintiff never claimed a SEC regulation had been violated. Also, in the Court's

<table>
<thead>
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<th>Time Period</th>
<th>Shareholder’s Equity</th>
<th>Market Capitalization</th>
<th>Goodwill</th>
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<td>2007 10K</td>
<td>21.47</td>
<td>18.67</td>
<td>18.45</td>
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<td>1st Quarter '08 10Q</td>
<td>21.66</td>
<td>15.03</td>
<td>18.48</td>
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<td>Quarter ending period 3/31/08</td>
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<td>2nd Quarter '08 10Q</td>
<td>21.9</td>
<td>13.27</td>
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<td>Quarter ending 6/30/08</td>
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<td>3rd Quarter '08 10Q</td>
<td>9.17</td>
<td>9.91</td>
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view the company statements were merely estimates of the value of goodwill. It noted that goodwill is measured by individual reporting units at different times in the year and not a single calculation for the entire enterprise. Finally, because the plaintiffs relied on the difference in value of the stockholder's equity and market capitalization, the Court questioned the plaintiffs’ theory of why the drop in the first quarter of 2008 necessitated a test for impairment of goodwill when in fact there was a drop at the end of 2007. Plaintiffs were never able to articulate a precise moment in time when they believed goodwill had been impaired.

With regard to scienter, the legal standard is that a “reasonable person [must] deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.” The court found the plaintiffs did not satisfy this requirement.

On appeal, the Court of Appeals for the Second Circuit affirmed the district court’s decision. The Second Circuit refers to its earlier decision in Fait v. Regions Fin. Corp. 655 F. 3d. 105, 112 that the plaintiff’s must “plausibly allege that the defendants did not believe [emphasis added] the statements regarding goodwill at the time they made them.”

Where Does This Leave Investors and Reporting Companies?

So where does this leave the investor who relied on the company's filings as to the value of goodwill? The 10K and 10Q still provide the window into a company’s financial well being. A savvy investor would be wise to form his or her own conclusions of the value of goodwill when there is a difference in shareholder equity and market capitalization. The CBS Court refused to find fraud when the information was not concealed and available to the public. And finally after the initial purchase of a company, courts have recognized that the value of goodwill is an opinion and should be regarded as such, thereby giving almost not cause of action based on company statements.

An investors' section 10(b) or 10b-5 claim relying on violations of SEC regulations, or even a more tenuous failure to follow GAAP guidelines is not assured of success. The SEC was created to regulate the securities industry and thereby provide the public with confidence in investing, not to provide investors with a private right of action for violations of GAAP or, even SEC rules and regulations. GAAP standards have been accepted by the SEC in an attempt to give an investor confidence in the accuracy of 10Ks and 10Qs. In the present case, the plaintiffs were unable to plausibly allege company fraud by reason of an inflated goodwill value despite the company's refusal to follow the SFAS guidelines. The SEC never brought an action against CBS. The SEC acknowledges GAAP standards but does not accept them as a bright-line test. Courts do not accept that any and all violations of SEC rules and regulations give rise to a private right of action or a section 10(b) or rule 10b-5 claim.

The plaintiffs in CBS were unable to adequately allege their case through the company's many optimistic statements as compared to later lower numbers reported to the investing public. Although not expressly relied upon by plaintiffs, there is the underlying supposition that such a significant drop in goodwill must have been previously known to the company since there was no triggering event. At this time, courts seem reluctant to make the leap that a write-down of goodwill because of a sea change in customer preferences or competitive conditions necessarily means the officers and directors knew that such a write-down would become necessary at an earlier point in time. Section 10(b) and Rule 10b-5 remain anti-fraud provisions as to which res ipsa loquitur and other negligence doctrines have no place.

REFERENCES


Rule 9(b) Fed.R.Civ.P. requires a plaintiff to allege fraud with particularity which has been practically interpreted to require the plaintiff to 1) specify the statements that the plaintiff contends were fraudulent,
(2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent. In addition the plaintiff must allege facts giving rise to a strong inference of recklessness or intent to deceive. In order to satisfy the fraudulent statement I’ll check that this isn’t scienter requirement, “a complaint may (1) allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness [emphasis added], or (2) allege facts to show that defendant had both motive and opportunity to commit fraud.” Rothman v. Gregor, 220 F.3d 81, 90 (2d Cir. 2000).

SFAS 142 28
A reporting unit is a component part of a company working independently and having separate incomes and expenses which is recorded and regularly reviewed by management.

Statement of Financial Accounting Standards (SFAS) No. 141
Those standards are recognized as authoritative by the Securities and Exchange Commission (SEC) and were reaffirmed in its April 2003 Policy Statement.
Information can be accessed at http://www.nielsen.com/us/en/insights/top10s/television.html as of 10/2/12
The Finance Committee of the Board and Financial Performance: A Resource Dependence Perspective

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This study examines whether properly staffed board-level finance committees improve firm performance. Using a sample of US firms, directors are categorized using resource dependence taxonomy. Hypotheses related to firm performance are formulated and metrics including accounting measures, stock market performance, and long-term investments tested. There is some support that firms with a finance committee showed greater Jensen productivity measures. The evidence also suggests that finance committees are most effective in improving performance when staffed with top management from publicly traded companies and investment or commercial bankers. Consistent with others, we find little association between firm performance and overall board composition.

A common question that arises in studies of corporate governance focuses on the relation between board composition and firm performance, particularly whether the presence of outside, independent directors improves the financial metrics upon which investors make decisions. Agency theory (Fama, 1980; Jensen & Meckling, 1976) provides theoretical support that independent board members should be better at monitoring management than management-directors themselves, thus forcing management to maximize shareholder wealth rather than managers’ own utility. According to John Biggs, CEO and chairman of TIAA-CREF (Biggs, 1995), more effective control should result in better firm performance. However, most studies find little or no correlation between board composition and various measures of performance (Baysinger & Butler, 1985; Bhagat & Black, 1999; Dalton, Daily, Certo & Roengpitya, 2003; Dalton, Daily, Ellstrand & Johnson, 1998; Hermalin & Weisbach, 1991; Mehran, 1995).

Much of the board literature has focused upon the oversight function whereby directors ratify management decisions and monitor their implementation (Baysinger & Butler, 1985; Baysinger & Hoskisson, 1990; Daily & Dalton, 1992; Fama & Jensen, 1983). Board responsibilities also include hiring, advising and/or terminating the CEO (Lorsch & MacIver, 1989; Warner, Watts & Wruck, 1988; Weisbach, 1988), acting as an important link to information and resources (Pfeffer, 1972; Pfeffer & Salancik, 1978; Zald, 1969), and assisting the CEO in the development of a strategic plan (Harrison, 1987; Nicholson & Kiel, 2004; Zahra & Pearce, 1989). It may be that the insiders, outsiders or affiliates classification method employed in the agency literature is useful for examining separation of ownership and control, but determining whether outside board members contribute strategically requires other approaches (Hillman, Cannella & Paetzold, 2002; Peng, 2004).
Pfeffer (1973) and Pfeffer and Salancik (1978) proffer a resource dependence perspective that directors are a resource used to allay environmental uncertainty, either when acting as counsel to provide information from insights based upon specialized knowledge and experience or when helping to acquire critical resources via their ties to other firms and stakeholders. In comparison to agency theory, empirical evidence to date suggests resource dependence theory “is a more successful lens” (Hillman, Withers & Collins, 2009, p. 1408) for understanding boards, and Peng (2004) suggests resource dependence theory may be particularly useful in examining the relationship between outside directors and firm performance.

In order to oversee the firm’s long-term investment strategy (Fama & Jensen, 1983; Zahra & Pearce, 1989), many boards have voluntarily established finance committees to assist them in discharging their responsibility for financial strategy and capital investments (Anderson & Anthony, 1986; Klein, 1998). Committees, in doing their work, meet separately and make recommendations for approval by the full board. Thus, meaningful policy input comes most frequently from the relevant committees’ members, rather than from board members who are not on the committee (Anderson & Anthony, 1986; Braiotta & Sommer, 1987). One might surmise that value-maximizing firms will staff finance committees either with insiders, who possess an employee perspective on the firm as Klein (1998) asserts, or with board members possessing financial expertise, experience and/or connections to the financial community. Therefore, examining whether finance committees, and the directors thereon, add value from the resource dependence perspective provides an important extension to the literature.

In this paper, we examine questions related to the composition and efficacy of corporate boards’ finance committees as related to firm performance using a sample of large United States firms. Specifically, we develop and test hypotheses related to whether the existence of a finance committee is associated with firm performance and whether the composition of the finance committee, categorized from a resource-dependence perspective, adds value. This study extends Klein’s (1998) prior work by examining a post-Sarbanes Oxley sample and by refining the measures of director backgrounds to include resource-dependence roles.

COMMITTEES OF THE BOARD

Committees provide the means, opportunity and structure that enable members to perform their fiduciary and other corporate governance duties as well as satisfy public demand for increased corporate accountability. Lorsch and MacIver (1989) argue that committees enable directors to better use their time when dealing with complex information. “Through these committees board members may probe into important areas of corporate concern more deeply than would be possible in a full board meeting” (Harold M. Williams, President & CEO, J. Paul Getty Trust [former chairman, Securities and Exchange Commission; former dean, Graduate School of Management, University of California at Los Angeles], in Braiotta & Sommer, 1987, p. xi – xii). Committees are also where much of the board’s work is, or should be, done (Anderson & Anthony, 1986).

There are two general types of committees (Braiotta & Sommer, 1987; Harrison, 1987). The audit, compensation and nominating committees, traditionally staffed with independent outsiders, comprise the first type. The principal reason for their existence is monitoring or control. The other group, the so-called management support or operating committees, provides advice to management and the board and, more specifically, include finance and executive committees. Membership generally consists of a mixture of insiders and outsiders (Harrison, 1987).

Klein (1998) argues that directors add value depending upon committee assignment and that committee membership acts as proxy for their duties on the board. Her intuition is insiders possess the specialized expertise and accumulated in-house experience necessary to evaluate and to ratify the firm’s long-term investment strategies, thus will be selected to serve on finance committees, whereas outside directors make better monitors and can more positively affect firm performance by sitting on audit or compensation committees. Her results show a significant and positive association between the percentage of inside directors on finance and investment committees and accounting and stock market measures even though she reports no significant relation between the percentage of insiders and firm performance as a
whole, and she shows no significant relation between the existence of a board-level finance committee and firm performance.

Two extensions of Klein’s work are pertinent to this study. First, she uses an agency theoretic approach to classify directors as insiders or outsiders/affiliates instead of a resource dependence approach which may provide new insights. Second, her work predates important legislation leading to boards and, by extension, committees predominantly staffed by outside board members. Following passage of the Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes Oxley), U.S. stock markets added rules pertaining to director independence and committee structure for publicly-traded companies. For companies traded on the New York Stock Exchange and the NASDAQ, listed companies must have a majority of independent directors. In other words, boards should be composed primarily of members or outsiders without personal, professional or familial ties to the corporation and its suppliers or affiliates of management. Moreover, nominating/corporate governance, compensation and audit committees must be composed entirely of independent directors (NASDAQ, 2003; NYSE, 2003), although NYSE Section 303A Corporate Governance Rules gave listed companies until their first annual meeting after June 30, 2005, to replace a director who would not be considered independent under proposed revisions to an “immediate family member” test in §303A.02(b)(iii).

It is not required that firms have a finance committee, nor are there any requirements related to staffing such a committee. That leads to the first of two hypotheses. First, a wealth-maximizing firm should have a finance committee only if it improves firm performance. Thus,

\[ H1: \text{The existence of a board-level finance committee has a positive impact on the firm’s financial performance.} \]

Second, the agency theory on which Klein (1998) bases her arguments suggests a strong management presence on finance committees. However, post-Sarbanes Oxley boards are increasingly staffed with outside members. Outside directors should be appointed to the finance committee only if they add value, as the committee itself and outsiders’ presence on the committee are both optional. If committee assignment provides insight into the directors’ role, and directors are elected because of their human capital and relational capital as resource dependence theory asserts, then finance committees should be staffed by members either known for their business/financial acumen (i.e., human capital) or their connections to the investment community (i.e., relational capital). The second hypothesis tests the likelihood of employee-directors vis-à-vis the resource dependence composition of the other board members comprising the finance committee. Hypothesis two states:

\[ H2: \text{There is a stronger likelihood that the membership of the finance committee will consist of outsiders known to possess financial expertise or connections rather than insiders with their more intimate knowledge of the firm.} \]

DIRECTORS AS A RESOURCE

In addition their fiduciary responsibilities and their role in reducing agency costs, directors also contribute knowledge and skills; information, counsel and advice; and links to the broader community. Such individuals bring diverse attributes, individual expertise and organizational experiences to the boardroom (Baysinger & Butler, 1985). In keeping with these other contributions, Pfeffer (1973) and Pfeffer and Salancik (1978) proffer a resource dependence perspective on board composition, in which individuals are nominated for their human capital (e.g., experience, expertise and reputation) and relational capital, linkages to other individuals and organizations (Hillman & Dalziel, 2003). As a provider of resources, the board helps reduce the organization’s reliance upon external factors and betters the firm’s response to contingencies arising within its environment and among its stakeholders.

The provision of resources lessens organization uncertainty, which should translate into improvements in firm performance (Hillman & Dalziel, 2003). Pfeffer (1972; 1973) argues that
companies confronting increased environmental uncertainty have greater need for effective external linkages, thus should have larger boards and higher ratios of outside directors. Using a meta-analysis approach of 27 prior studies with a total of 131 samples, Dalton, Daily, Johnson and Ellstrand (1999) show a positive relationship between board size and financial performance after controlling for firm size, board independence, and financial and market performance. Dalton et al. (1999) do not suggest big is better, but rather larger boards allow for multiple members to satisfy duties and responsibilities related to control, advice and counsel, and providing resources. The question arises as to what size is sufficient to lever these multiple roles. Yet, the trend is towards smaller rather than larger boards (Korn Ferry, 2008) even as environmental uncertainty increases with increases in the pace of technological change, globalization, and regulation. Hence, board size seems too simplistic a metric for judging resource dependence theory (Boyd, 1990; Pearce & Zahra, 1992).

Analyses of the correlation between board composition and financial performance are also consistent with resource dependence theory. The question arises whether there is some mixture of insiders, affiliate directors and independent outsiders that leads to superior firm performance as a consequence of the board’s independence from management. Dalton, Daily, Ellstrand and Johnson (1998), again using a meta-analysis approach of 54 studies of board composition, find little systematic evidence of board structure and performance. Although their arguments arise from agency theory, Bhagat and Black (1999; 2002) similarly report that there is no convincing evidence to suggest that board independence is consistently correlated with firm profitability or growth. However, Zahra and Pearce’s (1989) literature survey suggests some evidence showing a relationship between board composition and financial performance, but note that composition seems complicated by other board attributes and roles.

Boyd (1990) argues that it is the number of interlocks (other directorships) held that should be the focus in studies of board composition. In other words, it is the type of directors sitting on the board. But that would suggest more focus on the director’s business and social network (Koenig & Gogel, 1981) than the human capital contribution. Pfeffer and Salancik (1978) suggest that directors, having demonstrated the competence necessary to supply or to access critical resources vital to the firm’s success, bring four benefits to the organization. Outside directors act as boundary spanners – providing expertise and resources for managing external environmental factors, including 1) strategic advice and expertise; 2) communication channels to external organizations; 3) support from important elements outside the firm; and 4) legitimacy (Pfeffer, 1973; Pfeffer & Salancik, 1978). Insiders possess firm-specific information focused on internal problems and constraints (Fama & Jensen, 1983).

Based on these benefits, Hillman, et al., (2002) categorize directors as insiders, business experts, support specialists, and community influencers to show that U.S. airlines, following deregulation and facing added uncertainty related to increased competition and customer demand, altered the composition of their boards. As directors needed replacement, airlines shifted away from insiders, who were deemed necessary to satisfy the boards and the regulatory agency’s demand for information, and towards support specialists and those individuals with community influence and prestige. Adapting Hillman’s, et al. (2002) taxonomy to a sample of IPOs, Kroll, Walters and Le (2007) show young firms benefit when directors consist of original top management team members (insiders) and business experts selected to provide advice and counsel. Jones, Makri and Gomez-Mejia (2008) show that business expert and support specialist board members encourage family-owned companies to pursue growth via diversification. Mizruchi and Stearns show that the presence of directors associated with financial institutions increases borrowing (1994) and the types (1993) of financial institutions represented on boards are associated with the amounts and types of financing firms obtain. To summarize, the resource dependence empirical research has evolved to identifying particular types of directors, who match specific environmental needs, then examining their impact on the organization.

Resource dependence theory suggests outside directors are valued not only for their role as monitors but also for the experience, expertise, and guidance they provide. This viewpoint is consistent with movement towards more independent (of the CEO) boards as required by Sarbanes-Oxley, stock exchange requirements, and the desires of institutional investors. Whether directors strive to satisfy the needs of other constituencies in addition to maximizing shareholder wealth has not been extensively
studied (Hillman & Dalziel, 2003). We first examine whether a relationship exists between financial performance and the composition of the board as a whole, measured in terms of the director’s specific linkage to other businesses, suppliers or the community. We hypothesize:

**H3**: The composition of the board of directors, based on the members’ resource dependence role, has a positive impact on the company’s financial performance.

Dalton, et al. (1999, p. 682) states, “Another potentially interesting extension (of resource dependence theory) may include board committees.” Others have noted that much of the work is done in committee and not the board-at-large (Bilimoria & Piderit, 1994; Harrison, 1987; Kesner, 1988; Lorsch & MacIver, 1989; Peterson & Philpot, 2007; Peterson, Philpot & O’Shaughnessy, 2007). Bearden (1986) documents Singer Sewing Company’s ties to financial institutions with directors specifically chosen by the CEO for their close personal relationships with the banking community when staffing the newly created finance committee. This action by Singer’s CEO is consistent with Klein’s (1998) assertion that it is not board composition per se that affects financial performance but rather how the board uses committee membership that determine its effectiveness. Accordingly,

**H4**: The composition of the finance committee, based on the members’ resource dependence role, has a positive impact on metrics of the company’s financial performance.

**METHOD**

**Data and Sample**

We sample the 2002 Fortune 500 list of United States largest companies, based on prior year gross revenues. Most companies in the sample are publicly held including 421 that list on the New York Stock Exchange, 53 on the NASDAQ, 3 that trade on the American Stock Exchange, and 23 that were either privately or mutually-owned, merged or acquired during the time period between inclusion in the Fortune 500 and release of proxy materials, or fell into bankruptcy and liquidation. In addition to these 23, missing data omits another 116 companies including the 23 banks for which Compustat does not provide cash flow information. The final sample consists of 361 companies.

To assess the degree to which financial performance depends upon the resource dependence role directors fulfill, we construct a classification/taxonomy matrix suggested by Pfeffer and Salancik (1978) and Hillman, et al., (2002). We randomly selected 1,667 directors (30% of 5,500). Biographical information of individuals preceding their election to the board as reported in proxy statements was read and categorized by each author. Differences in opinion were reconciled with help from faculty not associated with the project. The data in Table 1 show that our sample includes 251 (15.1%) insiders, 700 (42.0%) business experts, 417 (25.0%) support specialists, and 299 (17.9%) community influential board members.

Further delineation shows the sample includes 45 founders or family members and 206 management directors. Nominating committees apparently value business expertise as the plurality (700; 42.0%) of directors comes from within the corporate ranks, especially CEOs from publicly (228) and privately (169) traded companies. Twenty-five percent of directors are support specialists with almost half of those (45.5%) possessing expertise in investment (139) or commercial banking (51). Another 40.7% have backgrounds in government (104) or the legal community (66). University faculty and administrators and research institute employees (177) dominate directors selected for their community ties.
TABLE 1
THE RESOURCE DEPENDENCE ROLE OF U.S. FORTUNE 500 DIRECTORS, 2002 (N = 1667)

<table>
<thead>
<tr>
<th>Taxonomy</th>
<th>Classification</th>
<th>N</th>
<th>Classification</th>
<th>Taxonomy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insiders</td>
<td>Founder or family</td>
<td>45</td>
<td>17.9%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Management</td>
<td>206</td>
<td>82.1%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Subtotal</td>
<td>251</td>
<td></td>
<td>15.1%</td>
</tr>
<tr>
<td>Business Experts</td>
<td>CEO public company</td>
<td>228</td>
<td>32.6%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Management publicly traded company</td>
<td>237</td>
<td>33.9%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>CEO privately held company</td>
<td>169</td>
<td>24.1%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Management privately held company</td>
<td>33</td>
<td>4.7%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Management foreign company</td>
<td>33</td>
<td>4.7%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Subtotal</td>
<td>700</td>
<td></td>
<td>42.0%</td>
</tr>
<tr>
<td>Support Specialists</td>
<td>Investment banking / money management</td>
<td>139</td>
<td>33.3%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Commercial banking</td>
<td>51</td>
<td>12.2%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Legal</td>
<td>66</td>
<td>15.8%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Government</td>
<td>104</td>
<td>24.9%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Public relations, affairs or advertising</td>
<td>14</td>
<td>3.4%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Non-university industry specialists</td>
<td>43</td>
<td>10.3%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Subtotal</td>
<td>417</td>
<td></td>
<td>25.0%</td>
</tr>
<tr>
<td>Community Influential</td>
<td>University or research institute</td>
<td>177</td>
<td>59.2%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Management non-profit organization</td>
<td>26</td>
<td>8.7%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Medical services or foundation</td>
<td>24</td>
<td>8.0%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Philanthropy or community foundation</td>
<td>26</td>
<td>8.7%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Historical or cultural organization</td>
<td>11</td>
<td>3.7%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Community leader</td>
<td>35</td>
<td>11.7%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Subtotal</td>
<td>299</td>
<td></td>
<td>17.9%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>1667</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

We examine finance committees in the year Sarbanes-Oxley was enacted and report committee membership on executive, nominating, compensation, auditing, and public affairs for comparison purposes in Table 2. We find 174 of the sampled 361 (48.2%) Fortune 500 boards included a finance committee in 2002 with an average membership of 5.2. In comparison, Heidrick (1985) reported that 53.7 percent of 520 companies had finance committees in 1981. Klein (1998) shows 201 (202) finance committees for firms listed on the S&P 500 in 1992 (1993) with an average number of 5.5 committee members. Klein’s classification system shows 21.8 (18.8) percent insiders, 59.2 (61.7) percent outsiders, and 19.0 (19.5) percent affiliates held finance committee seats in 1992 (1993). The sampling distribution amongst finance committee members using the Pfeffer Salancik (1978) taxonomy is 37 (11.2%) insiders, 135 (40.9%) business experts, 106 (32.1%) support specialists, and 52 (15.8%) community influential. The proportions – 14.2% insiders, 45.5% business experts, 30.5% support specialists, and 9.8% community influential – are similar for the population of companies whose boards of directors include a finance committee. Over the 10 year period from Klein’s to ours, finance committee membership shifted
towards fewer insiders and more affiliates/support specialists with outsiders/business experts plus community influential proportions remaining about equal.

The number of directors on the board as a whole also shrank from 12.3 to 11 (Klein (1998) vis-à-vis our sample) and the number of insiders (management-employees along with founders and family members) sitting on nominating (11.5% to 4.8%), compensation (4.0% to 3.1%) and audit (1.4% to 1.6%) committees decreased from 1992 to 2002. In addition to the finance committee, membership is not regulated for the executive and public affairs committees. Kenny (2004) notes both a diminished role and decline of executive committees among Fortune 500 companies. The public affairs group represents a collection of committees charged with a variety of charitable, social, philanthropic and/or environmental issues.

### TABLE 2

**BOARD AND COMMITTEE COMPOSITION FOR 2002 FORTUNE 500 FIRMS**

<table>
<thead>
<tr>
<th></th>
<th>Board</th>
<th>Executive</th>
<th>Nominating</th>
<th>Compensation</th>
<th>Audit</th>
<th>Finance</th>
<th>Finance (Pop.)</th>
<th>Public Affairs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insiders ²</td>
<td>251</td>
<td>97</td>
<td>29</td>
<td>18</td>
<td>11</td>
<td>37</td>
<td>127</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>15.1%</td>
<td>29.6%</td>
<td>4.8%</td>
<td>3.1%</td>
<td>1.6%</td>
<td>11.2%</td>
<td>14.2%</td>
<td>6.7%</td>
</tr>
<tr>
<td>Business Experts</td>
<td>700</td>
<td>116</td>
<td>281</td>
<td>313</td>
<td>350</td>
<td>135</td>
<td>408</td>
<td>91</td>
</tr>
<tr>
<td></td>
<td>42.0%</td>
<td>35.4%</td>
<td>46.6%</td>
<td>54.7%</td>
<td>50.1%</td>
<td>40.9%</td>
<td>45.5%</td>
<td>36.1%</td>
</tr>
<tr>
<td>Support Specialists</td>
<td>417</td>
<td>80</td>
<td>156</td>
<td>133</td>
<td>198</td>
<td>106</td>
<td>274</td>
<td>79</td>
</tr>
<tr>
<td></td>
<td>25.0%</td>
<td>24.4%</td>
<td>25.9%</td>
<td>23.3%</td>
<td>28.4%</td>
<td>32.1%</td>
<td>30.5%</td>
<td>31.3%</td>
</tr>
<tr>
<td>Community Influential</td>
<td>299</td>
<td>35</td>
<td>137</td>
<td>108</td>
<td>139</td>
<td>52</td>
<td>88</td>
<td>65</td>
</tr>
<tr>
<td></td>
<td>17.9%</td>
<td>10.7%</td>
<td>22.7%</td>
<td>18.9%</td>
<td>19.9%</td>
<td>15.8%</td>
<td>9.8%</td>
<td>25.8%</td>
</tr>
<tr>
<td>Total</td>
<td>1667</td>
<td>328</td>
<td>603</td>
<td>572</td>
<td>698</td>
<td>330</td>
<td>897</td>
<td>252</td>
</tr>
</tbody>
</table>

Note: Committee membership not mutually exclusive.

**Model**

Standing committees play an important role in corporate governance, as most work is done at this level and then forwarded to the board for additional consideration (Anderson & Anthony, 1986). Finance committees review and recommend financing, dividend, investment, and risk management plans and policies of the company and its relationship to the financial community (Braiotta & Sommer, 1987). For example, Altria’s finance committee is charged with monitoring:

"the Company’s financial condition, oversees the sources and uses of cash flow and the investment of certain employee benefit plan assets and advises the Board with respect to financing needs, dividend policy, share repurchase programs and other financial matters”
(Source: Altria Group, Inc., DEF 14A, April 24, 2008).

The model and variables are estimated with an OLS regression used to examine the cross-sectional relation between board composition and various metrics of firm performance. Following Klein (1998), three separate measures of performance are analyzed. The Jensen Productivity [JPROD] metric measures the corporation’s investment strategies and the productivity of its long-term assets (Jensen, 1994). It equals the change in the market value of the firm’s equity less a benchmark return on investment; the latter defined as the change in net property, plant and equipment times an estimated eight percent cost of capital (Jensen, 1994). The JPROD metric is deflated by sales. Market profitability is measured as annual
total return [MKRTX] including the effects of cash equivalent distributions. Our accounting measure of profitability is the ratio of operating margin before depreciation [OMBD] as a percentage of net sales.

Proxy statements delivered in 2002 report committee membership in 2001. To the extent that committee members recommend changes in financial policy, it is unlikely that the effect will be immediately reflected in the performance metrics. Thus, the relation between the dependent variables and these metrics are computed for 2002.

The OLS model is defined as:

\[
\text{Performance Metric} = \beta_0 + \beta_1 \text{FCOM} + \beta_2 \text{INVCF} + \beta_3 \text{FINCF} + \beta_4 \text{DVPOL} + \beta_5 \text{DSE} + \beta_6 \text{INSDR} + \beta_7 \text{BSXPRT} + \beta_8 \text{SUPSPC} + \beta_9 \text{BETA} + \beta_{10} \text{INST\%} + \beta_{11} \text{LMCAP}.
\]

FCOM is a dummy variable that equals 1 if a finance committee exists and 0 otherwise. If finance committees provide value above and beyond the guidance the board provides management towards maximizing stockholder wealth, realizing a significant and positive coefficient would be consistent with the first hypothesis.

Finance committee members are responsible for providing financial guidance, monitoring cash flows, dividend policy, and financing (Braiotta & Sommer, 1987). INVCF and FINCF are the net cash flows from investing and financing, respectively, deflated by sales (Klein, 1998). Cash dividends are omitted from financing cash flows given the usual historical stability of the payment. However, changes in dividend policy are the committee’s responsibility. DVPOL is a categorical variable equaling 1 when dividend policy changes due to the origination and -1 when dividend policy results in the cessation of cash dividends; 0 otherwise. Financial leverage, DSE, is measured as the ratio of long term debt to equity. Financial variables were obtained from S&P’s Compustat data base.

Explanatory variables include a categorization of directors based on their perceived resource dependence role (Hillman, et al., 2002; Hillman, Keim & Luce, 2001). Peterson and Philpot (2007) and Peterson, et al., (2007) report that committee composition varies based upon the role directors play as stakeholders. We compute the proportion of resource dependent classifications by firm and differentiate insiders (INSDR), business experts (BSXPRT), and support specialists (SUPSPC). In the results shown below, community influential directors are included in the estimate for the intercept because of the unit sum constraint in regression procedures. To the extent that board and committee composition matters, we would expect to find significant and positive parameter estimates for these variables.

Financial institutions have been shown to play an important role in corporate governance (Useem, Bowman, Myatt & Irvine, 1993). Unlike individual investors, who may show disapproval of firm policies or performance by selling their holdings, institutional investors can actively force change in the boardroom rather than incur large costs when management pursues its own interests (Davis & Thompson, 1994; Useem, et al., 1993). Carleton, Nelson and Weisbach (2002) found that TIAA-CREF’s concerns about governance led to private correspondence between itself and 45 companies that subsequently resulted in positive changes in 87% of the targets. Smith (1996) analyzing CalPERS’ effectiveness at shareholder activism, reports stock prices improved but there were no significant improvements in operating performance and alternative accounting measures for companies targeted. Thus, institutional ownership INST\%, measured as the proportion of institutional investors to shares outstanding as reported in Standard \& Poor’s Security Owner’s Stock Guide, June 2002, is included.

The model includes two variables to control for variability in company characteristics. BETA is obtained from a market model regression using company and S&P500 monthly returns including dividends for the preceding five year time period. The natural log of market capitalization LMCAP is used to measure corporate size.

Variable means and standard deviations are reported in Table 3. Sample companies average $10.8 billion in 2001 revenues. Sixty-four (64) percent of shares outstanding are held by financial institutions. Mean beta measured 0.8. Both the Jensen Productivity and the market return metrics were negative, most likely due to the poor performance of the market in 2002 when the S&P500 declined 22.5%. However,
operating margin before depreciation is almost 19%. Investment and financial (excluding cash dividends) cash flows as a percentage of sales are 12% and 3%, respectively. Financial leverage, measured as long term debt to book equity, is almost 2.5. Six percent of the companies initiated or omitted cash dividends. Composition of the boards is 15% insiders, 42% business experts, 25% support specialists and 18% community influential. Forty-eight (48) percent of sample companies have a board finance committee.

### TABLE 3

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
<th>Mean</th>
<th>Stdev</th>
</tr>
</thead>
<tbody>
<tr>
<td>JPROD</td>
<td>Market value less 8% ROI (Change in PPE) deflated by sales</td>
<td>-0.28</td>
<td>0.67</td>
</tr>
<tr>
<td>MKRTX</td>
<td>Market return including cash distributions</td>
<td>-6.37</td>
<td>31.50</td>
</tr>
<tr>
<td>OMBD</td>
<td>Operating margin before depreciation</td>
<td>18.82</td>
<td>15.43</td>
</tr>
<tr>
<td>FCOM</td>
<td>Finance committee membership</td>
<td>0.48</td>
<td>0.50</td>
</tr>
<tr>
<td>INVCF</td>
<td>Investment cash flows deflated by sales</td>
<td>-0.12</td>
<td>0.30</td>
</tr>
<tr>
<td>FINCF</td>
<td>Financial cash flows deflated by sales</td>
<td>0.03</td>
<td>0.31</td>
</tr>
<tr>
<td>DVPOL</td>
<td>Dividend policy change: 1 origination, -1 cessation, 0 otherwise</td>
<td>0.06</td>
<td>0.23</td>
</tr>
<tr>
<td>DSE</td>
<td>financial leverage LTD/E</td>
<td>2.46</td>
<td>17.20</td>
</tr>
<tr>
<td>INSDR</td>
<td>Corporate insider</td>
<td>0.15</td>
<td>0.36</td>
</tr>
<tr>
<td>BSXPT</td>
<td>Business expert</td>
<td>0.42</td>
<td>0.49</td>
</tr>
<tr>
<td>SUPSPC</td>
<td>Support specialist</td>
<td>0.25</td>
<td>0.44</td>
</tr>
<tr>
<td>COMINF</td>
<td>Community influential</td>
<td>0.18</td>
<td>0.38</td>
</tr>
<tr>
<td>BETA</td>
<td>Beta</td>
<td>0.80</td>
<td>0.66</td>
</tr>
<tr>
<td>INST%</td>
<td>Institutional ownership</td>
<td>0.64</td>
<td>0.17</td>
</tr>
<tr>
<td>LMCAP</td>
<td>Market capitalization</td>
<td>16.20</td>
<td>1.40</td>
</tr>
</tbody>
</table>

### RESULTS

#### Findings and Discussion

The research question centers on whether the presence of a board-level finance committee adds value. T-tests for differences in mean values indicate that firms with finance committees realized a greater, albeit negative, Jensen productivity measure than firms without finance committees (JPROD -0.24 v -0.32; t = 2.15, pr 0.03). Market returns for 2002 were negative for both groups but the difference is not significant (MKRTX -4.82 v -8.85; t = 1.30, pr 0.20). Finally, 2002 operating margins were significantly better for those corporations whose boards includes a finance committee (OMBD 18.59 v 15.96; t = 1.78, pr 0.08). These results are consistent with hypothesis one that the existence of a finance committee affects financial performance.

A major goal for boards of directors is to maximize shareholder value through the efficient allocation and management of scarce resources. OLS model and parameter estimates are shown in Table 4. The Jensen Productivity metric measures the market’s perception of stockholder wealth creation. It measures management’s performance at realizing long-term asset productivity and the success of its investment strategies from one year to the next (Jensen, 1994). When JPROD is regressed on the explanatory variables, the coefficient on FCOM is not significant (t = 0.74). Thus, we do not find support for the first hypothesis that finance committees add value after controlling for other variables. There exists a positive relationship between the variability in JPROD and investment (t = 1.96) and financial (t = 2.27) cash flows and changes in dividend policy (t = 2.47). None of the board composition metrics are significant which suggests little support for hypothesis three.
Separate regressions are shown for companies whose boards of directors include (row 2) and do not include (row 3) a finance committee. The cash flow measures along with the proportion of insiders are significant and positive in explaining the Jensen metric when the board includes a finance committee. These results are consistent with a committee charged with overseeing the sources and uses of cash flows and that insiders on the committee play a prominent role in making investment and financing decisions. When the board does not include a finance committee, changes in dividend policy – i.e., dividend initiation or omission – are significant and the explanatory power of cash flows becomes insignificant. Even though the committee may be charged with advising the board with respect to dividends, the board as a whole makes the decision to change policy.

### TABLE 4

**OLS REGRESSION: COMMITTEE MEMBERSHIP AND RESOURCE DEPENDENCE**

<table>
<thead>
<tr>
<th>DEPENDENT VARIABLE</th>
<th>JPROD</th>
<th>MKRTX</th>
<th>OMBD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
</tr>
<tr>
<td></td>
<td>Full</td>
<td>w/ FC</td>
<td>w/o FC</td>
</tr>
<tr>
<td>INT</td>
<td>2.25</td>
<td>2.13</td>
<td>2.22</td>
</tr>
<tr>
<td></td>
<td>6.17***</td>
<td>3.70***</td>
<td>4.63***</td>
</tr>
<tr>
<td>FCOM</td>
<td>0.04</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td></td>
<td>0.74</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>INVCF</td>
<td>0.55</td>
<td>1.60</td>
<td>0.06</td>
</tr>
<tr>
<td></td>
<td>1.96*</td>
<td>3.16**</td>
<td>0.18</td>
</tr>
<tr>
<td>FINCF</td>
<td>0.61</td>
<td>0.95</td>
<td>0.23</td>
</tr>
<tr>
<td></td>
<td>2.27*</td>
<td>1.89*</td>
<td>0.68</td>
</tr>
<tr>
<td>DVPOL</td>
<td>0.11</td>
<td>0.04</td>
<td>0.15</td>
</tr>
<tr>
<td></td>
<td>2.47*</td>
<td>0.60</td>
<td>2.54*</td>
</tr>
<tr>
<td>DSE</td>
<td>0.00</td>
<td>0.04</td>
<td>0.00</td>
</tr>
<tr>
<td></td>
<td>1.31</td>
<td>1.13</td>
<td>1.16</td>
</tr>
<tr>
<td>INSDR</td>
<td>0.23</td>
<td>0.66</td>
<td>0.20</td>
</tr>
<tr>
<td></td>
<td>1.20</td>
<td>1.87*</td>
<td>0.87</td>
</tr>
<tr>
<td>BSXPRT</td>
<td>0.05</td>
<td>-0.33</td>
<td>0.18</td>
</tr>
<tr>
<td></td>
<td>0.36</td>
<td>1.36</td>
<td>1.00</td>
</tr>
<tr>
<td>SUPSPC</td>
<td>0.11</td>
<td>-0.11</td>
<td>0.20</td>
</tr>
<tr>
<td></td>
<td>0.70</td>
<td>0.38</td>
<td>0.99</td>
</tr>
<tr>
<td>BETA</td>
<td>-0.31</td>
<td>-0.41</td>
<td>-0.27</td>
</tr>
<tr>
<td></td>
<td>7.39***</td>
<td>5.26***</td>
<td>5.24***</td>
</tr>
<tr>
<td>INST%</td>
<td>0.25</td>
<td>0.44</td>
<td>0.21</td>
</tr>
<tr>
<td></td>
<td>1.53</td>
<td>1.61</td>
<td>1.02</td>
</tr>
<tr>
<td>LMCAP</td>
<td>-0.16</td>
<td>-0.14</td>
<td>-0.17</td>
</tr>
<tr>
<td></td>
<td>7.76***</td>
<td>6.04***</td>
<td>6.19***</td>
</tr>
<tr>
<td>F</td>
<td>12.92</td>
<td>8.16</td>
<td>8.07</td>
</tr>
<tr>
<td>R²</td>
<td>0.29</td>
<td>0.37</td>
<td>0.27</td>
</tr>
<tr>
<td>N</td>
<td>320</td>
<td>125</td>
<td>195</td>
</tr>
</tbody>
</table>

Student t-statistics shown below parameter estimate.

\* p < 0.10  \* \* p < 0.05  \* \* \* p < 0.01  \* \* \* \* p < 0.001

The FCOM parameter estimate is not significant when either MKRTX or OMBD are the performance metric. Total market return may be a noisy measure because it is more sensitive than the Jensen metric to investor enthusiasm. As recent events such as the technology and housing bubbles have shown,
speculators can push stock and asset prices to unsustainable levels followed by a rather abrupt fall that
takes down entire market sectors without regard to underlying values. Board and committee performance
should be evaluated based upon long-term strategies and performance and not necessarily the vagaries of
the market (Hillman & Keim, 2001). The inherent problem in any accounting metric like operating
performance is that as a measure it is short-term in nature (Briloff, 1981; Fisher & McGowan, 1983;
Hayes & Abernathy, 1980), focused upon historical performance (McGuire, Sundgren & Schneeweis,
1988), and can be manipulated by management (Bentson, 1982; Briloff, 1972; Watts & Zimmerman,
1978).

Hypothesis 3 focuses on the composition of the board with implications for company financial
performance. Prior work has generally been unable to find a positive relation between board composition
and firm performance using a variety of board classification schemes and data sets. Our intent in testing
firm performance vis-à-vis whole board composition is to validate similarities between our findings and
others and to provide a baseline upon which to compare tests of finance committee composition and
performance.

There is evidence that management (INSDR) has a significant and positive effect on JPROD (finance
committee) and MKRTX (full sample). Insiders may provide strategic guidance through their service on
the finance committee, a finding consistent with Klein (1998) and Baysinger and Hoskisson’s (1990)
argument that insiders may be better at strategic decisions than outsiders. However, the coefficients on
INSDR (full sample and no finance committee) and BSXPRT (no finance committee) are significant and
negative for OMBD. Most of the resource dependence variables are not significant which suggests that
board composition has little direct effect on firm performance, a finding consistent with prior empirical
studies (Bhagat & Black, 1999; 2002; Dalton, et. al., 1998).

Several other observations can be made. Both BETA and company size (LMCAP) are statistically
significant in explaining the variability in the productivity and accounting performance measurements.
Only beta contributes towards explaining market performance. Extant research in investments shows that,
on average, returns volatility and beta are inversely related to company size. Thus, the negative
coefficients suggest a stronger explanatory relationship between the three dependent variables and large
market cap, small systematic risk companies.

Our second hypothesis asks which group of board members helps set corporate financial strategy as
measured by the odds of finance committee membership. We used the resource dependence taxonomy
shown in Table 1 to classify all 2,112 directors from those 174 U.S. Fortune 500 boards including a
finance committee in 2002. The population consists of 399 (18.9%) insiders, 957 (45.3%) business
experts, 503 (23.8%) support specialists, and 253 (12.0%) influential community members. Logistic
regression is then used to predict the odds that finance committees will be staffed with business experts,
specialists, or community influential members (Hillman, et.al, 2002) after controlling for investment,
financing, and dividend policies (Braiotta & Sommer, 1987) and other firm characteristics. The model is:

\[
\text{FCOM} = f (\text{INVCF}, \text{FINCF}, \text{DVPOL}, \text{DSE}, \text{BSXPRT}, \text{SUPSPC}, \text{COMINFL}, \text{BETA}, \text{INST\%}, \text{LMCAP})
\]

with participation on the finance committee measured dichotomously – 0 representing membership and 1
non-membership.

The statistical procedure estimates the odds of a director being included on the finance committee
with odds defined as the ratio of the predicted probability of service to the predicted probability of not
serving. Parameter estimates for BSXPRT, SUPSPC and COMINFL measure the likelihood that an
outside board member from a particular group will sit on the committee. Odds increase with the
magnitude of the coefficient, ceteris paribus. The sign and significance of the intercept show the status of
insiders on committee membership. Partial regression coefficients indicate the direction and magnitude
of each variables influence, holding the others constant, on odds (Cohen, Cohen, West & Aiken, 2002).
Companies without a finance committee are excluded.
Parameter coefficients are reported in Table 5. The chi-square statistic showing model fit is significant indicating that parameter coefficients can be meaningfully interpreted. In the first model, significant and positive coefficients for BSXPRT and SUPSPC predict finance committees composed of business experts and support specialists. In the second model, insiders are substituted for community influential board members. The coefficient on INSDR is not significant suggesting that owners, family members, and management are not likely to find themselves seated on the committee.

### TABLE 5

**LOGISTIC REGRESSION: COMMITTEE MEMBERSHIP AND RESOURCE DEPENDENCE**

<table>
<thead>
<tr>
<th>DEPENDENT VARIABLE</th>
<th>FCOM MEMBER</th>
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</tr>
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<td></td>
<td>50.21***</td>
</tr>
<tr>
<td></td>
<td>-0.63</td>
</tr>
<tr>
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</tr>
<tr>
<td></td>
<td>-0.78</td>
</tr>
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<td></td>
<td>1.19</td>
</tr>
<tr>
<td></td>
<td>0.99</td>
</tr>
<tr>
<td>INVCF</td>
<td>1.88</td>
</tr>
<tr>
<td></td>
<td>11.53***</td>
</tr>
<tr>
<td></td>
<td>1.33</td>
</tr>
<tr>
<td></td>
<td>4.96*</td>
</tr>
<tr>
<td>FINCF</td>
<td>1.79</td>
</tr>
<tr>
<td></td>
<td>10.65***</td>
</tr>
<tr>
<td></td>
<td>1.26</td>
</tr>
<tr>
<td></td>
<td>4.37*</td>
</tr>
<tr>
<td>DVPOL</td>
<td>0.14</td>
</tr>
<tr>
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<td>3.05</td>
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<td></td>
<td>0.11</td>
</tr>
<tr>
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</tr>
<tr>
<td>DSE</td>
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<td>0.05</td>
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<tr>
<td></td>
<td>0.14</td>
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<tr>
<td>INSDR</td>
<td>---</td>
</tr>
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<td></td>
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<td>0.61</td>
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<tr>
<td>BSXPRT</td>
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<td></td>
<td>13.65***</td>
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<td>0.33</td>
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<tr>
<td></td>
<td>5.07**</td>
</tr>
<tr>
<td></td>
<td>0.48</td>
</tr>
<tr>
<td></td>
<td>10.88***</td>
</tr>
<tr>
<td>SUPSPC</td>
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</tr>
<tr>
<td></td>
<td>45.25***</td>
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<tr>
<td></td>
<td>0.81</td>
</tr>
<tr>
<td></td>
<td>25.66***</td>
</tr>
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<td></td>
<td>1.11</td>
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<td></td>
<td>45.93***</td>
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<tr>
<td>COMINFL</td>
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<td>0.61</td>
</tr>
<tr>
<td></td>
<td>---</td>
</tr>
<tr>
<td></td>
<td>0.24</td>
</tr>
<tr>
<td></td>
<td>1.41</td>
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<tr>
<td>BETA</td>
<td>0.09</td>
</tr>
<tr>
<td></td>
<td>1.25</td>
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<tr>
<td>INST%</td>
<td>-0.48</td>
</tr>
<tr>
<td></td>
<td>1.58</td>
</tr>
<tr>
<td>LMCAP</td>
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<td>0.18</td>
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<td>CHI-SQ</td>
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</tr>
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<td>NOBS</td>
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<tr>
<td>RESPONSE</td>
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<td>PUBCEO</td>
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</tr>
<tr>
<td>B2</td>
<td>0.48</td>
</tr>
<tr>
<td>PUBMGT</td>
<td>5.67*</td>
</tr>
<tr>
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<td>0.33</td>
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<td>PRVCEO</td>
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<tr>
<td>PRVMGT</td>
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<td>S1</td>
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<tr>
<td>IB</td>
<td>43.92***</td>
</tr>
<tr>
<td>S2</td>
<td>1.49</td>
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<tr>
<td>CB</td>
<td>30.58***</td>
</tr>
<tr>
<td>S3</td>
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<td>LEGAL</td>
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<td>S4</td>
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</tr>
<tr>
<td>GOVT</td>
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</tr>
<tr>
<td>S5</td>
<td>1.47</td>
</tr>
<tr>
<td>PR</td>
<td>5.77*</td>
</tr>
<tr>
<td>RESP</td>
<td>88.6***</td>
</tr>
<tr>
<td>LMCP</td>
<td>1573</td>
</tr>
<tr>
<td>LMCP</td>
<td>688</td>
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</tbody>
</table>

B1 and B2 are the proportions of public company CEOs and management; B3 and B4 are private company CEOs and management. S1 and S2 are investment and commercial bankers; S3 is legal (judges and lawyers); S4 is government (ex-politicians and regulators); and S5 is public relations specialists.

Wald $\chi^2$ statistic reported below parameter estimate.

* $p < 0.05$  
** $p < 0.01$  
*** $p < 0.001$

Results for the third model, consistent with models one and two, also suggest finance committees staffed with business experts and specialists after controlling for investment (INVCF) and financing (FINCF). These two variables are consistent with the duties and responsibilities for which the finance committee has been charged. Company factors BETA, INST% and LMCAP are not significant in
affecting the likelihood of committee membership. The fourth model further differentiates directors into business experts or support specialists using the taxonomy shown in Table 1. It shows that committee members are more likely to be CEOs and senior management of publicly traded companies or bankers. Surprisingly, public relations experts also sit on this committee.

Overall, the findings support hypothesis two that finance committee assignments fall to members possessing expertise in finance and lend additional support to Mizruchi and Stearns (1993; 1994) arguments and findings that particular types of directors (those associated with financial institutions) are identified to match specific organizational needs (amounts and types of borrowing). This finding is not consistent with Klein (1998), who argues that employee-directors should hold a seat on the finance and investment committee maximizes shareholder wealth as it proxies for their role within the organization. It should be noted that Klein (1998) classifies directors as insiders, outside board members and affiliates.

Hypothesis four questions whether the composition of the finance committee itself adds value. Table 6, model 1, shows a significant and positive relationship between the corporate investment strategy and the productivity of long-term investments (JPROD) and committees composed of business experts (BSXPRT $t = 2.43$), support specialists (SUPSPC $t = 1.93$), and insiders (INSDR $t = 1.64$). This finding complements results shown in Table 5 pertaining to staffing finance committees with members possessing a financial background. It also supports Klein’s (1998) assertion that insiders provide value by way of a

**TABLE 6**

<table>
<thead>
<tr>
<th>DEPENDENT VARIABLE</th>
<th>JPROD</th>
<th>MKRTX</th>
<th>OMBD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
</tr>
<tr>
<td>INT</td>
<td>1.46</td>
<td>9.75</td>
<td>-24.20</td>
</tr>
<tr>
<td></td>
<td>2.43*</td>
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<td>1.95&quot;</td>
</tr>
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<td>46.13</td>
<td>-35.96</td>
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<tr>
<td></td>
<td>3.10**</td>
<td>1.92&quot;</td>
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</tr>
<tr>
<td>FOMCF</td>
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<td>2.13*</td>
<td>1.96&quot;</td>
<td>0.56</td>
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<td>2.75</td>
</tr>
<tr>
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<td>2.11*</td>
</tr>
<tr>
<td>DSE</td>
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<td>-3.40</td>
<td>0.79</td>
</tr>
<tr>
<td></td>
<td>1.02</td>
<td>2.06**</td>
<td>1.26</td>
</tr>
<tr>
<td>INSDR</td>
<td>0.58</td>
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<td>-12.21</td>
</tr>
<tr>
<td></td>
<td>1.64&quot;</td>
<td>0.50</td>
<td>1.68&quot;</td>
</tr>
<tr>
<td>BSXPRT</td>
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<td>2.43*</td>
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<td>0.15</td>
</tr>
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<td>SUPSPC</td>
<td>0.67</td>
<td>-2.88</td>
<td>3.99</td>
</tr>
<tr>
<td></td>
<td>1.93&quot;</td>
<td>0.15</td>
<td>0.58</td>
</tr>
<tr>
<td>BETA</td>
<td>-0.35</td>
<td>-10.32</td>
<td>-2.08</td>
</tr>
<tr>
<td></td>
<td>4.97***</td>
<td>2.74**</td>
<td>1.51</td>
</tr>
<tr>
<td>INST%</td>
<td>0.20</td>
<td>13.08</td>
<td>-11.01</td>
</tr>
<tr>
<td></td>
<td>0.77</td>
<td>0.91</td>
<td>2.08*</td>
</tr>
<tr>
<td>LMCAP</td>
<td>-0.13</td>
<td>-0.53</td>
<td>2.72</td>
</tr>
<tr>
<td></td>
<td>4.03***</td>
<td>0.30</td>
<td>4.04***</td>
</tr>
<tr>
<td>F</td>
<td>7.98</td>
<td>2.04</td>
<td>11.38*</td>
</tr>
<tr>
<td>R²</td>
<td>0.36</td>
<td>0.07</td>
<td>0.44</td>
</tr>
<tr>
<td>N</td>
<td>124</td>
<td>130</td>
<td>131</td>
</tr>
</tbody>
</table>

Student t-statistics shown below parameter estimate.

* $p < 0.10$  ** $p < 0.05$  *** $p < 0.001$
seat on this committee. Helping explain variation in JPROD are net cash flows from investment (INVCF t= 3.10) and financing (FINCF t = 2.13) along with beta (BETA t = 4.97) and market capitalization (LMCAP t = 4.03). Models 2 and 3 show committee composition does not explain market returns (MKRTX) or operating margin before depreciation (OMBD).

Limitations

There are several problems inherent in this type of analysis. First, the U.S. Fortune 500 changes annually with 20 to 30 companies entering the list as others depart due to takeovers, mergers and acquisitions, bankruptcy and liquidation, or some other reason. Moreover, the mix of public corporations and private firms is not static. That makes comparisons across different studies, as well as a single longitudinal study, difficult. There is also evidence of size bias with large firms having not only more directors but also more committees (Peterson, et al., 2007). It may well be that as firms increase the number of board level committees, the traditional functions of a finance committee may be in part spread among other committees, weakening inference about the efficacy of a finance committee.

Does committee membership adequately represent an individual’s current contribution to performance or does board and committee composition reflect past performance? Hermalin and Weisbach (1988) and Pearce and Zahra (1992) report correlations between poor past performance and subsequent changes in boards towards more independent directors. Thus, finding a significant relationship between committee composition and performance may be evidence of a persistence factor and not do to how a member’s unique knowledge, skills and experiences are used. On the other hand, Bhagat and Black (1999) find no evidence that board composition is correlated with either lagged or contemporaneous measures of company profitability or growth. These directors may have been sitting on the finance committee for several years preceding measurement and recommendations may have already been realized by improvements in performance. Committee structure may matter, but any material benefit from selecting one director rather than another may not be realized until years later. That type of assessment would require committee notes and minutes of board meetings. Further, some directors may serve as figureheads with little real input (Burgess & Tharenou, 2002).

Several limits on the statistical analysis also bear mention. An endogenous relationship may exist between board composition and company performance. If so, ordinary least squares will produce biased estimates (Pindyck & Rubinfeld, 1991), but any simultaneous equation techniques that attempt to correct the problem may produce results that are no more and perhaps less reliable because they are highly sensitive to the specific model being tested (Barnhart & Rosenstein, 1998; Bhagat & Black, 1999). And in studies of board composition, OLS estimates should not be casually dismissed (Barnhart & Rosenstein, 1998). In addition, using categorical variables to classify directors according to some taxonomy limits our understanding of the broad range of experience and expertise these individuals bring to the boardroom. However, for purposes of analysis discrete categorization of director background is necessary.

Finally, in any study of director resource dependence, it is necessary to assume that firms use directors with the goal of maximizing the benefits of the directors’ primary area of expertise. If a non-management director has a background in finance, it is also assumed that the value-maximizing firm will use him or her as a resource consistent with their expertise. It is possible that this is not always the case, and when it is not inferences about the efficacy of directors based on resource dependence are hard to make.

CONCLUSION

We examine the use and staffing of board-level finance committees by very large United States firms in 2002. Prior work by Klein (1998) finds that the mere existence of a finance committee has no effect on firm performance. Since that time (1992-3), changes in corporate governance practice in response to government and exchange regulations have left the finance committee as one of few flexible board committees, both in its existence and staffing. We find some evidence that companies with board-level
finance committees outperform those without in comparisons of the mean values for the financial metrics. However, differences are small after controlling for other company characteristics.

We also examine whether boards maximize their members’ contribution through their placement on the finance committee. Contribution is measured based upon a resource dependence taxonomy in which directors are categorized according to their role as insider/management, business experts, support staff professionals or influential within the community. The flexibility of the finance committee allows it to be staffed with management/insiders as well as outsiders with particular financial expertise. We find evidence that the committee will be staffed with top management of publicly traded companies and investment and commercial bankers. Moreover, finance committees have a positive effect on corporate investment strategy and the productivity of long-term investments as measured by the Jensen (1994) productivity metric. These findings supplement Klein (1998), but extend the result to include the potential efficacy of other experts on the committee.

A major premise underlying agency theory is the director’s fiduciary obligation to monitor management behavior and maximize stockholder wealth. Resource dependence theory posits complimentary roles for board members, who may be valued for their network to other organizations and constituencies or selected to provide strategic guidance to management. Ideally, nominating committees will recommend the best individual available recognizing that the candidate, if elected, will have other responsibilities. Committee work is an important part of a board member’s duties. Firms may do well to make use of finance committees led by members of management and outside directors who are themselves business managers or financial experts.

ENDNOTES

1. Reasons vary for declining insider representation on these three committees. In 1980, the American Bar Association Committee on Corporate Laws recommended nominating committees should consist entirely of independent directors, although some committee members believed that CEOs should at least participate in approving who its members put forth as candidates (Business Lawyer, 1980). Management presence on compensation committees declined following 1993 changes to IRS regulations [§162(m)] that disallowed tax deductibility of excessive (over $1 million) executive compensation in cases where insiders participated on the compensation committee. In 1977, the SEC approved an NYSE rule requiring all listed domestic companies to establish an audit committee comprised solely of independent directors free from any relationship that would interfere with the exercise of independent judgment as a committee member.

2. Section 303A Corporate Governance Rules of the New York Stock Exchange were approved by the SEC on November 4, 2003, and amended on November 3, 2004. Section 303A defines director independence including the requirement that nominating/corporate governance, compensation, and audit committees be composed entirely of independent directors. On November 2, 2004, the NYSE filed amendments giving listed companies until their first annual meeting after June 30, 2005, to replace a director who was independent under the prior test but who would not be independent under the proposed revised Section 303A.02(b)(iii) [immediate family member relationship to the firm].

3. Shown is the resource dependence classification of the finance committee for the population of 174 companies whose boards have a finance committee. The population (2,112) consists of 399 (18.9%) insiders, 957 (45.3%) business experts, 503 (23.8%) support specialists, and 253 (12.0%) community influential members.

4. Note that the four alternative resource dependence classifications are fully specified by three dummy variables with the fourth implicit. The introduction of a separate insider classification would add a non-independent equation in the derivation of the least squares estimators (Pindyck & Rubinfeld, 1991, p. 106-108).

REFERENCES


The Relationship Between Equity Dependence and Environmental Performance

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How does a corporation’s dependence on its shareholders affect the sustainability of its commitment to environmental performance? Although the literature has investigated how the financial markets respond to environmental and green initiatives, it has yet to examine the relationship between a firm’s commitment to the environment and its dependence on the equity markets. In this research, we explore the relationship between equity dependence and environmental performance and find equity dependence is significantly related to corporations’ environmental concerns but not their environmental strengths.

INTRODUCTION

Although the literature has investigated how the financial markets respond to corporate social responsibility (CSR) initiatives, to our knowledge, there has been limited research on how financial market perceptions affect CSR investments. Furthermore, even less research has been done on firms’ CSR decisions when those firms are heavily dependent on the financial markets. In this research, we examine the theory and evidence for how a firm’s equity dependence influences its environmental record. Given that environmental performance and “green” issues have become hot button topics in the age of global warming, how equity dependence influences a firm’s environmental practices is an important piece of the puzzle.

Our focus on environmental performance instead of the more encompassing CSR measure facilitates the contribution of this paper in two important ways. First, there is empirical evidence that different categories of social responsibility have variable financial impact (see Berman, Wicks, Kotha and Jones, 1999). Second, as noted in the introduction, environmental and “green” issues are hot-button topics in an increasingly environmentally aware society. Especially as global warming and the health impacts of environmental problems have become more obvious, environmental performance has become an important piece of overall CSR performance.

LITERATURE REVIEW

“In response to the surge of reported negative firm behaviors as well as the increased levels of sensitivity of customers, employees, and other stakeholders to social and environmental issues, more companies are making corporate social responsibility (CSR) an important strategic objective” (Wagner, Lutz, and Weitz, 2009, p. 77). Although some stakeholders may feel that management actions, such as those related to CSR, reflect the perceptions of various stakeholders, Zinkhan and Carlson (1995) point out that not all stakeholder groups will concurrently be pleased with management actions.

Building on the idea of asymmetric stakeholder responses to CSR initiatives, Davis and MacDonald (2010) suggest that the sustainability of such initiatives depends on how they are received by salient stakeholders. Salience, in this context, refers to the priority a firm gives a stakeholder and is derived primarily from a stakeholder’s power and urgency (Mitchell, Agle, and Wood, 1997). Power is defined as the ability or potential to apply a high level of direct economic reward or punishment, coercive or physical force, and/or positive or negative social influence. Stakeholder urgency exists when there is a pressing call for attention (Magness, 2007).

Given that organizations have finite resources in terms of time and money, they are unlikely to proactively address the concerns of all stakeholders all the time. Research on stakeholder salience indicates that corporations will pay more attention to stakeholders who control critical resources and have a sense of urgency in their claims (e.g., Agle et al. 1999). In our particular case, we assume that shareholder power, and especially shareholder urgency, increase as firms become more dependent on equity financing versus other financing mechanisms (such as internal funding from profitability). In practical terms, the stock market’s preference for short-term profitability over the long-term viability of their investments reduces firms’ incentives to invest in long-term assets like R&D, advertising/branding, and CSR initiatives (Lahart, 2009).

The issue of shareholder salience is an important one for firms considering investments in CSR and environmental projects as there is a contentious relationship between CSR performance (and the environmental practices that are a big part of that equation) and financial metrics (especially those related to stock markets). On one hand, we have free market prosthelytizers that view the firm’s sole goal as maximizing profits so that socially responsible investments above a regulatory minimum simply burnish manager egos (Friedman, 1970). On the other hand, CSR true believers use the stakeholder theory detailed above to argue that CSR initiatives increase the trustworthiness of the firm with stakeholders and reduce agency costs that can lead to suboptimal investments. For example, CSR could help attract and keep better employees, brand firm outputs in a positive way with consumers, reduce operating costs by reducing agency costs with suppliers, and serve as a reservoir of goodwill that helps the firm weather downturns (Barnett, 2007).

The empirical evidence on these opposing views is inconsistent. Margolis and Walsh review 127 articles from 1972 to 2002 and find that “[a] simple compilation of the findings suggest a positive association, and certainly very little evidence of a negative association, between a company’s social performance and its financial performance”; however, they later admit, “[t]he imperfect nature of these studies makes research between the link between CSP [social performance] and CFP [financial performance] self-perpetuating: each successive study promises a definitive conclusion, while also revealing the inevitable inadequacies of empirically tackling the question” (Margolis and Walsh 2003, pp. 277-278). The ubiquitous practice of CSR investing also bolsters a positive CSR/financial link. However, a more cynical review of the literature is also fairly common: “[t]he result is that after more than 30 years of research, we cannot clearly conclude that whether a one-dollar investment in social initiatives returns more or less than one dollar in benefit to the shareholder” (Barnet, 2007, p. 794).

The impact of CSR on stock performance is seriously complicated by theories and evidence that the key direction of causation is from stock prices to investment (CSR included). Thus, higher stock returns lead to higher CSR initiatives since firms are less constrained financially. Baker, Stein and Wurgler (2003) argue that inefficient stock markets cut off firms from equity financing when their prices are irrationally low, which is especially troublesome for firms that don’t generate the internal or debt
financing to fund all positive net present value (NPV) projects—equity dependent firms. The relationship between investment and stock prices is therefore especially strong for these equity-dependent firms that have to placate a salient group of shareholders. An alternative explanation for the strong empirical relationship between equity dependence and investment found in Baker et al. (2003) is that markets are rational, but market imperfections related to debt overhang, information asymmetry and financial distress costs are the root causes; not over/under valuation of firm stock (Ovtchinnikov and McConnell, 2009).

Besides the problems inherent in using stock returns to measure financial performance, the CSR/financial performance link is also impacted by the long-term nature of a socially responsible investment such as environmental projects. Like R&D and corporate reputations, the payoff for these investments depends on a variety of factors and often the impact is cumulative. R&D is a good example: basic research might be good for the overall social good, but firms with an “absorptive capacity” (Cohen and Levinthal, 1990) honed by experience can use that to create a competitive advantage; they have a platform that allows them exploit new knowledge better than others. In the same way, CSR or environmental investment payoffs can build on themselves so that current returns depend on past investment. Thus, investment returns to CSR/environmental projects vary across time for individual firms (there is a life cycle for CSR acts) and cross-sectionally for all firms; which certainly complicates the econometric properties of the relationship.

Based on the above discussion, the main proposition explored by this manuscript is: Equity dependence and environmental performance are significantly and negatively related. That is, as equity dependence increases, firms invest less in projects that increase the environmental performance of the firm.

RESEARCH METHODOLOGY

Measuring Equity Dependence

According to Diamond (1991), a sensible measure of equity dependence would likely be negatively related to operating cash flow, debt capacity, and cash on hand while being positively related to proxies for growth opportunities actual leverage. Consistent with Diamond’s position, Kaplan and Zingales (1997), study the financial constraints faced by a sample of 49 low-dividend manufacturing firms using both objective and subjective criteria. Kaplan and Zingales (1997) classify firms into discrete categories of financial constraint and then use an ordered logit regression to relate their classifications to accounting variables. The resulting KZ index is offered as comprehensive measure of a firm’s dependence on equity that has been used in a number of financial market studies (e.g., Lamont, Polk & Saá-Requejo, 2001). Firms with a high KZ index have high debt, low cash, and low dividends (Lamont, Polk, and Saá-Requejo, 2001. The five-variable version of the KZ index used is shown in Figure 1.

**FIGURE 1**

FOUR VARIABLE VERSION OF THE KZ INDEX

\[
KZ_{it} = -1.002 CF_{it}/A_{it-1} -39.368 DIV_{it}/A_{it} -1.315 C_{it}/A_{it-1} + 3.139 LEV_{it} + 0.283 Q_{it}
\]

where \( CF_{it}/A_{it-1} \) is cash flow over lagged assets; \( DIV_{it}/A_{it-1} \) is cash dividends over lagged assets; \( C_{it}/A_{it-1} \) is cash balances over assets; \( LEV_{it} \) is leverage; and \( Q \) is the market value of equity plus total assets minus the book value of equity all over total assets. All item measures are based on data provided by Standard and Poor’s Compustat database.

The KZ index has been used in numerous empirical tests of financial constraints. The most notable works, with respect to this research, are by Lamont, Polk, and Saá-Requejo (2001), Baker, Stein, and Wurgler (2003), and Ovtchinnikov and McConnell (2009). Lamont, Polk, and Saá-Requejo (2001), use the KZ index to test if firms face financial constraints that hamper their ability to invest. The authors conclude that there is a financial constraints factor, an identifiable independent common source of
economic shocks to firm value. The evidence suggests that financial constraints do affect firm value and that the severity of constraints varies over time.

Baker, Stein, and Wurgler (2003), find that among the firms most likely to be equity dependent, stock prices have a larger effect on investment than does cash flow. Furthermore, these authors suggest that this finding stands in contrast to the general belief that the effect of cash flow dominates that of Tobin’s $Q$ in investment equations.

Finally, Ovtchinnikov and McConnell (2009) use the KZ index to study the effects of financial constraints on a much larger sample of 91,957 firm-year observations, representing 10,732 unique firms. The authors show that higher KZ index firms exhibit an increased sensitivity of investment to stock prices and argue that these firms are more likely to suffer from debt overhang (high levels of debt that hinder a firm’s borrowing ability) and information asymmetry problems. Because of high leverage, these firms are also more likely to encounter costly financial distress. It is thus plausible that these market imperfections will affect these firms’ financing decisions as well as their investment decisions. Such imperfections will affect investment decisions in such a way that investments will appear to exhibit increased sensitivity to stock prices (even though they do not) (Ovtchinnikov and McConnell, 2009, p. 558).

KZ Index robustness. A particularly interesting finding of the Baker, Stein, and Wurgler (2003) study is that the KZ index is a robust measure of financial constraints. For example, although the original Kaplan and Zingales (1997) study was based on a relatively small sample of firms, Baker, Stein, and Wurgler (2003) achieve very similar results when the index is applied either to a subsample similar to that originally studied by Kaplan and Zingales—i.e., low-dividend manufacturing firms—or to its exact complement 985. Furthermore, Baker, Stein, and Wurgler (2003) find similar results when $Q$ is dropped from the KZ index and the coefficients on the other four variables remain the same. That is, when the four-variable version of the KZ index was used on the original KZ sample, Baker, Stein, and Wurgler (2003) find that the coefficients on the other four variables are virtually identical whether or not $Q$ is included in the regression. We use the four variable version of the KZ index in our analysis.

Measuring Environmental Performance

In addition to measures of Financial Market Dependence, we require a measure of firms’ environmental performance. The most prominent and comprehensive measure of corporate social performance (CSP) has been developed by the investment firm Kinder, Lydenberg, Domini, and Company (KLD) (Mitchel et al., 1997). KLD uses company surveys and secondary sources to obtain information on approximately three thousand companies. The company collects CSR data in terms of strengths and weakness over eight broad categories: i) community; ii) corporate governance; iii) diversity; iv) employee relations; v) environment; vi) human rights; vii) product quality; and viii) controversial business issues.

Following the approach of Hillman and Keim (2001), we use the KLD STATS database to construct three key measures of Environmental Performance: Environmental Concerns (EnvCons), Environmental Strengths (EnvStrs), and Net Environmental Performance (EnvNet). We restricted our analysis to the years 2000 to 2009. The variables included in the EnvCons and EnsStrs measures are presented in Table 1. The EnvNet measure is simply the result of subtracting EnvCons from EnvStrs. The seven stakeholder and social issues areas, as well as the strength and concern indicators by dimension, are listed in Table 1. Because the number of measures for the EnvStrs measure changed between 2000 and 2009, we sum the total strength indicators for each year and then divide by the number of indicators. For example, from 2000 to 2005 there were five indicators of environmental strengths but six indicators from 2006 to 2009. Although the number of indicators for the EnvCons measure did not change, we also scale that variable by the number of EnvCons indicators (i.e., seven).
TABLE 1
ENVIRONMENTAL PERFORMANCE MEASURES

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Concerns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beneficial Products &amp; Services</td>
<td>Agricultural Chemicals</td>
</tr>
<tr>
<td>Alternative Fuels (Clean Energy)</td>
<td>Climate Change (added in 1999)</td>
</tr>
<tr>
<td>Pollution Prevention</td>
<td>Ozone Depleting Chemicals</td>
</tr>
<tr>
<td>Recycling</td>
<td>Regulatory Problems</td>
</tr>
<tr>
<td>Other Strength</td>
<td>Substantial Emissions</td>
</tr>
<tr>
<td></td>
<td>Other Concern</td>
</tr>
</tbody>
</table>

Control Variables
Because size, performance, and industry have been suggested in previous articles to be factors that affect CSR and potentially environmental performance (e.g., Ullman, 1985; Mathur and Mathur, 2000; Udayasankar, 2007), each of these characteristics was operationalized as a control variable. We control for firm size by using sales. Our industry controls were based on the 13 industry classifications used in Waddock and Graves (1997). Industry was determined by the firm’s 4-digit SIC and represented in the model by dummy variables. Finally, we control for firm performance differences by including measures of return on assets (ROA) and gross profit margin (GPM). Although debt/equity, total assets, and cash have also been used as control variables in previous research on social responsibility, we did not control for these variables because of their inclusion in the KZ index.

Analysis
Table 2 lists the industries, SIC codes, and average industry Environmental Performance ratings (Env. Cons, Env. Strs., and Net Env.). The Banking and Finance related industries were omitted from the dataset based on previous research on the KZ index (see Baker, Stein, and Wurgler, 2003 and Ovtchinnikov and McConnell, 2009). Table 3 details descriptive statistics for all variables used in the

TABLE 2
INDUSTRIES IN THE SAMPLE

<table>
<thead>
<tr>
<th>Industry</th>
<th>SIC</th>
<th>N</th>
<th>EnvCons</th>
<th>EnvStrs</th>
<th>NetEnv.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining, Construction</td>
<td>1</td>
<td>260</td>
<td>0.072</td>
<td>0.020</td>
<td>-0.052</td>
</tr>
<tr>
<td>Food, textiles, apparel</td>
<td>2</td>
<td>120</td>
<td>0.037</td>
<td>0.037</td>
<td>0.001</td>
</tr>
<tr>
<td>Forest products, paper, publishing</td>
<td>3</td>
<td>112</td>
<td>0.048</td>
<td>0.064</td>
<td>0.016</td>
</tr>
<tr>
<td>Chemicals, Pharmaceuticals</td>
<td>4</td>
<td>354</td>
<td>0.057</td>
<td>0.038</td>
<td>-0.019</td>
</tr>
<tr>
<td>Refining, rubber, plastics</td>
<td>5</td>
<td>67</td>
<td>0.135</td>
<td>0.049</td>
<td>-0.087</td>
</tr>
<tr>
<td>Containers, steel, heavy mfg.</td>
<td>6</td>
<td>221</td>
<td>0.056</td>
<td>0.043</td>
<td>-0.013</td>
</tr>
<tr>
<td>Computers, autos, aerospace</td>
<td>7</td>
<td>719</td>
<td>0.023</td>
<td>0.035</td>
<td>0.012</td>
</tr>
<tr>
<td>Transportation</td>
<td>8</td>
<td>120</td>
<td>0.026</td>
<td>0.007</td>
<td>-0.019</td>
</tr>
<tr>
<td>Telephone and Utilities</td>
<td>9</td>
<td>291</td>
<td>0.100</td>
<td>0.043</td>
<td>-0.057</td>
</tr>
<tr>
<td>Wholesale, retail</td>
<td>10</td>
<td>411</td>
<td>0.013</td>
<td>0.010</td>
<td>-0.003</td>
</tr>
<tr>
<td>Hotel, entertainment</td>
<td>12</td>
<td>588</td>
<td>0.002</td>
<td>0.004</td>
<td>0.0023</td>
</tr>
<tr>
<td>Hospital Management</td>
<td>13</td>
<td>149</td>
<td>0.001</td>
<td>0.004</td>
<td>-0.009</td>
</tr>
</tbody>
</table>
study. We use regression analysis to explore the relationship between equity dependence and environmental performance. The first model uses Environmental Concerns (Env. Cons.) as the dependent variable, the second model uses Environmental Strengths (Env. Strs.), and the third model uses Net Environmental Performance (Net Env.). Equity dependence (KZ index) serves as the independent variable in each model. Furthermore, in each regression we control for firm performance (ROA, gross profit margin (GPM), firm size (sales), and industry. Following Baker, Stein, and Wurgler (2003) and Ovtchinnikov and McConnell (2009) all variables were Windsorized by industry using the first and 99th percentiles as cutoffs.

**TABLE 3**

**DESCRIPTIVE STATISTICS**

<table>
<thead>
<tr>
<th>Variable</th>
<th>N</th>
<th>Mean</th>
<th>S.E.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental Cons</td>
<td>17388</td>
<td>0.0308</td>
<td>0.00078</td>
</tr>
<tr>
<td>Environmental Strs</td>
<td>17388</td>
<td>0.0270</td>
<td>0.00065</td>
</tr>
<tr>
<td>Net Environment</td>
<td>17388</td>
<td>-0.0110</td>
<td>0.00084</td>
</tr>
<tr>
<td>Total Sales</td>
<td>17388</td>
<td>3922.72M$</td>
<td>21.22M$</td>
</tr>
<tr>
<td>GPM</td>
<td>17388</td>
<td>35.14</td>
<td>0.098</td>
</tr>
<tr>
<td>ROA</td>
<td>17388</td>
<td>2.33</td>
<td>0.019</td>
</tr>
</tbody>
</table>

**RESULTS**

A total of 17,388 firm years and 3412 companies remained in the sample after companies missing either financial or environmental performance data were eliminated. As can be seen in Table II, there are considerable differences in the ratings among industries. The industry with the most environmental concerns is refining, rubber, and plastics while the forest products, paper, and publishing industry has the highest environmental strengths rating and highest net environmental performance. Telephone and Utilities has the lowest when environmental concerns are subtracted from environmental strengths. Note from Table II that most industries (9 out of 12) were rated below 0 on the overall CSP scoring and that only those industries not engaged in activities as likely to have significant CSP consequences (e.g., environmental impact or community, employee, and product-related issues) were rated positively on overall CSP. These descriptive results indicate the importance of controlling for industry in the assessment of the relationship between financial and environmental performance.

Table 4 provides the correlation matrices for the key variables. As expected, equity dependence (KZ index) is negatively correlated with sales. Equity dependence was not significantly correlated with gross profit margin (GPM) or return on assets (ROA). Of greater interest is the finding that equity dependence is negatively and significantly related to environmental concerns (EnvCons) but the relationship between equity dependence and environmental strengths (EnvStrs) is not significant. Finally, equity dependence and net environmental performance (NetEnv) are significantly correlated but the relationship is positive rather than negative. Note that the opposing signs for the KZ (equity dependence) correlations of EnvCon (negative) and EnvNet (positive) is a function of how the EnvNet variable is constructed (scaled strengths minus cons). Thus, a higher value for cons actually makes the net lower when they are subtracted out.
Table 5 presents the results of the regression analysis using the three measures of environmental performance (EnvCons, EnvStrs, and NetEnv) as dependent variables and equity dependence (KZ index) as the independent variable while controlling for firm performance, size, and industry (industry controls are omitted from the table in the interest of space).

As can be seen (Table 5), each of the models is significant overall at the $p < 0.001$ level. With respect to the control variables, ROA is significantly ($p < 0.001$) and positively related to both environmental concerns (EnvCons) and environmental strengths (EnvStrs) but is not significantly related to net environmental performance (NetEnv). Gross profit margin (GPM) is not significantly related to environmental concerns or environmental strengths but is related to net environmental performance at the $p < 0.01$ level. Firm size (sales) is significantly ($p < 0.001$) and positively related to both environmental concerns and environmental strengths but negatively related to net environmental performance ($p < 0.001$). Although not displayed in Table V, our results suggest a strong industry effect as seven of the twelve industry dummy variables were significant at the $p < 0.001$. Three of industry dummies were significant at the $p < 0.01$ level.

In terms of the relationship between equity dependence and environmental performance, equity dependence (KZ) is negatively related ($p < 0.001$) to environmental concerns (EnvCons) but positively related ($p < 0.001$) to net environmental performance. Although equity dependence was not significantly related to environmental strengths the relationship was positive and approached significance at the $p < 0.079$ level.
TABLE 5
REGRESSION ANALYSIS

<table>
<thead>
<tr>
<th>Dependent variable: Env. Cons</th>
<th>Std. β</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Dependence (KZ)</td>
<td>-0.154**</td>
<td>0.000</td>
</tr>
<tr>
<td>Sales</td>
<td>0.350**</td>
<td>0.000</td>
</tr>
<tr>
<td>GPM</td>
<td>-0.008</td>
<td>0.338</td>
</tr>
<tr>
<td>ROA</td>
<td>0.036**</td>
<td>0.001</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.257</td>
<td></td>
</tr>
<tr>
<td>Adj. $R^2$</td>
<td>0.256</td>
<td></td>
</tr>
<tr>
<td>$F$</td>
<td>339.1**</td>
<td>0.000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Dependent variable: Env. Strengths</th>
<th>Std. β</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Dependence (KZ)</td>
<td>-0.054</td>
<td>0.079</td>
</tr>
<tr>
<td>Sales</td>
<td>0.449**</td>
<td>0.000</td>
</tr>
<tr>
<td>GPM</td>
<td>0.042</td>
<td>0.150</td>
</tr>
<tr>
<td>ROA</td>
<td>0.131**</td>
<td>0.000</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.074</td>
<td></td>
</tr>
<tr>
<td>Adj. $R^2$</td>
<td>0.073</td>
<td></td>
</tr>
<tr>
<td>$F$</td>
<td>77.93**</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Dependent variable: Net Env. (EN)</th>
<th>Std. β</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Dependence (KZ)</td>
<td>0.101**</td>
<td>0.001</td>
</tr>
<tr>
<td>Sales</td>
<td>-0.627**</td>
<td>0.000</td>
</tr>
<tr>
<td>GPM</td>
<td>0.009</td>
<td>0.751</td>
</tr>
<tr>
<td>ROA</td>
<td>0.033</td>
<td>0.147</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.109</td>
<td></td>
</tr>
<tr>
<td>Adj. $R^2$</td>
<td>0.108</td>
<td></td>
</tr>
<tr>
<td>$F$</td>
<td>119.65**</td>
<td>0.000</td>
</tr>
</tbody>
</table>

**DISCUSSION**

Based on previous research, we posited equity dependent firms would invest less in environmental projects, in part because the payoffs are long-term and intangible in nature. But regression results show that net environmental scores increase with equity dependence. Breaking environmental records down into strengths and cons helps explain that dichotomy. Environmental cons drive the results; they are significantly negatively related to equity dependence, while environmental strengths have an insignificant relationship.

Based on our literature review, a tentative, yet plausible explanation for our findings is that equity markets are more willing to invest in environmental projects that reduce the uncertainty of their investment—and reducing environmental concerns (e.g., reducing hazardous waste, the use of ozone depleting chemicals, and avoiding regulatory problems) mitigates potential downside risk. On the other hand, investing in environmental strengths (e.g., use of alternative fuels, recycling, and producing
beneficial products and services) has the long-term and intangible benefits that are not favored by capital markets. Another way to look at it is that shareholders are willing to pay to reduce uncertainty, so that the market discipline provided by more salient shareholders is effective at disciplining environmental concerns. But the benefits of increasing environmental strengths are hard to quantify and complicated by the associated information asymmetry, cumulative nature, and long-term horizon of that type of investment.

CONCLUSION

We have known for many years that returns to CSR are contingent rather than universal (see Ullmann, 1985); however, much of the research on social responsibility and environmental performance fails to address the theoretical underpinnings for these differences (Rowley and Berman, 2000). We attempt to explain this heterogeneity by exploring the relationship between equity dependence and environmental performance. Based on the literature on stakeholder salience, social responsibility, and financial performance we propose a negative relationship between equity dependence and overall environmental performance. That is, as firms become more dependent on equity to finance investments, we expect increased shareholder salience and a growing emphasis on short-term returns to have a limiting effect on investments in environmental projects.

Our results show a significant relationship between equity dependence and environmental performance that is positive rather than negative. However, this relationship appears to be driven by a tendency to reduce environmental concerns as equity dependence increases. We suspect that the increasing salience of the equity markets encourages firms to reduce their environmental risk and uncertainty by investing in decreasing their environmental concerns rather than increasing their environmental strengths. Based on our results, we suggest that salient shareholders do affect firms’ decisions related to environmental policy.

A primary finding of this research is that the relationship between equity dependence and environmental performance is complicated. Future research is encouraged in a number of related areas. For example, our finding of highly significant industry effects suggests that an exploration of the factors that cause the differential nature of the equity dependence – environmental performance relationship across industries would be fruitful. Additionally, we recommend that future research investigate the long-term nature of the relationship by incorporating lagged independent variables. Finally, environmental performance is just one component of social responsibility and corporate social performance. Future research should explore the relationship between equity dependence and other CSR related variables such as employee relations, diversity, and corporate governance.

ACKNOWLEDGEMENTS

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REFERENCES


Bioethics has been the leading area of ethical focus and concern in the hospital industry. This focus on clinical operations and performance dominates the field of health care ethics. Much less attention has been paid to administrative ethics dealing with management concerns and overall organizational culture. This study examines what forces, both internal and external, cause hospital chief executive officers to pursue ethical integration within their organizations. In studying a range of factors, two issues prove to be the major motivators in this regard. These factors of market environment and patient satisfaction have strong economic overtones.

INTRODUCTION

The health care industry is unique as a social institution strongly connected to its local communities, yet viewed by society at large as a repository of skills, knowledge, and competency for the greater good of all. A major responsibility for assuring that health care organizations fulfill this social charter falls to the organization’s chief executive officer and members of that person’s senior management team. As Morrison states in her text describing the role of the health care administrator, *Ethics in health administration: A practical approach for decision makers*:

“Health care administrators certainly do not provide the care, conduct the research, or design the technology. Yet, they are critical to the success of these system functions. They provide an environment where the important work of health care can take place; they are the creators of structure and support. Health care administrators have the ethical obligation to provide a safe environment for patients and employees. They are also the connection to the community and the stewards of the resources society invests in health care. (Morrison 2006, pp.1-2)”.

Squazzo adds to the critical weight ethics represents for health care executives as she suggests that there is no simple way to assure staff behaves ethically. Yet, leading any health care organization requires administrators to understand how to instill and maintain cultures where “. . . . ethical decision making and behavior are the norm.” (Squazzo, 2012, p.32). This form of leadership skills must constantly be
practiced since a health care organization’s success is very much dependent on having an effective ethical culture.

As important as it is to know how CEOs and senior administrators develop this competency and learn to practice it within their organizations, what is relevant for this research is what motivates hospital CEOs to commit to integrate ethical practices within their organizations. There is considerable literature on the role of bioethics and its relationship to clinical decision-making. The range of this work is impressive from ethical practices focusing on physicians’ behavior to the role and work of hospital ethics committees (O’Reilly, 2008; Aleksandrova, 2008; Deshpande, 2009; Salladay, 2006; Davis, 2006; Mino et al., 2008; McGee et al., 2002). These studies examine various aspects of institutionalizing health care ethical practices such as the role of these committees to decide policy for patients’ wishes or how ethics committees measure their impact and success, and what are effective strategies for training and the education of potential and current committee members. Much of this work then deals with how hospital ethics committees are structured and work (Ross et al., 1993; Cohen, 1990; Veatch, 1983; Scheirton, 1993). What is far less understood is how CEOs think about what represents effective ethical practices within their organizations and what factors motivate them to institute such practices. The need for a systematic approach to ethics operating within a supportive cultural framework has been advocated for some time (Buell, 2009). The American College of Healthcare Executives’ (ACHE) initiative, Fund for Innovation in Healthcare Leadership, established in 2006, made ethics a key priority (Buell, 2009). ACHE has been a consistent champion of developing and practicing ethics for health care leaders as evidenced by the launch of its Ethics Self-Assessment project in 1992. The original Code began in the early 1940s and has seen continuing updating and improvements since that time (American College of Healthcare Executives, 2010). This history speaks to the acknowledged importance of ethical practices by leaders of health care but not on corporate ethical integration. There are a number of well-respected commentaries on the value and necessity of organizational-wide ethical practices that support the overall call for ethical leadership at the top of health care organizations. In the recent article Ethical challenges and responsibilities of leaders, Howard Prince, II, director of the Center for Ethical Leadership in the Lyndon B. Johnson School of Public Affairs at the University of Texas at Austin, offered the observation that in healthcare there is a growing problem of ethical misconduct and perhaps two of the leading reasons for this is a more acute scarcity of resource along with an increase in excessive competition. Prince comments, “We have to be good diagnosticians about what’s going on in our organizations that could be corrosive” (Squazzo, 2012, p.37). Healthcare leaders have the obligation to establish a culture of ethics and foster this type of behavior with employees and staff.

LITERATURE REVIEW

The vast majority of studies dealing with healthcare ethics are in the bioethics/medical domain. These are studies focused on ethical questions related to clinical concerns and direct patient care (Clark, 2007; Boren, 2008; Deshpande, 2009; Aleksandrova, 2008). By extension there has been major work done on the importance of hospital ethics committees and their functions within institutional settings (Sallady, 2006; Mino et al., 2008; Micah, 2008; O’Reilly, 2008). McGee and his colleagues developed a landmark study in 2002 that asked the question of the perceived success and impact hospital ethics committees have on the ethical decision-making within their organizations (McGee et al., 2002). This national study suggested there was wide variation in how the Chairs of hospital ethics committees saw the success of their committee work in several categories. Four categories were seen as important contributors to their mission and goals: education, consultation/mediation, policy formulation/evaluation, and administrative functions. McGee et al. (2002) also reported major frustration dealing with administrative functions due mostly to physician and hospital administrator reluctance to either commit to policy development or to implement policies that would promote their work. Fenton and Arras (2010) called for an increased need for the application of bioethics across the globe (Fenton and Arras, 2010). Their premise was that institutional healthcare needs the guidance, beneficence, and disciplined thinking bioethics brings to the practice of medicine within all forms of organized healthcare delivery. What has been a more common
practice in most industrialized societies now needs to be applied in countries that have more newly
developed centralized health systems with national health policies. Davis argued that many hospitals in
the United States have experienced a failure in the development of their ethics committees and in their
work to achieve ethically driven organizations (Davis, 2006). He sees this as an unfortunate gap in the
evolutionary process for healthcare institutions. The logical progression would be to move beyond the
work of the ethics committee to a broad institutional-wide ethics program supporting ethics audits, ethics
training and education, and the promotion of ethics-based cultures of care delivery. Snow (2009)
discusses the set-backs for hospitals when their care delivery lacks ethical input or is done in an ethical
void. This work, as well as the studies described above, supports the relatively large volume of research
dealing with bioethics and its application in patient care delivery. A more intense examination of
healthcare ethics is needed to discover ethics as a topic in the arena of healthcare administration.

The texts by Kurt Darr (2005) and Eileen Morrison (2006) do offer a comprehensive review of ethics
in health management and administration. Both books begin with a strong emphasis on moral
philosophies and the origin of modern ethical practice having its roots in these schools of thought.
Morrison explores the core ethical foundations of autonomy, non-malfeasance, beneficence, and justice as
critically important to understand current ethical thinking and practice in the healthcare industry. She also
spends a significant amount of time exploring the organizational and administrative aspects of ethics
especially discussing areas of mission, culture, and compliance. In the last few chapters of her work,
Morrison focuses on the practice of ethics from the viewpoint of administration. She explains, “... acting
as an ethics-based administrator can provide you with a level of integrity that will last for your entire
career in the field of health administration” (Morrison, 2006, p.267). Darr strikes a balance between
administrative and biomedical ethical issues. He sees administrative ethics closely linked to concerns
about mission, vision, organizational values and codes of practice and behavior. “An organization’s
values are inextricably linked to its culture. To transform the organization so that its culture is a living
reflection of values that facilitate the mission and vision, management must know which values are
present in the culture” (Darr, 2005, p.57). Also like Morrison, he limits his discussion of the integration of
ethics within healthcare organizations to large institutional components such as the mission and vision
statements or codes of ethics. Whether these items are the principle way CEOs assess the level of ethical
integration within their organizations or the reasons they commit to ethical practices is not considered.

Silva notes, “Despite professional and public concerns and sometimes outrage about ethical
transgressions, little about organizational and administrative ethics has appeared in the health care
literature” (Silva, 1998). She ties these ethical gaps to a lack of organizational culture integrating ethics as
a necessary cultural component in today’s hospital industry. Her observation is that there is a significant
amount of literature on healthcare ethics for various clinical situations but considerably less material on
healthcare organizational and administrative ethics. Perry echoes the same theme, suggesting that
healthcare managers may pay attention to their responsibility for ethical matters relating to clinical
practices, but overlook ethical business and people management practices denying the obligations they
have for the complete development of an ethical culture (Perry, 2002).

Lauer strongly urges hospital CEOs to set the tone within their organizations for the level of ethical
standards their hospitals need to have. Buell stresses the need for CEOs to take action to establish “... a
systematic approach to ethics so when ethical issues do occur, the organization’s actions to address them
match its core values” (Buell, 2009, p.54).

The need for senior healthcare administrators to behave ethically and to create a corporate culture that
promotes ethical practices and decision-making continues to dominate discussions about ethical practice.
Stango focused more on the ethical role of the chief financial officer than that of the CEO, but her
message was similar, there needs to be an increased scrutiny of healthcare leaders regarding their ethical
philosophies and practices for their organizations. Integrity starts at the top and without that commitment
there can be no true ethical integration (Stango, 2006).

Literature dealing with what motivates hospital CEOs to pursue ethical practice is non-existent. Only
tangential interpretations of this subject exist. This study begins to fill this major void of health
administration. It serves as an important first step in the understanding of the factors motivating hospital CEOs to pursue ethical integration within their organizations.

**RESEARCH QUESTION**

The central question of this study is what motivates hospital CEOs to commit to ethical integration. It sub-divides into three independent variables: the type of hospital the CEO represents, the size of the institution’s operating budget, and the size of the organization’s net margin. The study’s null hypothesis is that any differences in how CEOs view this commitment by hospital type, operating budget, or net margins is a random event and not related to any of these three factors.

**Design and Methodology**

The three independent variables are compared to seven categories of dependent variables: market environment, patient satisfaction, administrator resources, medical resources, organizational culture, administrator/manager action, and administrator/manager behavior. These dependent variables are defined as: 1) Market environment: competitive forces, 2) Patient satisfaction: end-user perceptions of quality of care, 3) Administrative resources: institutional components that support ethical decision-making, 4) Medical resources: medical components that support ethical decision-making, 5) Organizational culture: ethical components upon which culture is built, 6) Administrative/manager action: specific decisions that impact key stakeholders, and 7) Administrative/manager behavior: ethical practices directed toward key stakeholders.

A quantitative methodology utilizing a survey research instrument is followed. The survey instrument was distributed randomly to a targeted audience of hospital chief executive officers in the mid-Atlantic states of Pennsylvania, New Jersey, Delaware, and Maryland. The instrument was validated through a pilot study of a six-member panel of hospital chief executive officers between November 2010 and January 2011. A draft survey instrument was developed based upon a review of the literature and distributed to this six-member panel for review. The review and rewrite process involved three iterations of the instrument before the panel affirmed the content and format of the survey was valid. In late February 2011, the revised instrument was distributed to 163 chief executive officers as the randomly selected CEO participants. By the end of March 2011, 52 completed survey instruments were returned representing a response rate of 31.9%. Of that number 32 instruments were acceptable and found to be error-free in completeness and response selection.

**RESULTS**

**TABLE 1**

**CRONBACH’S ALPHA RESULTS WITH CONSTRUCTION OF COMPONENTS IN MEDICAL AND ADMINISTRATIVE RESOURCES**

<table>
<thead>
<tr>
<th>Dependent Variables</th>
<th>Cronbach’s Alpha Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patient satisfaction</td>
<td>.89**</td>
</tr>
<tr>
<td>Market environment</td>
<td>.93***</td>
</tr>
<tr>
<td>Organizational culture</td>
<td>.72*</td>
</tr>
<tr>
<td>Administrative behavior</td>
<td>.83**</td>
</tr>
<tr>
<td>Administrative action</td>
<td>.76*</td>
</tr>
<tr>
<td>Medical resources</td>
<td>.79*</td>
</tr>
<tr>
<td>Administrative resources</td>
<td>.70*</td>
</tr>
</tbody>
</table>

*α = acceptable reliability, **α = strong reliability, ***α = excellent reliability
The study’s main research question is what motivates hospital CEOs to commit to integrate ethical practices in their organizations. The first level of data analysis was for survey instrument reliability. Measures of reliability were run on each of the dependent variable sets using the Cronbach’s Alpha test, with $\alpha = .70-.79$ considered as acceptable reliability, $\alpha = .80-.89$ as strong reliability, and $\alpha \geq .90$ as excellent reliability. Initial reliability was achieved for five of the seven dependent variables. The Cronbach’s Alpha scores improved from .48 to .70 by constraining and revising the variable sets. This was done for the variables of mission and ethics officer. Cronbach’s Alpha measure then increased to an acceptable .79.

**TABLE 2**

**SUMMARY OF ONE-WAY ANALYSIS OF VARIANCE FOR THE INDEPENDENT VARIABLES OF HOSPITAL TYPE, OPERATING BUDGET, AND NET TOTAL MARGINS**

<table>
<thead>
<tr>
<th>Independent Variable</th>
<th>Dependent Variable</th>
<th>Df</th>
<th>M²</th>
<th>F</th>
<th>P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hospital Type</td>
<td>Patient Satisfaction</td>
<td>3</td>
<td>2.262</td>
<td>3.515</td>
<td>.028</td>
</tr>
<tr>
<td>Medical Resources</td>
<td>Administrative Resources</td>
<td>3</td>
<td>.005</td>
<td>.028</td>
<td>.993</td>
</tr>
<tr>
<td>Organizational Culture</td>
<td>Administrative Resources</td>
<td>3</td>
<td>.123</td>
<td>.381</td>
<td>.768</td>
</tr>
<tr>
<td>Administrative Action</td>
<td>Administrative Resources</td>
<td>3</td>
<td>.057</td>
<td>.402</td>
<td>.753</td>
</tr>
<tr>
<td>Administrative Behavior</td>
<td>Administrative Resources</td>
<td>3</td>
<td>.066</td>
<td>.486</td>
<td>.695</td>
</tr>
<tr>
<td>Market Environment</td>
<td>Administrative Resources</td>
<td>3</td>
<td>.095</td>
<td>.597</td>
<td>.622</td>
</tr>
</tbody>
</table>

| Operating Budget     | Patient Satisfaction        | 2  | .211 | .251 | .779 |
| Medical Resources    | Administrative Resources    | 2  | .096 | .658 | .526 |
| Organizational Culture| Administrative Resources    | 2  | .015 | .052 | .950 |
| Administrative Action| Administrative Resources    | 2  | .083 | .600 | .555 |
| Administrative Behavior| Administrative Resources   | 2  | .034 | .252 | .779 |
| Market Environment   | Administrative Resources    | 2  | .102 | .653 | .528 |

| Net Total Margins    | Patient Satisfaction        | 2  | .357 | .415 | .664 |
| Medical Resources    | Administrative Resources    | 2  | .021 | .139 | .871 |
| Organizational Culture| Administrative Resources    | 2  | .152 | .525 | .597 |
| Administrative Action| Administrative Resources    | 2  | .030 | .209 | .813 |
| Administrative Behavior| Administrative Resources   | 2  | .069 | .497 | .613 |
| Market Environment   | Administrative Resources    | 2  | .058 | .360 | .701 |

All dependent variable sets were compared with each of the three independent variables of hospital type, net total margin, and operating budget using a one-way analysis of variance. The dependent variable of market environment showed a marginally significant relationship for both net total margin and operating budget. It was the only dependent variable to reveal differences among the status groups for these two independent variables. Greater significant relationships surfaced for the independent variable of hospital types. Not only was market environment significant but the dependent variable of patient satisfaction was significant at the $p=.05$ level. Both of these variables achieved a higher significant relationship than their relationship with net total margins and operating budgets.
Running a multiple correlation on the dependent variable of market environment for hospital types showed major differences between the CEOs of regional medical centers and the CEOs of urban teaching hospitals. Strong differences also occurred between CEOs of community hospitals and CEOs of urban teaching hospitals although this was statistically recorded as marginally significant. There was a similar finding between CEOs of community teaching hospitals and CEOs of urban teaching hospitals. Doing the same analysis for patient satisfaction showed major differences between community teaching hospitals and urban teaching hospitals.

The Duncan LSD test was run to determine genuine significance for the relationship between patient satisfaction, market environment and hospital types. There was statistical significance of .043 for patient satisfaction and .039 for market environment. The accurate interpretation is that a tendency for significance exists between these variables that are supported by the findings from the Duncan LSD analysis. Because this study represented a relatively low sample size, the message is to conduct further research in this arena to pay attention to these variables since they may prove to have genuine significant relationships given a larger subject population.

### Table 3

**Multiple Correlations for the Dependent Variables of Market Environment and Patient Satisfaction**

<table>
<thead>
<tr>
<th>Dependent Variable</th>
<th>Hospital Type</th>
<th>Mean Difference</th>
<th>Standard Error</th>
<th>P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Environment</td>
<td>Regional Medical Center</td>
<td>1.43214</td>
<td>.47030</td>
<td>.005</td>
</tr>
<tr>
<td></td>
<td>Urban Teaching Hospital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market Environment</td>
<td>Community Hospital</td>
<td>.97143</td>
<td>.48572</td>
<td>.055</td>
</tr>
<tr>
<td></td>
<td>Urban Teaching Hospital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market Environment</td>
<td>Community Teaching Hospital</td>
<td>.85714</td>
<td>.44781</td>
<td>.066</td>
</tr>
<tr>
<td></td>
<td>Urban Teaching Hospital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Patient Satisfaction</td>
<td>Community Teaching Hospital</td>
<td>-1.09048</td>
<td>.39533</td>
<td>.010</td>
</tr>
<tr>
<td></td>
<td>Urban Teaching Hospital</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Table 4

**Multivariate Within Subjects Results for the Dependent Variable Groups of Patient Satisfaction, Organizational Culture, and Administrative Action**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Value</th>
<th>F</th>
<th>Hypothesis</th>
<th>Error df</th>
<th>Significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patient Satisfaction</td>
<td>.393</td>
<td>6.800</td>
<td>5.000</td>
<td>22.000</td>
<td>.001</td>
</tr>
<tr>
<td>Organizational Culture</td>
<td>.585</td>
<td>3.122</td>
<td>5.000</td>
<td>22.000</td>
<td>.028</td>
</tr>
<tr>
<td>Administrative Action</td>
<td>.763</td>
<td>1.367</td>
<td>5.000</td>
<td>22.000</td>
<td>.275</td>
</tr>
</tbody>
</table>
The Wilk’s Lambda multivariate test for within subjects was used to determine whether or not there
were differences between the means of the subjects for the various dependent variable groups. Table 4
displays the results of this test for the dependent variable sets of patient satisfaction, organizational
culture, and administrative action respectively. The statistical significant differences among items ranged
from .001 to .275, which indicates this difference was not due to random responses by subjects, but to
deliberate differences between responses for both patient satisfaction and organizational culture.

DISCUSSION

Two factors stood out in this analysis, the dependent variables of market environment and patient
satisfaction. Whether CEOs represented institutions with large, moderate, or relatively low net margins or
operating budgets, or whether they were CEOs of community hospitals, community teaching hospitals,
urban teaching hospitals, or regional medical centers, there was meaningful differences in how they
responded to factors they used to identify their motivation for pursuing ethical integration. It was clear the
reality of their markets in terms of competitive factors and the importance of patient satisfaction within
the larger context of delivering health care services were motivating factors. The type of institutions these
CEOs represented showed significance differences for patient satisfaction as well as market environment.
The largest differences existed between urban teaching hospitals and regional medical centers in terms of
the market environment and between community teaching hospitals and urban teaching hospitals for
patient satisfaction.

The market environment difference between CEOs of urban teaching institutions and those of
regional medical centers is best understood through the differences of how these two types of institutions
view their respective market environments. Regional medical centers traditionally draw patient volume
from wide geographic areas with distinctions made between primary, secondary, tertiary, and even
quaternary markets. Urban teaching hospitals have a more concentrated patient market. The exception to
this rule are patients from areas such as out-of-state, nationally, or even international driven by the
reputation of the organization. These patients, however, do not comprise the majority of patient volume.

For patient satisfaction, the two types of hospitals that showed statistical significance were
community teaching institutions and urban teaching hospitals. A possible explanation for this difference
is that community teaching hospitals usually have a strong commitment to quality patient satisfaction. It
is a singular agenda for their mission and vision of the community they serve. Urban teaching hospitals
usually have multiple strategic agendas including medical research and medical education along with
patient care delivery. The urban teaching hospital CEOs need to balance the importance of patient
satisfaction with the critical agendas of research and teaching.

The results of this data strongly suggest only a few factors motivate hospital CEOs to integrate ethical
practices in their organizations. CEOs respond to what is happening in their external environments
regarding competitive forces, and they respond to patient satisfaction issues in the delivery of health care
services. All of the other factors: administrative resources such as mission and vision, medical resources
such as codes of ethics, organizational culture such as philosophies based on general ethical principle had
no meaningful impact for CEOs to commit to ethical integration. Even administrative behaviors or action
failed to serve as motivators. It was only those factors that have tangible economic impact, whether due to
business and referral volumes or legal costs from malpractice issues, triggered the CEO response for
institution-wide ethics integration.

CONCLUSION

The findings of this study are disturbing within the larger context of health administration. Major
support for incorporating ethics throughout hospital management is widely promoted by the American
College of Healthcare Executives. This is also the case for the American Hospital Association and the
various state chapters of AHA. There is no shortage of professional organizations in health administration
making the strong case for ethical practice and behavior in the business of health care services and
delivery. Yet, this study suggests a narrower perspective is used by hospital chief executive officers. It is an economically driven perspective focused on market environments and perceived patient satisfaction.

This conclusion demands further investigation. It is based on only one region of the United States. It is impossible to know whether these results would be replicated in other regions of the country or nationally. The accurate interpretation from this study is that in this area of the country the motivating factors used by hospital CEOs to pursue ethical integration are quite limited, based primarily on concerns with economic overtones. In a nation where health care is perceived as market-driven and practiced in ways that support that perception, these motivators for ethical integration are no surprise. But if America’s acute care, hospital industry is to ultimately fulfill its social charter within this society, there will need to be additional factors influencing the motivation of hospital chief executive officers to develop and create an integrated ethical culture within their institutions.

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The Relationship Between Followers’ Personality and Preferences in Leadership

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Our Lady of the Lake University-San Antonio

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Our Lady of the Lake University-San Antonio

Catalina Zarate
Our Lady of the Lake University-San Antonio

One hundred thirty-two working adults from a variety of organizations in South Texas, ranging from Fortune 500 companies to small businesses, completed the NEO-PI Big Five personality assessment, and the Project GLOBE Leadership Questionnaire. The Project GLOBE Leadership Questionnaire asks participants to answer 112 questions regarding behaviors that contribute to, or inhibit, the general idea of outstanding leadership. These questions can be scored as 21 dimensions of leadership. This study found that participant personality predicted 13 of the 21 dimensions of leadership. The Big Five personality trait of agreeableness was the most consistent predictor of attitudes concerning leadership.

INTRODUCTION

When studying leadership, several methods are common. One method is for followers or additional stakeholders to assess the behaviors of actual leaders. Typically these behaviors are treated as independent variables, and analysis is done on dependent variables, such as follower satisfaction, commitment, and performance.

An emerging type of leadership study is called implicit leadership. In this type of study, no actual leader is rated. Rather, the concept of desired, or outstanding leadership, is measured. In these types of studies, participants complete a survey concerning their prototypes of what constitutes outstanding leadership. There may be a second instrument, such as personality, in order to look at associations between the second construct, and the participants’ implicit views of what constitutes outstanding leadership, or the leadership scores obtained may be analyzed for participant demographics.

To date, the largest study of implicit leadership was the Global Leadership and Organizational Behavior Effectiveness Research Program (GLOBE study) (House, Hanges, Javidan, Dorfman, & Gupta, 2004). This study surveyed over 17,000 participants worldwide regarding what contributed to the
participants’ concepts of outstanding leadership. The 17,000 participants were from 62 countries or societies.

The primary focus of the GLOBE study was to analyze how cultural preferences predicted leadership preferences. While this study added significantly to the body of literature related to implicit leadership, the study did not report how participants’ personalities impacted their views of leadership. This present study builds upon the findings of the GLOBE study by analyzing how participants’ personalities impacts implicit leadership views.

PREVIOUS STUDIES

Project GLOBE

GLOBE measured six higher-order dimensions of leadership. Charismatic/value-based leadership is the ability to inspire, motivate, and expect high performance outcomes from others based on firmly held core values. Team-oriented leadership emphasizes effective team building, and an implementation of a common purpose, or goal, among team members. Self-protective leadership consists of ensuring the safety, and security of the individual and group, through status enhancement and face saving endeavors. Participative leadership reflects the degree to which managers involve others in making, and implementing decisions. Humane-oriented leadership reflects supportive, considerate leadership, but also includes compassion, and generosity factors. Autonomous leadership reflects independent and individualistic leadership attributes.

To simplify interpretation of global differences, the GLOBE study created clusters of countries. The ten clusters created were Eastern Europe, Latin America, Latin Europe, Confucian Asia, Nordic Europe, Anglo, Sub-Saharan Africa, Southern Asia, Germanic Europe, and the Middle East. Table 1 provides the means for each global cluster, and the higher-order dimensions of leadership.

<table>
<thead>
<tr>
<th>Societal Cluster</th>
<th>CV</th>
<th>TO</th>
<th>P</th>
<th>HO</th>
<th>A</th>
<th>SP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Europe</td>
<td>5.74</td>
<td>5.88</td>
<td>5.08</td>
<td>4.76</td>
<td><strong>4.20</strong></td>
<td>3.67</td>
</tr>
<tr>
<td>Latin America</td>
<td>5.99</td>
<td><strong>5.96</strong></td>
<td>5.42</td>
<td>4.85</td>
<td>3.51</td>
<td>3.62</td>
</tr>
<tr>
<td>Latin Europe</td>
<td>5.78</td>
<td>5.73</td>
<td>5.37</td>
<td>4.45</td>
<td>3.66</td>
<td>3.19</td>
</tr>
<tr>
<td>Confucian Asia</td>
<td>5.63</td>
<td>5.61</td>
<td>4.99</td>
<td>5.04</td>
<td>4.04</td>
<td>3.72</td>
</tr>
<tr>
<td>Nordic Europe</td>
<td>5.93</td>
<td>5.77</td>
<td>5.75</td>
<td><strong>4.42</strong></td>
<td>3.94</td>
<td><strong>2.72</strong></td>
</tr>
<tr>
<td>Anglo</td>
<td><strong>6.05</strong></td>
<td>5.74</td>
<td>5.73</td>
<td>5.08</td>
<td>3.82</td>
<td>3.08</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>5.79</td>
<td>5.70</td>
<td>5.31</td>
<td>5.16</td>
<td><strong>3.63</strong></td>
<td>3.55</td>
</tr>
<tr>
<td>Southern Asia</td>
<td>5.97</td>
<td>5.86</td>
<td>5.06</td>
<td><strong>5.38</strong></td>
<td>3.99</td>
<td>3.83</td>
</tr>
<tr>
<td>Germanic Europe</td>
<td>5.93</td>
<td>5.62</td>
<td><strong>5.86</strong></td>
<td>4.71</td>
<td>4.16</td>
<td>3.03</td>
</tr>
<tr>
<td>Middle East</td>
<td><strong>5.55</strong></td>
<td><strong>5.47</strong></td>
<td><strong>4.97</strong></td>
<td>4.80</td>
<td>3.68</td>
<td><strong>3.79</strong></td>
</tr>
</tbody>
</table>

Note. CV – Charismatic/Value-Based, TO – Team Oriented, P – Participative, HO – Humane-Oriented, A – Autonomous SP – Self-Protective, CLT – Culturally Endorsed Leadership Theory Dimensions

Items shown underlined and in bold represent the highest and lowest societal preferences for that dimension of leadership. In interpreting the scores, it is important to understand that the participants responded to 112 leadership behaviors on a Likert scale that ranged from one to seven. A rating of one was actually a very strong, negative rating, indicating that the respondent believed this leadership
behavior greatly inhibited a person from being an outstanding leader. A rating of seven, on the other end of the Likert scale, represented a belief that this leadership behavior greatly contributed to a person being an outstanding leader. Scoring options of two or six represents factors which somewhat inhibited, or somewhat contributed, to outstanding leadership. Scoring options of three or five represents factors which slightly inhibited, or slightly contributed, to outstanding leadership. The middle Likert choice of four represents that this behavior had no impact on a person being an outstanding leader. Table 1 illustrates that charismatic/value based leadership, and team-oriented leadership are desired attributes in leaders worldwide.

Charismatic/value-based leadership, however, can be further clarified by considering fundamental or first-order dimensions. These include (a) Visionary Charisma - having foresight, being prepared, and able to plan ahead (b) Inspirational Charisma - being enthusiastic, positive, a morale booster, and a motive arouser (c) Self-Sacrificing Charisma - being a risk taker, self-sacrificial, and convincing (d) Integrity – soundness of moral character (e) Decisive – displaying no or little hesitation (f) Performance-Oriented – the desire to achieve highly on external indicators of success. Team-oriented leadership can be further divided into (a) Collaborative Team Leadership - being group-oriented, collaborative, loyal, and consultative and (b) Team Integrator - being communicative, a team builder, informative, and an integrator (c) Diplomatic – using or marked by tact and sensitivity when dealing with others (d) Malevolent (reversed-scored) – having or exhibiting ill will (e) Administratively Competent – the capacity or authority to manage or direct the affairs of public or private office.

**Personality and Leadership Perceptions**

The literature on follower personality and perceptions of leadership generally indicates that the more extraverted, agreeable and conscientious followers are, the higher the rate leaders as transformational. Conversely, the more neurotic followers are, the lower they rate leaders as transactional.

Felfe and Schyns (2006), in a study of undergraduate students, found that the more extraverted the participants, the more they recognized, and reacted positively to transformational leadership. However, no relationships were found for the personality traits of neuroticism, occupational self-efficacy, and need for structure. Bono, Hooper, and Yoon (2012) found positive relationships between follower agreeableness, extraversion, and conscientiousness for ratings of transformational leadership. Schyns and Sanders (2007) also found positive relationships between follower extraversion, agreeableness, and conscientiousness for ratings of transformational leadership. Surprisingly, neuroticism was positively related to the perception of transformational leadership.

Moss and Ngū’s (2006) study found that extraversion, and conscientiousness correlated positively with transformational leadership, while agreeableness and openness to new experiences were negatively related with transactional leadership. In addition, agreeableness was inversely related to laissez-faire leadership, while neuroticism was positively related.

Do and Rhee (2007) examined followers’ personalities, and whether personality influenced (positively or negatively) perceptions of transformational leadership. The investigators found that followers with high agreeableness perceived leaders as more transformational, and those with neuroticism perceived leaders as less transformational. However, no relationships were found between followers’ extraversion, and perceived transformational leadership, or openness to new experiences, and perceived transformational leadership.

A 2010 study conducted by Felfe and Schyns in a financial service company found that followers who scored high in extraversion, and agreeableness rated their leaders higher on transformational leadership than other participants. Additionally, followers high in neuroticism rated leaders lower on the individualized consideration component of transformational leadership. Conversely, followers who were high in emotional stability rated their leaders high on individualized consideration, and for openness to new experiences, no relationship was found. Table 2 provides an overview of the literature on follower personality and perceptions of leadership.
TABLE 2
FOLLOWER PERSONALITY AND PERCEPTIONS OF LEADERSHIP

<table>
<thead>
<tr>
<th>Positive Predictors of Perceptions of Transformational Leadership</th>
</tr>
</thead>
</table>
| Extraversion  
(Bono, Hooper, & Yoon, 2012; Felfe & Schyns, 2010; Schyns & Sanders, 2007; Felfe, & Schyns, 2006; Moss & Ngu, 2006) |
| Conscientiousness  
(Bono, Hooper, & Yoon, 2012; Schyns & Sanders, 2007; Moss & Ngu, 2006) |
| Agreeableness  
(Bono, Hooper, & Yoon, 2012; Felfe & Schyns, 2010; Do & Rhee ,2007; Schyns & Sanders, 2007) |

<table>
<thead>
<tr>
<th>Negative Predictors of Perceptions of Transformational Leadership</th>
</tr>
</thead>
</table>
| Neuroticism  
Do & Rhee, 2007; Moss & Ngu ,2006) |
| Openness  
Moss & Ngu, 2006) |

PARTICIPANTS

One hundred thirty-two working adults from south Texas completed two instruments, the NEO-PI Big-five personality assessment, and the Project GLOBE Leadership Questionnaire. There were 81 females and 48 males in the study. There were 75 Hispanic, 30 Black, 12 white participants, and 15 who were of other ethnicities. The sample consisted of college-educated, full-time workers from a variety of business types, and sizes. The ages of the participants ranged from 26 to 58 with a mean of 40 years. Participants could best be described as mid-level managers, or leaders in their organizations.

INSTRUMENTS

Project GLOBE Leadership Questionnaire

The instrument used was the Project GLOBE Leadership Questionnaire. This instrument has been used by over 20,000 participants worldwide. To develop the Project GLOBE Leadership Questionnaire, two empirical pilot studies were conducted in 28 countries to assess the psychometric properties. In the first pilot study, the survey was distributed in 28 countries to people who had full-time work experience as a white-collar employee, or manager. Exploratory factor analysis, aggregation analysis, reliability analysis, and intra-class correlations were then conducted on the results of the surveys. A second pilot study was then conducted in 15 countries that did not participate in the first pilot study in order to replicate the scales in a different sample. The results confirmed the findings from the first pilot study and verified through aggregation tests the target level of analysis (House et al., 2004).

The GLOBE instrument consists of 112 questions. For each question, the participant is asked to rate to what degree that behavior or characteristic inhibits, or contributes to outstanding leadership. The rating scale ranges from one to seven. The instrument measures 21 first-order dimensions of leadership. The dimensions are: Administratively Competent, Autocratic, Autonomous, Charismatic 1: Visionary, Charismatic 2: Inspirational, Charismatic 3: Self-Sacrifice, Conflict Inducer, Decisive, Diplomatic, Face Saver, Humane Orientation, Independent, Individualistic, Integrity, Malevolent, Modesty, Non-Participative, Performance Oriented, Procedural, Self-Centered, Status Conscious, Team 1: Collaborative Team Orientation, Team 2: Team Integrator, and Unique. Definitions of each measure are provided (see Appendix A: Aspects of Leadership Measured by the Project GLOBE Leadership Questionnaire).
NEO-PI

The NEO-PI was developed by Costa and McCrae (1985). The 181-item questionnaire was developed through rational and factor analytic methods to measure the five major factors of personality including, conscientiousness, agreeableness, neuroticism, openness to new experiences, and extraversion. Items are answered on a 5-point Likert scale ranging from strongly agrees to strongly disagree, and scales are balanced to control for the effects of agreement.

METHOD

An initial analysis was conducted in which 21 separate multiple regressions were run in which each dimension of leadership was regressed on the followers’ Big-Five personality scores. Following this initial analysis both exploratory and confirmatory analyses were conducted on the 21 dimensions of leadership. These analyses identified four higher-order dimensions of leadership that were somewhat different than the six higher-order dimensions used in the GLOBE study. As a final analysis, structural equation modeling was used to analyze the inter-relationships among the five dimensions of personality and the four dimensions of leadership.

RESULTS

Multiple Dimensions of Leadership

Table 3 provides an overview of an initial analysis of the five measures of personality, and the 21 measures of leadership. In cases in which more than one dimension of personality was significant, a stepwise multiple regression was run using all five dimensions of personality as predictor variables. The results of the regression are shown in these cases, giving a sense of which dimensions of personality were the strongest predictors of that aspect of leadership. As Table 3 illustrates, participant agreeableness was the most frequent predictor of leadership preferences.
### TABLE 3
**DIMENSIONS OF PERSONALITY AND THEIR ASSOCIATIONS TO PREFERENCES IN LEADERSHIP**

<table>
<thead>
<tr>
<th>Leadership Behavior</th>
<th>Association</th>
<th>O</th>
<th>C</th>
<th>E</th>
<th>A</th>
<th>N</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Integrity</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>.21**</td>
<td>6.64</td>
<td></td>
</tr>
<tr>
<td>Performance Ori.</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>18**</td>
<td>6.55</td>
<td></td>
</tr>
<tr>
<td>Admin. Comp.</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>.18**</td>
<td>6.31</td>
<td></td>
</tr>
<tr>
<td>Participative</td>
<td>R</td>
<td></td>
<td></td>
<td>.16*</td>
<td>.21**</td>
<td>6.22</td>
<td></td>
</tr>
<tr>
<td>Decisive</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>.21**</td>
<td>6.18</td>
<td></td>
</tr>
<tr>
<td>Team II</td>
<td>R</td>
<td></td>
<td>.15*</td>
<td>.21**</td>
<td>.27***</td>
<td>6.13</td>
<td></td>
</tr>
<tr>
<td>Humane Ori.</td>
<td>R</td>
<td></td>
<td></td>
<td></td>
<td>.17*</td>
<td>6.08</td>
<td></td>
</tr>
<tr>
<td>Modesty</td>
<td>R</td>
<td></td>
<td></td>
<td>.15*</td>
<td></td>
<td>5.86</td>
<td></td>
</tr>
<tr>
<td>Autonomous</td>
<td>R</td>
<td></td>
<td></td>
<td>-.23**</td>
<td>-.16*</td>
<td>4.62</td>
<td></td>
</tr>
</tbody>
</table>

**Contributes to Outstanding Leadership**

**Inhibits Outstanding Leadership**

<table>
<thead>
<tr>
<th>Leadership Behavior</th>
<th>Association</th>
<th>O</th>
<th>C</th>
<th>E</th>
<th>A</th>
<th>N</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Status Conscious</td>
<td>R</td>
<td>-.27***</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>4.30</td>
</tr>
<tr>
<td>Conflict Inducer</td>
<td>R</td>
<td></td>
<td></td>
<td>-.24**</td>
<td>.15*</td>
<td></td>
<td>3.47</td>
</tr>
<tr>
<td>Self-Centered</td>
<td>R</td>
<td></td>
<td></td>
<td>-.15*</td>
<td>.15*</td>
<td></td>
<td>1.94</td>
</tr>
<tr>
<td>Autocratic</td>
<td>R</td>
<td></td>
<td></td>
<td>-.21*</td>
<td>.15*</td>
<td></td>
<td>1.86</td>
</tr>
</tbody>
</table>

*Note. Only significant dimensions shown. p < .10*, p < .05**, p < .01***.*

**Reduced Dimensions of Leadership**

An exploratory factor analysis using the Principle Components Method with Varimax rotation was next conducted. Four components were found that had an Eigenvalue greater than one. Each component from the rotated model was then analyzed. The components are shown in Table 3. The first component, which was labeled *Charismatic, Value Based Team Leadership* had an Eigenvalue of 7.3 and explained 38.9% of the variance in scores. Table 4 shows that twelve scales loaded on this component with an Eigenvector score greater than 0.6 or less than negative 0.6. The second component was labeled *Self-Serving Leadership*. The third component was labeled *Bureaucratic Leadership*, and the fourth component *Directive Leadership*.
TABLE 4  
PERSONALITY AND PREFERENCES IN LEADERSHIP  
EXPLORATORY FACTOR ANALYSIS

<table>
<thead>
<tr>
<th></th>
<th>Charismatic, Value Based Team Leadership</th>
<th>Self-Serving Leadership</th>
<th>Bureaucratic Leadership</th>
<th>Directive Leadership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administratively Competent</td>
<td>.693</td>
<td>-.088</td>
<td>.244</td>
<td>.251</td>
</tr>
<tr>
<td>Charismatic I: Visionary</td>
<td>.895</td>
<td>-.158</td>
<td>.045</td>
<td>.194</td>
</tr>
<tr>
<td>Charismatic II: Inspirational</td>
<td>.715</td>
<td>.186</td>
<td>.310</td>
<td>-.020</td>
</tr>
<tr>
<td>Charismatic III: Self-Sacrifice</td>
<td>.753</td>
<td>.151</td>
<td>-.280</td>
<td>-.016</td>
</tr>
<tr>
<td>Decisive</td>
<td>.628</td>
<td>.040</td>
<td>.346</td>
<td>.110</td>
</tr>
<tr>
<td>Diplomatic</td>
<td>.784</td>
<td>-.271</td>
<td>.068</td>
<td>.123</td>
</tr>
<tr>
<td>Humane Orientation</td>
<td>.747</td>
<td>-.201</td>
<td>.356</td>
<td>-.085</td>
</tr>
<tr>
<td>Integrity</td>
<td>.794</td>
<td>-.349</td>
<td>.176</td>
<td>-.037</td>
</tr>
<tr>
<td>Malevolent</td>
<td>-.863</td>
<td>.292</td>
<td>.051</td>
<td>-.077</td>
</tr>
<tr>
<td>Modesty</td>
<td>.698</td>
<td>-.376</td>
<td>.204</td>
<td>-.034</td>
</tr>
<tr>
<td>Team I: Collaborative Team Orientation</td>
<td>.547</td>
<td>-.245</td>
<td>.251</td>
<td>-.165</td>
</tr>
<tr>
<td>Team II: Team Integrator</td>
<td>.618</td>
<td>-.468</td>
<td>-.046</td>
<td>.142</td>
</tr>
<tr>
<td>Autocratic</td>
<td>-.259</td>
<td>.810</td>
<td>.120</td>
<td>.000</td>
</tr>
<tr>
<td>Self-Centered</td>
<td>-.381</td>
<td>.624</td>
<td>-.006</td>
<td>.004</td>
</tr>
<tr>
<td>Face Saver</td>
<td>.091</td>
<td>.835</td>
<td>.055</td>
<td>-.043</td>
</tr>
<tr>
<td>Proc_Bea</td>
<td>.257</td>
<td>.042</td>
<td>.769</td>
<td>.074</td>
</tr>
<tr>
<td>Status Conscious</td>
<td>.018</td>
<td>.126</td>
<td>.889</td>
<td>.148</td>
</tr>
<tr>
<td>Autonomous</td>
<td>.212</td>
<td>.061</td>
<td>.037</td>
<td>.061</td>
</tr>
<tr>
<td>Performance Oriented</td>
<td>.448</td>
<td>-.214</td>
<td>-.204</td>
<td>.619</td>
</tr>
<tr>
<td>Conflict Inducer</td>
<td>.030</td>
<td>.028</td>
<td>.351</td>
<td>.869</td>
</tr>
</tbody>
</table>

Following the exploratory factor analysis, a confirmatory factor analysis was conducted on each of the four dimensions. Each of the tested components had a Goodness of Fit Index greater than .90. As a final step to better understand the relationships among the participants’ personalities and their attitudes about what contributes to, and inhibits outstanding leadership, a structural equation model was run using the five observed dimensions of personality, and the four latent variables of Charismatic, Value-Based Team Leadership; Self-Serving Leadership; Bureaucratic Leadership; and Directive Leadership. The significant correlations found as a result of a structural equation model (SEM) are provided (see Figure 1: Personality and Reduced Dimensions of Leadership). Among the dimensions of leadership, positive relationships were found among Charismatic, Value-Based Team Leadership, Bureaucratic Leadership, and Directive Leadership. These were, in turn, generally inversely related to Self-Serving Leadership.
Extraversion and Openness

The more extraverted and the more open to new experiences the participants’ personalities, the more they believed Directive Leadership contributed to being an outstanding leader. Conversely, the more extraverted, and the more open to new experiences the participants, the less they believed Bureaucratic Leadership contributed to outstanding leadership, and the more they believed that Self-Serving Leadership inhibited outstanding leadership.

Agreeableness

Comparable to extraversion, the more agreeable the participants, the more they believed Self-Serving Leadership behaviors inhibited good leadership.

Neuroticism

Perhaps the most surprising finding from the SEM was that the more neurotic the participants’ personalities, the more they believed both Charismatic, Value-Based Team Leadership, and Directive Leadership contributed to outstanding leadership. This connotes that good, quality-based leadership seems to appeal to followers across four of the five aspects of personality. Conscientiousness, the fifth personality dimension was not significant.

DISCUSSION

Judge, Bono, Ilies, and Gerhardt (2004) conducted a meta-analysis involving 60 studies consisting of 222 correlations from 73 samples that studied leader personality. Their findings were that leader extraversion (\(p = .31\)) (where \(p\) = estimated corrected correlation) was the strongest correlate of effective leadership. Conscientiousness (\(p = .28\)), neuroticism (\(p = -.24\)), and openness to new experiences (\(p = .24\)) displayed the next strongest correlations (where \(p\) = estimated corrected correlation) with leadership. Agreeableness showed a relatively weak correlation with leadership (\(p = .08\)).

This current study found that the followers’ personality trait of agreeableness was a consistently strong predictor of preferences regarding leadership. Followers’ openness to new experiences was particularly incongruent with Bureaucratic Leadership. Perhaps the most interesting finding was that personality traits were positively related to Charismatic, Value-Based Team Leadership and Directive Leadership, and negatively related to Bureaucratic Leadership and Self-Serving Leadership. This tends to indicate that both good and bad clearly transcend follower’s personality.

REFERENCES


**APPENDIX**

Aspects of Leadership Measured by the *Project GLOBE Leadership Questionnaire*

1. **Administratively Competent**: orderly, administratively skilled, organized, good administrator
2. **Autocratic**: autocratic, dictatorial, bossy, elitist
3. **Autonomous**: individualistic, independent, autonomous, unique
4. **Charismatic 1: Visionary**: foresight, prepared, anticipatory, plans ahead
5. **Charismatic 2: Inspirational**: enthusiastic, positive, morale booster, motive arouser
6. **Charismatic 3: Self-Sacrifice**: risk taker, self-sacrificial, convincing
7. **Conflict Inducer**: normative, secretive, intragroup competitor
8. **Decisive**: willful, decisive, logical, intuitive
9. **Diplomatic**: diplomatic, worldly, win-win problem solver, effective bargainer
10. **Face Saver**: indirect, avoids negatives, evasive
11. **Humane Orientation**: generous, compassionate
12. **Independent**: free from the influence, guidance, or control of another or others.
13. **Individualistic**: the action or principle of asserting one's independence and individuality.
14. **Integrity**: honest, sincere, just, trustworthy
15. **Malevolent**: hostile, dishonest, vindictive, irritable
16. **Modesty**: modest, self-effacing, patient
17. **Non-Participative**: to not share in something.
18. **Performance Oriented**: improvement-oriented, excellence-oriented, performance-oriented
19. **Procedural**: ritualistic, formal, habitual, procedural
20. **Self-Centered**: self-centered, non-participative, loner, asocial
21. **Self-protective** leadership focuses on ensuring the safety and security of the individual and group through status enhancement and face saving.
22. **Status Conscious**: status-conscious, class-conscious
23. **Team 1: Collaborative Team Orientation**: group-oriented, collaborative, loyal, consultative
24. **Team 2: Team Integrator**: communicative, team builder, informed, integrator
Neuroticism was positively correlated with preferences for Charismatic Leadership ($M = 6.00$) and Directive Leadership ($M = 5.00$)

Extraversion was positively correlated with preferences for Directive Leadership ($M = 5.00$) and negatively correlated with tolerance for Bureaucratic ($M = 4.4$) and Self Serving Leadership ($M = 2.33$)

Agreeableness was positively correlated with preferences for Charismatic Leadership ($M = 6.00$) and Directive Leadership ($M = 5.00$) and negatively correlated with tolerance for Self Serving Leadership ($M = 2.33$)

Openness was positively correlated with preferences for Directive Leadership ($M = 5.00$) and negatively correlated with tolerance for Bureaucratic ($M = 4.4$) and Self Serving Leadership ($M = 2.33$)
In 2010 the Securities and Exchange Commission passed a rule that made it easier for shareholders to nominate people for the slate for a corporation’s board of directors. The rule was challenged successfully before a federal circuit court and the rule was invalidated on the grounds that it was “arbitrary and capricious.” The article discusses whether the rule (or the circuit court case) was justified and what the burden of proof should be when a circuit court reviews a rule of an administrative agency.

INTRODUCTION

What is a “shareholder”? Is a shareholder an owner of a corporation? If so, does a shareholder have some control of the corporation? Of course, as we all know, one of the fundamental distinctions between a corporation and a general partnership is that general partners control their business directly. In a corporation (except close corporations), the shareholders are separated from control by two entities: the board of directors and the managers. However, since the shareholders elect the board and the board picks the managers, it would seem that shareholders do in some sense control the corporation (indirectly). But is this actually the case? Do shareholders of most medium to large corporations even indirectly have any major control over companies?

This article will examine that question and how shareholder control has changed over the decades and how it continues to evolve. Because shareholders have many rights, the article will mainly focus on the relationship between shareholders and the board members. The Securities and Exchange Commission (SEC) passed several rules related to shareholder access to having a say on who sits on the board. The article will examine the SEC’s recent rules relating to the subject and a recent D. C. Circuit ruling striking down one of the rules.

In earlier times, with corporations whose major shareholders were John Rockefeller, Cornelius Vanderbilt, Andrew Carnegie, and Andrew Mellon, it was probably correct to think that these shareholders did control their corporations. In recent years, few corporations exist where one individual both owns a major portion of the corporation and also controls it--such as Mark Zuckerberg, Bill Gates, and Sam Walton. During a number of decades, corporate shareholder ownership has fractionated significantly (particularly for those traded on major stock exchanges). Many of those who do own shares, either directly or through mutual funds, may own just a few shares in many different companies. With this dilution, shareholder control has diminished enormously.
Thus, it is probably correct today that shareholders do not own the corporation in the same way that one owns a car or a house. Shareholders own shares and the question is what ownership of shares practically means. In all states, shareholders do get to vote for the board of directors; but for large to medium sized companies this means little. Since management controls the slate for the ballot and since there is no choice for shareholders, voting has all the effect of a North Korean election. The net result is what is called the “Wall Street Rule”: shareholders can either live with management control or sell their shares (Monks and Minow, 2011). Shareholders are left with little control. But is this a bad thing?

The arguments, both economic and otherwise, swirl over whether or not shareholders should have more control over the board election. The basic economic arguments fall into two camps: (1) The shareholders do not understand the complexities of the economy or the situation of the corporation and thus are unable to exercise any rational control of the company. (2) Not all shareholders are ignorant. Many corporations do have shareholders who are large parties or entities and who can make an informed judgment about whether the corporation is being run efficiently. These may include mutual funds, pension funds, institutional funds, and in some cases employee stock plans. Note that there also can be non-economic reasons, as noted below.

**WHO OWNS STOCKS TODAY**

For a long time it has been assumed that ownership of stock is and was spread among many shareholders, and thus it undoubtedly is the case that the owners are unlikely to have all but a cursory understanding of what is happening with the corporations whose shares they own. At one time this was substantially true. The chart below, derived from the U.S. Census Office, shows that in 1952 over 90% of the shares were owned by private households. In 2010, that percent was significantly reduced to around 37%. The other large categories would include pension funds, life insurance companies, and mutual funds (including closed end funds and ETFs).

Now the “Household Sector” may be somewhat misleading. These are shares owned by private individuals. But this could include individuals who own large stakes in particular companies; persons like Bill Gates and Warren Buffet might be included.

Certainly large shareholders, mutual funds, retirement funds, and insurance companies would have a large incentive to follow the inner workings of the corporations in which they own shares. The rise of the Internet makes it easier than ever to study the performance of particular companies that are traded on stock exchanges. Cable channels such as CNBC and Fox Business examine particular stocks. Legally required financial statements such as 10-K’s and 10-Q’s are freely available online.

On the other hand, it would be wrong to think that casual investors or even institutions such as mutual funds know as much about a company as its top managers. Nevertheless, it is sometimes the case that top management has performed poorly. In such cases, shareholders could sell (often at a loss) but they might feel that the company could be turned around with new management and thus their share price or dividends may increase. Should they have an option other than just to sell?
THE RIGHTS OF SHAREHOLDERS

It would be presumptuous to say that shareholders own shares and thus control the corporation. Perhaps we can only say that shareholders own shares. But what does that mean?

Monks and Minow (2011) argue in their book that the loss of control of the corporation is linked with the limited liability of shareholders. With limited partnerships, general partners have control and unlimited liability, whereas limited partners, while having no general control, have limited liability. Still in recent years we have seen the rise of limited liability companies in which the member-owners have both limited liability and control (for member-managed LLCs).

So what specific rights do shareholders have? Edward Epstein (1986) mentions five: (1) the right to sell their stock; (2) the right to vote the proxy (though this has been very limited); (3) the right to bring shareholder derivative lawsuits for grossly mismanaged companies; (4) the right to certain information from larger companies (such as 10-K’s), and (5) the right to be repaid their investment.

There are typically other rights that shareholders have. They can expect those management to exercise their fiduciary duty to act in the interest of shareholders and the shareholders can bring a “derivative lawsuit” if that duty is broken. They also have the right to inspect the books, to notice of shareholder meetings, and to vote on various matters such as amending the corporate charter, mergers, and the sale of the business.
Shareholder meetings are often arranged by top management with little or no shareholder involvement. Monks and Minow (2011) say that such meetings are just “formalities.” Usually, the shareholders have the right to ask questions, but in some cases management may avoid the questions. Board members may not be present. In one case, a Houston based company moved their shareholder meeting to a remote Texas town. In another case the meeting was moved to Asia. In 2010, Symantec had a “virtual” meeting with no one physically present.

THE SEC ACTS TO PROVIDE SHAREHOLDER ACCESS TO VOTING FOR THE BOARD

On August 25, 2010, the Securities and Exchange Commission on a three to two vote agreed to adopt a rule 14a-11 (later struck down) which would have provided some access for shareholders to nominate board members. To be sure, the rule was substantially limited. Access was to be denied if the state in which the company is incorporated prohibits such access. The rule applied only to companies that are “registered” with the SEC. (SEC Facilitating Shareholder Director Nominations (2010), p. 56674)

This rule required the shareholder (individually or in a group) to hold at least 3% of the total voting shares that are entitled to vote for the board. The shareholder or group would also have to own the shares for three years.

More importantly, under Rule 14a-11, the number of proposed directors was substantially limited. A successful proposal was not going to give such shareholders control of the company. The number of board members that could be elected was either one or one quarter of the board, whichever is higher. If the one quarter rule was used, the number would be rounded down. For example, if the number of directors is 9, the number that could be proposed would be 2. These maximum numbers would have applied regardless of whether the directors were voted in all together or whether they were elected in a staggered election (SEC Facilitating, p. 56675).

If there were competing shareholders that were nominating, the group with the highest number of votes would have priority. If the group with priority did not use up all of the available number that could be nominated by shareholders, the lesser group could “fill in the gap.”

And if those limitations were not enough, the shareholders could not have the purpose of “changing control” of the company. While in a sense this appears to be a big change for the SEC, which had always limited shareholder access significantly, the newly proposed change hardly had the effect of really threatening management’s control of a company. The original proposal was part of a 451 page explanation by the SEC. In the opening page, the SEC said that the proposal “will benefit shareholders by improving corporate suffrage, the disclosure provided in connection with corporate proxy solicitations, and communication between shareholders in the proxy process”(SEC Facilitating, p. 56668).

The opening justification would seem to indicate that the SEC was interested in more than just economic efficiency. The use of the word “suffrage” harkens back to the women’s movement to vote. It seems to be a defense of a right that ought to exist and a right that is currently suffocated by the current system. It is a right that exists not only as an economic right but also would seem to be a personal right (perhaps a property right), as viewed by the SEC. The justification also seems to indicate that it would improve corporate proxy disclosure, in that management’s proxy might have to compete with that of the shareholder. Finally, it might improve the shareholders’ understanding of corporate matters through communication, not only between the corporation and the shareholder, but also between shareholder and shareholder.

THE JUDICIAL CHALLENGE TO THE RULE

The Business Roundtable and the Chamber of Commerce of the United States challenged the rule as being “arbitrary and capricious” (Business Roundtable v. United States (2011), p. 1148, citing Administrative Procedure Act (2010) §706(2)(a)). The District of Columbia Circuit Court cited a Supreme Court case that the agency should “examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choices made”
The D.C. Circuit Court said that the Commission:

- inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters (Business Roundtable v. SEC (2011), pp. 1148-49).

The Court recognized the fairly strict limitations of the rule, as noted above (Business Roundtable v. SEC (2011), p. 1147). The SEC said that the rule would reduce the costs of a conventional proxy fight and “has the potential of improving board performance and enhancing shareholder value” (SEC Facilitating, p. 56,670). But the Commission also noted that there would be increased costs to the corporation in sending out the shareholder proxy materials. Also, there was the possibility of adverse effects on the board and company performance. (SEC Facilitating, p. 56,764). But overall, the Commission thought that the rule would benefit the efficiency of the economy as a whole and that the benefits would justify the costs (SEC Facilitating, p. 56,771).

The Circuit Court believed that the SEC underestimated the costs involved. The Chamber of Commerce pointed out that the costs that companies had incurred in fighting proxy contests ranged from $4 to $14 million for large companies and $800,000 to $3 million for smaller ones (Business Roundtable v. SEC (2011), p. 1150).

The Circuit Court noted that the SEC looked at some conflicting economic studies about how companies with hybrid boards (with management controlled and proxy board members) perform compared to their peers. Several studies showed that such companies underperformed, with one study saying they underperformed from 19% to 40% (Business Roundtable v. SEC, p. 1151, citing Buckberg and Macey, 2009). The SEC also looked at several studies that showed that proxy directors or hybrid directors improved shareholder value. The Circuit Court found these studies unpersuasive (Business Roundtable v. SEC, p. 1151). The Court also found that the SEC discounted the costs of the rule, but not the benefits, because under traditional State law, the right to nominate directors would cause directors to reduce the time spent on strategic and long-term thinking (Business Roundtable v. SEC, p. 1151).

The second criticism by the Court was that the SEC had failed to consider how union and state pension funds might “leverage” the rule to gain concessions, “such as additional benefits for unionized employees, unrelated to shareholder value” (Business Roundtable v. SEC, pp. 1151-52). The SEC thought that the problem would be rather limited because unions and pension funds could not control the board; this is because of the rule’s limitations on the number of board members nominated, and also because other shareholders would be alerted to such candidates’ interests (Business Roundtable v. SEC, p. 1152).

The third issue that the District Court had with the rule relates to the number of contests that would be initiated as a result of the rule. The SEC had dropped the number from an earlier proposal because of additional limitations on who could use the rule and new information on the number of contested elections in the previous year (Business Roundtable v. SEC, pp. 1152-53). The Court criticized this argument by saying that the SEC did not consider to what extent this new proxy method might take the place of the traditional proxy fight. The SEC thought there might be fewer traditional proxy fights with this avenue available. The Court said that the SEC could not quantify this, though (Business Roundtable v. SEC, pp. 1153-54). Several commentators that participated in the rule making thought that the number of new directors being proposed through this new rule might be considerably higher than the SEC thought (such as 15% higher). (Business Roundtable v. SEC, p. 1154 citing Altman Group (2011)). In addition, there might be more proxy fights from groups that have special interests such as “public and union funds”
which might be more concerned with jobs rather than shareholder value (Business Roundtable v. SEC, p. 1152).

Finally, the Court said that the SEC anticipated frequent use of the rule when looking at benefits and infrequent use when looking at the associated costs. These problems made the adopting of the rule “arbitrary” (Business Roundtable v. SEC, pp. 1153-54).

THE SEC’S RESPONSE

On September 6, 2011, the Chairman of the SEC, Mary Shapiro, announced that the SEC would not appeal the Circuit Court’s decision. Chairman Shapiro issued the following statement about her position on the issue:

I firmly believe that providing a meaningful opportunity for shareholders to exercise their right to nominate directors at their companies is in the best interest of investors and our markets. It is a process that helps make boards more accountable for the risks undertaken by the companies they manage. I remain committed to finding a way to make it easier for shareholders to nominate candidates to corporate boards.

At the same time, I want to be sure that we carefully consider and learn from the Court's objections as we determine the best path forward. I have asked the staff to continue reviewing the decision as well as the comments that we previously received from interested parties (Shapiro, 2011).

Perhaps the SEC was worried about losing before the Supreme Court. While the SEC lost the battle for shareholder access to the board, it has not completely lost the war, as is clear in Ms. Shapiro’s statement. When the SEC adopted Rule 14a-11 (which was struck down by the D.C. Circuit), it also adopted Rule 14a-8 (SEC Allowing Shareholders Proposals (2011). This rule, which was not challenged in the Business Roundtable case may provide for shareholders to get access to the corporate board by asking that rules (such as the by-laws) be subject to a shareholder vote.

This is discussed in Ms. Shapiro’s statement:

Last year, when the Commission adopted Rule 14a-11, it also adopted amendments to Rule 14a-8, the shareholder proposal rule. Under those amendments, eligible shareholders are permitted to require companies to include shareholder proposals regarding proxy access procedures in company proxy materials. Through this procedure, shareholders and companies have the opportunity to establish proxy access standards on a company-by-company basis -- rather than a specified standard like that contained in Rule 14a-11 (Shapiro, 2011).

Ironically, while Rule 14a-11 is a more indirect and lengthy process for shareholder access to the board, this rule could have even more effect. While Rule 14a-8 allowed for only one shareholder or a quarter of the board to be elected through proxy access, Rule 14a-11 does not have such a limit.

Use of Rule 14a-8 does not allow for a direct nomination of a particular person, but it does appear to allow for the adoption of general rules for access to the slate for the board. The requirement to submit such a proposal is only 1% or $2,000 of market value of stock. (SEC Allowing, pp. 56674-56678).

One commentator on Rule 14a-8 has said that this rule compared to 14a-11 may be even more useful for corporate activists:

The revisions to Rule 14a-8 are a potent weapon for activist investors that we have long advised clients could create far more issues than the now vacated proxy access rules. The reason is simple: There are no onerous ownership or length of holding thresholds. Under Rule 14a-8, a shareholder need only own $2,000 worth of stock and have held it for one
year. Long time Rule 14a-8 activists like John Chevedden may have a field day. Well funded activists may become disruptive (Radoff, 2011).

It is perhaps surprising that the plaintiffs did not challenge Rule 14a-8 along with Rule 14a-11. The enactment of the changed Rule 14a-8 may also be part of the reason that the SEC did not appeal the DC Court’s decision. The American Bar Association’s Business Law Section urged the SEC to negate Rule 14a-8 given the court’s decision (American Bar Association, 2011). Perhaps the Business Roundtable and its associates may challenge 14a-8 in the future.

DID THE D.C. CIRCUIT’S OPINION ESTABLISH THAT SEC RULE 14A-11 WAS “ARBITRARY AND CAPRICIOUS”?

Under the Federal Administrative Procedure Act, the agency is not to act in a way that is “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law” (Administrative Procedural Act, § 706(2)(A)). The Circuit Court cited a 1983 U.S. Supreme Court Case which said that the agency should “examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choices made” (Business Roundtable, p. 1148 citing Motor Vehicle Manufacturers Association of U.S. v. State Farm Mutual Insurance Co. (1983), p. 43). It also cited one of its cases (from the D.C. Circuit) saying that the Commission has a “statutory obligation to determine as best it can the economic implications of the rule” (Business Roundtable v. SEC, p. 1148 citing Chamber of Commerce v. Securities Exchange Commission (2005), p. 143).

The standard for examining administrative rules appeared to change dramatically in 1971 with a Supreme Court case, Citizens to Preserve Overton Park, Inc. v. Volpe (1971). The idea of what is “arbitrary and capricious” under court review of an agency’s rule making is far from a low standard, as is found under the equal protection clause for most economic regulation. The Supreme Court said in this case that while the appeal was not a new review, it still required “the reviewing court to engage in a substantial inquiry” (Citizens to Preserve Overton Park, Inc., p.415). The court should find that “the decision was based on a consideration of the relevant factors.” Still the court said that the “decision is entitled to a presumption of regularity” and that the reviewing court should determine “whether there has been a clear error of judgment.” Finally, “the ultimate standard of review is a narrow one. The court is not empowered to substitute its judgment for that of the agency” (Citizens to Preserve Overton Park, Inc., p.416).

This has come to be known as the “hard look” standard. But, the caveats quoted immediately above show that there should still be a presumption in favor of the agency. The D.C. Circuit cited a later case in line with the above Citizens ruling: Motor Vehicle Manufacturers Association v. State Farm Mutual Insurance Co. (1983). As discussed earlier, an “agency must examine the relevant data and articulate a satisfactory explanation for its action.” (Motor Vehicle Manufacturers Association v. State Farm Mutual Insurance Co., (1983), p. 43) But the Supreme Court also indicated some deference is due the agency: “We will, however, ‘uphold a decision of less than ideal clarity if the agency’s path may reasonably be discerned’” (Motor Vehicle Manufacturers Association v. State Farm Mutual Insurance Co., (1983), p. 43, citing Burlington Truck Lines, Inc. v. United States (1962), p. 168).

The petitioners in their brief to the court (Business Roundtable) relied on Motor Vehicle Manufacturers. It also relied (Petitioner’s Brief of Business Roundtable (2011), p. 27) on some D.C. Circuit cases that require that “the agency must respond in a reasoned manner to those that raise significant problems” (Covad Communications Co. v. FCC (2006), p. 550). It also said the court should “vacate the order” if it adopted the rule with a “flawed rationale.” (Natural Fuel Gas Supply v. FERC (2006)).

The Supreme Court has also said that the courts must be unusually deferential when the agency is making predictions, though this was in the area of science. (Baltimore Gas & Electric Co. v. Natural Resources Defense Council (1983), p. 103). This is known as the “soft look rule.” But this was in the
area of nuclear reactors, a matter of science. Still while it is in the realm of estimating the effects of the
rule, the SEC is involved in making predictions.

The SEC also relied on a Supreme Court Case, Black & Decker Disability Plan v. Nord in which the
Court ruled that when an agency adopts a “comprehensive regulatory scheme,” “the scope of permissible
judicial innovations is narrower in areas where other federal actors are engaged” (2003, pp. 831, 832). Still, it might be doubted whether the SEC’s rule that was struck down is a “comprehensive regulatory
scheme.”

One question about the Circuit Court’s ruling is that it seems to say that a rule is “arbitrary and
capricious” unless it carefully picks the absolutely best rule based on economic factors. There doesn’t
seem to be any wiggle room for factors based on non-economic concerns or for trying to choose between
conflicting economic studies which have not and cannot predict the exact consequences of a rule that has
yet to be put in place for the first time. If the agency does not know precisely what would happen under
the rule, the regulation would under the D.C. Circuit’s ruling would seem to be “arbitrary and capricious.”
Then, the question is whether it is an impossible criteria for an administrative agency. It is probably the
case that the SEC did not do a perfect job of analyzing every factor. But such a tough burden would seem
to paralyze any administrative rule making.

The crucial question, it would seem, is whether the ruling on appeal to a court should be granted some
deferece under the “arbitrary and capricious” standard. The U.S. Supreme Court took up this matter in
2001 in United States v. Mead (2001). The Supreme Court admitted that in previous cases there was found “a spectrum of responses, from great respect at one end… to near indifference at the other…” in
regard to deference (United States v. Mead (2001), p. 228). If there is an explicit or implicit legislative
delegation from Congress to the agency, “a reviewing court has no business rejecting an agency’s
expertise or its generally conferred authority to resolve a particular statutory ambiguity because the
agency’s chosen resolution seems unwise” and this forms the basis of the meaning of “arbitrary and
capricious.” (United States v. Mead, (2001), p. 229) But according to the Court, if it is not clear that that
the agency was delegated authority, a much tougher standard is in order (United States v. Mead (2001), p.
231).

In the case of proxy access, the most explicit and recent statutory grant is a provision of the Dodd-
Frank Act, sections 971 (A) and (B). Dodd-Frank does not say that the SEC must pass rules for
shareholder proxy access to the board of directors, but it does explicitly say that it may. It also says that it
may exempt certain entities and it explicitly mentions “small issuers.” The law reads:

(b) REGULATIONS.—The Commission may issue rules permitting the use by a
shareholder of proxy solicitation materials supplied by an issuer of securities for the
purpose of nominating individuals to membership on the board of directors of the issuer,
under such terms and conditions as the Commission determines are in the interests of
shareholders and for the protection of investors.

(c) EXEMPTIONS.—The Commission may, by rule or order, exempt an issuer or class
of issuers from the requirement made by this section or an amendment made by this
section.

In determining whether to make an exemption under this subsection, the Commission
shall take into account, among other considerations, whether the requirement in the
amendment made by subsection (b) disproportionately burdens small investors. (Dodd-
Frank Act (2011)).

The text of the law does not say that economic cost-benefit analysis should be the sole criterion for
the rule (except perhaps for small issuers). Obviously, how the rule will affect the financial success of
covered corporations must be a relevant factor given the Administrative Procedure Act and other
securities laws. Given the language of Mead, it is apparent that Congress specifically delegated authority
to the SEC regarding director proxy access.
The D.C. Circuit Court does not mention the Dodd-Frank Act, even though it was in effect. The Court says that the SEC does have an obligation “to consider the rule’s effect upon efficiency, competition, and capital formation” as required by the Exchange Act and the Investment Company Act of 1940 (2010). The language of Dodd-Frank, as noted above, includes other factors, not specifically mentioned by the Court: interests of shareholders and protections of investors. Also, the Exchange Act says that the Commission should regulate proxies “as necessary or appropriate in the public interest or for the protection of shareholders” (Securities and Exchange Act of 1934 (2010)). Is it the sole interest of the shareholders and the public interest to maximize efficiency and profits within the company? This would seem to go straight at the shareholder/stakeholder theory faceoff. These terms, however, seem to assume that shareholders themselves are only interested in payoff for their investments; maybe they are interested in other stakeholders. Furthermore, it may be more realistic to add a third theory to shareholder and stakeholder positions and that is “agency theory” (or the principal/agent problem): it may be in the managers’ interest to run the corporation to their own benefit. Of course, it may be possible that the managers are running the corporation poorly to no one’s interest. Thus the protection of investors may mean that some oversight could be useful.

DID THE SEC DO A PROPER ANALYSIS: AN EXAMINATION OF BOTH SIDES

Some support for the D.C. Circuit’s opinion comes from an analysis of the economic issues in the case. There were two studies which the Circuit Court said were relied upon “exclusively and heavily” by the agency to support its proposed rule, though the court characterized these studies as “relatively unpersuasive” (Business Roundtable v. SEC (2011), p. 1151). The first was an article by Mulherin and Poulsen (1998) entitled “Proxy Contests and Corporate Change: Implications for Shareholder Wealth.” The study was prompted by previous findings of other researchers which tended to show that proxy contests correlated negatively with changes in shareholder value. Mulherin and Poulsen argued that this is counterintuitive since a proxy contest in conjunction with a takeover attempt should be an economic device to target and discipline badly managed firms. If the “market for corporate control” is working efficiently, such contests should more often increase rather than lessen shareholder value.

Using a broader sample than earlier studies had, the authors found a fairly strong correlation between proxy contests and increases in shareholder value (Mulherin and Poulsen, 1998, p. 293). The pattern was that a substantial positive “announcement effect” on share values occurred at the initiation of the takeover attempt; some of this effect would be dissipated later but the long term result was a modest but significant gain for shareholders. There could be a serious problem with the agency putting too much reliance on this study, however. The study focused on proxy contests occurring in the context of a takeover attempt, not in the context of attempts of a dissident faction to gain seats on a corporate board in the absence of a takeover attempt. Mulherin and Poulsen devoted a substantial portion of their paper to disaggregating their overall data and carefully explaining that the finding of corporate wealth gains from proxy contests is driven by the proxy contest resulting in a successful takeover, or at least in major subsequent changes in corporate management at the highest level. In the absence of such major changes, they found no positive wealth effects on shareholder value from proxy contests (Mulherin and Poulsen, 1998, pp. 302-303). The SEC rule would have made easier the creation of “hybrid” boards (containing one or more non-management-appointed directors). This would not be the type of relatively drastic change in management which Mulherin and Poulsen show producing increases in shareholder value after a proxy contest. Thus the study was a bit off focus for the specific issue of the probable effects on shareholder value of adoption of proposed rule 14a-11.

The second study relied on by the SEC, to the Circuit Court’s disapproval, was “Effectiveness of Hybrid Boards” a publication of the IRRC (Investor Responsibility Research Center) Institute, published by four co-authors, Cernich, Fenn, Anderson, and Westcott (2009). Much of this study is a valuable documentation of the increasing importance of hybrid boards. A very positive view--one often taken issue within the literature--is presented of the effect of institutional investors placing directors on boards and, in particular, of the effects of hedge funds as informed, savvy investors whose activities often tend to
promote positive managerial changes. The result of the study that would seem most directly relevant to
the proposed SEC rule was a statistical finding based on a sample of 120 firms in the period 2005-2008
that corporations with hybrid boards showed a shareholder value 17.8% higher than in peer corporations
without hybrid boards (Cernich, Fenn, Anderson, and Westcott, 2009, p. 3).

Upon analysis, however, two reservations occur about the usefulness of this study as support for the
SEC’s proposed rule. One is mentioned by the four authors themselves, and may be why the Circuit Court
said that the study’s “long-term findings on shareholder value creation are difficult to interpret.” The
study’s overall average hides results that show a high degree of “bimodality”. In the words of the authors,
“perhaps most significantly, though, the individual outcomes within the group of ongoing businesses
varied substantially, dwarfing the mean average results within each measurement period and significantly
reducing the relevancy of these averages” (Cernich, Fenn, Anderson, and Westcott, 2009, p. 27)
(emphasis added).

The other problem is more conceptual. The study looks at the performance of hybrid boards which
came into being despite the absence of any SEC rule facilitating the creation of such boards. It shows--
apart from some statistical raggedness referenced above—that these hybrid boards may increase
shareholder value on average. But it is likely that hybrid boards that develop outside of the context of
federal regulatory authorities encouraging such boards tend to be those in circumstances where, for one
reason or another, such a board can improve the management of the company. By contrast, it is
undisputed by both advocates and opponents of the rule that there may be particular situations where such
boards would not improve and perhaps even weaken the performance of a board for a particular company.
In the absence of any rule facilitating proxy challenges, companies in this kind of a circumstance would
probably be significantly less likely to experience a proxy challenge aimed at creating a hybrid board.
Thus, to some degree the Cernich study is weighted towards looking at corporate contexts in which
hybrid boards would indeed tend to work better and thus enhance performance, whereas the proposed rule
would apply not only in those contexts, but also in those in which hybrid boards would not tend to work
well and thus weaken performance. The Cernich study doesn’t give direct evidence, thus, about how
adoption of the rule might affect shareholder value overall.

The major study cited in the Circuit Court opinion in opposition to the proposed SEC rule was an
article by Elaine Buckberg and Jonathan Macey (2009), “Report on Effects of Proposed SEC Rule 14a-
11 on Efficiency, Competitiveness and Capital Formation”, published by NERA Economic Consulting.
This article was more directly on point in the sense that it was written specifically as an evaluation of the
proposed rule. It does not contain new research but summarizes previous research that might have
negative implications for the proposed rule. Thus it cites several empirical studies which found negative
correlations between dissident board directors winning seats on the one hand and share performance on
the other. One study was the subject of a direct, detailed critique in the article by Mulherin and Poulsen
(1998, pp. 284-85) cited above which persuasively cast doubt on its finding. However, several other
studies with similar results (a 19-22% negative correlation) are cited, though none of the studies are more
recent than 1997 (Buckberg and Macey, 2009, pp. 9-10). Another major concern of Buckberg and
Macey’s article was the potential problem for corporations and their shareholders posed by institutional
investors who, as shareholders, might be more interested in political goals or their own institutional goals
rather than in maximizing shareholder value. Large corporations are always faced with the problem of
trying to align the incentives of their management with that of their theoretical bosses, the shareholders.
But when a shareholder is itself an institution with its own principal-agent problem (e.g., the imperfect
alignment of union officials’ interests with those of the pension funds they manage) there is a resulting
“principal-agent problem within the principal-agent problem” with unpredictable, perhaps negative
efficiency results (Buckberg and Macey, 2009, p. 12). Because of this concern Buckberg and Macy
suggest adoption of a much higher threshold level for subsidized shareholder proxy access than that
proposed in the SEC rule (p. 15). In sum, what this study presents in a thorough manner is a survey of
some of the reasons to oppose the proposed rule; it doesn’t seem to be definitive on the question, though,
in the sense of establishing beyond reasonable dispute the undesirability of the proposed SEC rule.
On the other side of the question, one could argue that the D.C. Circuit Court should not be acting as a fact-finder as long as the SEC did not act in an arbitrary and capricious manner regarding the promulgation of the rule. The cost-benefit analysis of the rule is about 96 pages long, and the whole justification of the rule includes more factors than just board and company’s economic performance.

The SEC examined four benefits:

1. facilitating shareholder’s ability to exercise their state law rights to nominate and elect directors;
2. minimum uniform procedures for inclusion of shareholder director nomination and enhanced ability for shareholders to adopt director nomination procedures;
3. potential improved board performance; and
4. more informed voting decisions in director elections due to improved disclosure of shareholder director nominations and enhanced shareholder communications.

The Committee also looked at three costs: adverse effects on company and board performance, additional complexity in the process, and costs of disclosure, printing and mailing. The SEC also looked at the “consideration of burden on competition and promotion of efficiency, competition, and capital formation.” It also examined significant issues raised by public comments and reasons to reduce the burden for small entities (SEC Facilitating, pp. 56,671-56,676).

The SEC quickly stated that some benefits of the rules are not easily computed: “We note, however, the benefits of the new rules are not limited to those that are quantifiable (such as the direct savings in printing and mailing costs) and instead include benefits that are not as easily quantifiable (such as the possibility of greater shareholder participation and communication in the director nomination process…). We believe that these benefits, collectively, justify the costs of the new rules” (SEC, Facilitating, p. 56,755).

The SEC noted a June 2009 survey that said that 82% of shareholders thought they should be able to nominate and elect directors (SEC Facilitating, p. 56,775 n.863, citing ShareOwners.Org Letter (2010)). But should the right to nominate directors be a property right of shareholders?

While the SEC said that there was more to the proposal than efficiency, it noted a number of economic studies that showed that companies with stronger shareholder rights had better performance. As one of many examples, the agency cited an article by Gompers, Ishii and Metrick that stated that “firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth…” (SEC Facilitating, p. 56,761 citing Gompers, Ishii, and Metrick, 2003). Another study by Hermalin and Weisbach (1998) showed a link between accountability of the board and performance. They noted a comment from Harvard Law Professors Bebchuk and Hirst (2010) that said there was “substantial empirical evidence indicating that director insulation from removal is associated with lower firm value and worse performance” (SEC Facilitating, p. 56,761 citing Bebchuck and Hirst (2010)). Other studies relating to firm performance were cited both pro and con. The SEC noted limitations on both types of studies (SEC Facilitating, pp. 56,763).

One can imagine all the variables in such studies that one would have to control. First, there are probably not all that many boards that have members that are independently elected. Second, the negative studies, that show that boards with members that are independently elected after a proxy fight do worse than their peers, do not necessarily prove anything conclusively either. The reason for proxy fights and the push for independent directors may be caused by a company’s poor performance compared to their peers. Shareholders owning stock in companies that are doing well do not have much incentive to intervene.

The SEC noted that even if a company is doing poorly, it may be unattractive for shareholders to mount a full scale proxy fight. If the shareholder owns the stock as part of a mutual fund (such as an indexed fund), “voting with their feet” by selling may also not be a good alternative (SEC Facilitating, p. 56,773). The SEC also said that the range of proposals in its new rules would lead to more informed voting decisions for the board and increase and improve the disclosure relating to the candidates.
Shareholders who form groups to nominate directors can have improved communication (SEC Facilitating, p. 56,764).

The SEC also looked at comments and studies relating to costs. Besides the fact that proxy-nominated directors could be distracting and time consuming for boards, it is also possible that the proposal may lead to lower quality boards. The Commission noted that its proposal did not allow for anything close to a takeover of the board, given the number of directors that could be elected under its proposals. Furthermore, the requirement of substantial disclosure for director candidates can allow shareholders to make more informed decisions about whether or not changes need to be made to the board. If the bulk of the shareholders are satisfied with company performance and the board, they would vote against any change (SEC Facilitating, p. 56,765).

The Commission also examined the more quantifiable costs and complexities: for example, cumulative versus standard (or straight) voting or different classes of voting stock (which are found, for example, at Facebook and other companies). But the SEC also said that it had simplified the process by instituting standard procedures, minimum stock ownership, and methods to resolve multiple groups that might attempt to use the process (SEC Facilitating, pp. 56,767-56,768). The Commission also considered printing and mailing costs, though some of these costs would be incurred when the company sends out its own proxy requests to the shareholders (SEC Facilitating, pp. 56,768-56,770). Another cost mentioned by many comments is that many boards and management groups might incur extraordinary costs to fight any independent board members (SEC Facilitating, p. 56,770). While this could happen, it would seem to be mitigated by the small number of directors that can be elected in this fashion; the rule does not allow for a hostile takeover of the company. The SEC questioned whether such expenditures would normally be in the best interests of the company. It might even violate the board member’s “fiduciary duty” to the company, leading in some cases to the shareholders putting up a fight (SEC Facilitating, p. 56,770). This raises the possibility that this might occur at a poorly run company where there is fear that the truth of the management’s ineptitude might be exposed.

Finally, the SEC looked at the effect of the rule on competition, efficiency, and capital formation. Much of the discussion seems to have been already examined above. The Commission noted that no state prohibits shareholders from nominating board members (though companies may often make it difficult). The Commission noted that in many other capitalist economies, shareholders have access to nominating directors. Overall, it thought the rules would “promote efficiency of the economy on the whole” (SEC Facilitating, p. 56,771) and would result in “improved board accountability and corporate governance” (SEC Facilitating, p. 56,761).

The Commission also viewed it as a way to restore “investor confidence in the U.S. markets” (SEC Facilitating, p. 56,774). They also noted that some states such as Delaware have moved toward greater access for shareholders to nominate directors (SEC Facilitating, p. 56,775 n. 1056).

Delaware is an important state since a majority of the large corporations are incorporated there. Thus, its state law is particularly relevant. Effective August 2009, section 112 of Delaware incorporation’s law provides that the bylaws may include the following: (1) the amount of stock owned by the nominator; (2) a certain period of time of ownership; (3) certain types of information about the nominator and the nominee; (4) limits on the number or proportion of directors that can be nominated at a given time; (5) a prohibition of nominating those who have acquired a certain amount of control of the corporation; and (6) indemnification of the corporation for false or misleading information submitted (Act to Amend Title 8 of Delaware Corporate Code (2009)). Note that this is an “opt-in” law. These provisions are not mandatory. However, shareholders can make them mandatory by proposing them as part of the bylaws.

While the initial bylaws can be determined by the incorporators or the initial board, later “the power to adopt, amend, or repeal bylaws shall be in the stockholders entitled to vote” (Act to Amend Title 8 of Delaware Corporate Code (2009)). The bylaws also may include provisions that require the corporation to reimburse shareholders’ expenses for proxy solicitation (Act to Amend Title 8 of Delaware Corporate Code (2009)).

The Delaware provisions are potentially more potent than the SEC’s now deceased Rule 14a-11. Potentially the voting shareholders could remove all or most of the board and thus gain control of the
corporation from the previous board. SEC Rule 14a-11 only allowed one board member or 25% of the board. However, the Delaware process is more laborious since the bylaws must be passed before new board members can be nominated. Of course, for successful corporations, this would be unlikely. Poorly run corporations are more likely to be targeted.

The SEC still has Rule 14a-8 on the books, as noted above. It allows shareholders with as little as $2,000 of stock ownership to propose bylaws. The rule does not allow the corporation to exclude bylaws that allow for shareholder nominated directors. However, one limitation is that 14a-8 cannot be used if state law does not permit shareholders to vote on changes to the bylaws. (SEC Allowing (2010)) Rule 14a-11 could have been used regardless of state law. The burden of showing that state law does not permit shareholders to vote on bylaws is on the corporation, according to Rule 14a-8 (SEC Allowing (2010)).

Some states do vest the power to make bylaws in the board. For example, in Nevada the board can override even a shareholder-passed bylaw (Nevada, An Act Relating to Business Associations (2009). In Missouri, the default rule is that shareholders may pass bylaws unless it is prohibited in the articles of incorporation. Then the board has the sole right (Missouri. Revisions to the Corporate Code of 1975, 2009). Thus, whether Rule 14a-8 is useful for shareholder access depends on state law and sometimes on the articles of incorporation.

**CONCLUDING REMARKS**

Did the D.C. Circuit make the right decision regard SEC Rule 14a-11? Was the decision made in an “arbitrary and capricious” manner? The statutory authority under Dodd-Frank would seem to indicate that Congress thought that the SEC might well implement such a rule and that in effect Congress might be encouraging such a rule though it left the details to the agency and did not mandate the rule. But was the “arbitrary and capricious” standard met under the “hard look” rule? It certainly requires the agency to justify the rule using available studies and reasoning.

The SEC did look at a number of studies and engaged in extensive reasoning in reaching its rule. The agency did admit that some of its studies (both pro and con) had deficiencies. Would such an admission make it “arbitrary and capricious”? As noted above, the economic studies are on both sides of the issue though an evaluation might lean slightly against the SEC. Still is it appropriate for a reviewing court to be in effect a fact finder on somewhat close calls—particularly when the statute indicates that there are non-economic factors to be considered?

The problem with such a position is that there is no economic study that examines the specifics of the particular rule because it never has been tried before. So there are no past studies that would fit exactly and any detailed study would be, at best, speculative. The comments (and there were many) were somewhat useful but lined up (not surprisingly) by the two sides. Corporate managements’ comments indicated that they want to continue to select directors and not have disruptive board members. Such corporations are used to being able to “cherry pick” their directors with virtually no chance that they will be challenged. As noted above, in business ethics, we often talk about the shareholder versus stakeholder theory; but there is also the principal/agent problem. Managers may, in some cases, manage largely in their own economic interests, though they cannot ignore their stock price, their profits, or their own shareholders. The rise of the “principal/agent” problem (which may be also called “agency theory”) (Noe, Hollenbeck, Gererhart, and Wright, 2003) has corresponded to the rise of boards that are in “the pocket” of management.

On the other side comments were from shareholder activists, individuals, and other groups. Their position would naturally be the opposite of corporations. The shareholder activists view proxy access not only as a way to discipline poorly performing companies, but they also may have other interests in mind—their own or other social interests. It is possible that their interests may be counter to those of the shareholder (such as those of a union). They tend to view proxy access as a property right (associated with the ownership of stock)—a right that has been gradually taken from shareholders in recent decades.
Indeed, the SEC Rule 14a-11 did seem to create a type of property right. While economic efficiency and profits are important, it might seem that corporations may also be or should be trying to benefit other interests—as are commonly associated with stakeholder theory—customers, workers, and the community.

What is generally considered to be a result of this case is that it will be difficult for the SEC (and other agencies such as CFTC) to meet the burden of proof to issue regulations because of the stiff economic requirements to justify the rule. One commentator, who liked the result, thought the burden for the agency in trying to promulgate a regulation may not be justified:

There are many (and I am one) who, although believing the SEC acted unwisely in adopting proxy access, at least in the form of Rule 14a-11, are concerned about the high, nigh impossible, bar the Court set that could put in jeopardy most SEC rulemaking of any complexity or controversy (Keller, 2011).

Rule 14a-11 was, at best, a fairly weak rule in terms of proxy access since the board could hardly be taken over as a result of the rule. Unions or employees could not take control though they could potentially be disruptive. Still dissenting board members may provide a useful perspective. Undoubtedly, corporations probably viewed the rule as a slippery slope where management could lose total control of their boards. The rule was struck down though it is apparent that the proxy access fight continues. The fight continues at the corporate level in certain cases, in state law governing the corporation, and within the SEC.

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Practice What You Preach: Using an Experiential Learning Approach to Teach Leadership

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In many college courses or corporate professional development seminars on leadership, the emphasis is on leadership theories and the chosen method for content delivery is lecture. In this manuscript, two main arguments are put forth: 1) the emphasis should be on leadership skills; and 2) participants should be responsible for their own learning as well as that of one another. A leadership course developed and delivered which focuses on making participants better leaders by emphasizing leadership skills and using team-based learning as the principle delivery method is described.

INTRODUCTION

In too many leadership courses offered on campuses (or corporate professional development seminars offered in various venues) worldwide, the emphasis is on passive learning with participants listening to someone lecture to them on leadership theories. While familiarizing oneself with these theories may serve to inform course participants, it does little toward making each a better leader. For example: assume in a lecture that participants are told that most effective leaders are visionary and inspirational; Does this mean that the participants themselves will become more forward-looking and better able to motivate others as a result? Of course not. So, what have participants truly “learned”?

Learning Theory

Bloom’s Taxonomy (1956) and subsequent revisions are considered to be the seminal works regarding the various “levels” of learning. In the cognitive domain, from the lowest order process to the most complex, the levels are: remembering, understanding, applying, analyzing, evaluating, and creating (Anderson & Krathwohl, 2001). The first level involves the acquisition of knowledge; the ability to recall information acquired. The second level involves comprehension of the information acquired; the ability to explain what it means. The third level involves the ability to apply the knowledge acquired; to solve problems in new contexts using the knowledge acquired. The next three levels involve critical thinking and go beyond the scope of this discussion.

In his Theory of Andragogy, Knowles (1984) outlined four assumptions about adult learners: (1) adults tend to be more self-directed; (2) adults possess personal histories which defines their identities and serve as a resource of experiential learning upon which new learnings can be applied; (3) motivation in adults is directed to more socially relevant learning; and (4) adult learners have interest in immediate application for problem-solving. It is this last statement that connects to level 3 of Bloom’s Taxonomy. In a related vein, adult education must be seen as life-enhancing (Boggs, 1981). Several situations which Boggs predicts adults will not perceive as life-enhancing include those where: 1) the learner is provided...
with answers rather than arriving at them independently; 2) the learner is not challenged to exceed previous personal performance standards; and 3) the learner accumulates information without contextual relevance and interpretive or reflective skill building.

**Delivery Method**

Once we are clear on the type of learning objectives we have set (i.e., at what level of Bloom’s Taxonomy we are aiming), we must then explore the various methods used to deliver the information and facilitate the learning process. So, if we assume our objective is for learners to come away with the ability to apply what they have learned, we must identify the delivery method necessary to accomplish this objective.

Regardless of whether you look at the type (depth) of learning taking place or the methods used to most effectively facilitate the learning process, adult learning theory clearly indicates that we learn the most by doing. This has been borne out by research conducted at the National Training Laboratory in Bethel, Maine which indicates that there is 75% retention of information that is acquired through “experience” versus only 5% retention of information acquired via lecture. In order to accomplish this objective in a leadership “learning” context, each participant needs to be given the tools used by exemplary leaders and opportunities to practice and use them (i.e., experience them). The purpose of this paper is to introduce readers to a leadership skills course developed using a Team-Based Learning (TBL) approach to offer such opportunities.

**COURSE DEVELOPMENT**

A colleague and I were tasked with the creation of a new leadership course for our management majors. During the course development process, we had to come to terms with our respective biases, assumptions, and experiences. We ultimately agreed on two basic assumptions: 1) everyone will find him/herself in a situation where they have to lead others; and 2) everyone can become a better leader (i.e., improve their leadership skills). Therefore, the main objective of the course became: **make each participant a better leader**. We identified three major participant outcomes: 1) understand what makes a leader effective; 2) be able to identify effective leadership behaviors in others; and 3) have significantly improved leadership skills. While we reviewed many “traditional” leadership texts, we found most of them emphasized leadership theory, as opposed to leadership skills. One resource, Kouzes and Posner’s (2007) *The Leadership Challenge*, met most of our needs. The authors conducted extensive research and identified “five practices of exemplary leadership”: Model the Way, Inspire a Shared Vision, Challenge The Process, Enable Others to Act, and Encourage the Heart. While one does not have to master each of the five in order to be considered a leader, the better one gets at any or all, the more effective leader one will become. We then had to choose a delivery method that would allow participants opportunities to practice and hone their skills in each of these five areas.

**Team-Based Learning**

One of the hallmarks of Team-Based Learning (TBL; Michaelsen et al., 2002) is the assumption that individuals learn more from one another than they do on their own. However, TBL is not simply placing participants into small groups; it typically requires changing the entire structure of a course. As Fink (2002) says, “Team-based learning takes small group learning to an even greater level of effectiveness. When the groups are properly formed, remain intact long enough to become cohesive teams, and are repeatedly given challenging tasks with prompt and clear feedback, then students learn the content, they learn how to use the content, they learn about themselves and how to interact with others on major tasks, and they learn how to keep on learning after the course is over”. (p. 8).

TBL consists of repeating sequences of 3 phases (see Figure 1). In Phase 1, learners study independently outside of class to master key concepts from their assigned readings (i.e., information acquisition).
Phase 2 focuses on ensuring learners’ readiness to apply Phase 1 knowledge (i.e., information recall and comprehension). In Phase 2, individual learners first complete a multiple-choice “readiness assessment test” (RAT) and hand in their answer sheets. While the individual answers are being scored, each team then re-takes the RAT using a “scratch-off” answer sheet that provides both immediate feedback and the opportunity to receive partial credit if their initial team answer is not correct. Both tests are graded and count towards the final course grade. At this point, the instructor can further explain any concepts the participants were not able to learn on their own. The advantage of doing so at this time is it allows the instructor to limit “instruction” to those content areas that were problematic for the students (as opposed to covering material already understood and running the risk of losing their attention). Phase 3 focuses on higher-level learning and skill development (i.e., application, analysis and teaching others). The next several sessions include experiential activities for the teams in which they are required to “use” the content (e.g., answer questions, solve problems, acquire a skill, etc.)

In our leadership course, the use of *The Leadership Challenge* fits perfectly, as there are five “modules” (corresponding to each of the “Five Practices of Exemplary Leadership”). At the beginning of each module, students are given a RAT over the assigned reading (there are two chapters per module), followed by the team RAT. For the application activities, each team is assigned one of the “Five Practices of Exemplary Leadership” and must develop and deliver a workshop in which the members of the other teams are participants. This not only allows workshop participants the opportunity to practice that particular leadership skill, but it also allows students to practice and use all five skills in the development and delivery of the workshop. In addition, both the instructor and the workshop participants (members from the other teams) provide feedback to the team that developed and delivered the workshop.

**Course Administration**

Earlier, three major participant outcomes were identified: 1) understand what makes a leader effective; 2) be able to identify effective leadership behaviors in others; and 3) have significantly improved leadership skills. We accomplish the first through the assigned readings from the text (self-preparation) and from the class discussion (limited by necessity) that follows the RATs. We accomplish the second in several ways: instructor-led workshop; team workshops; and final assessment. Near the beginning of the term, when the students have just been introduced to the Five Practices of Exemplary Leadership (through reading of the Preface, plus Chapters 1, 2, and 13 in the text), the instructor leads class participants through a workshop involving the use of the feature film *Hoosiers*. Teams view the film, then are given a set of five flash cards containing the name of each of the practices of exemplary leadership. One team is given a specific scene from the film and, after sufficient time to discuss, asked to
identify the particular practice of exemplary leadership illustrated in that scene. Then, the other teams are asked to reveal their decisions by the showing of the flash cards each selected. Any discrepancies are discussed. The “point team” is then asked to identify any other scenes from the film it believes illustrate that particular leadership practice. This sequence of events occurs over and over until each team has had an opportunity to be the “point team”. In each subsequent workshop delivered by the teams, one of the requirements is that the workshop contains an activity where the participants have to identify effective leadership behaviors in others (either through the use of videos or role plays). The final assessment involves the use of another feature film, Flight of the Phoenix. Participants view the film and then are asked to respond to questions regarding the various characters and scenes in the film and the specific leadership practices that are illustrated. The workshops that each team must develop and deliver allow us to accomplish the third major participant outcome (have significantly improved leadership skills). In the delivery of the workshop (which must contain experiential activities related to the assigned leadership practice), the other members of the class gain hands-on experience and become more skilled at that particular leadership practice. In addition, the members of the team facilitating the workshop hone their skills in all five leadership practices during the workshop development and delivery processes.

Impact on Student Learning
The author recently concluded a section of the leadership course described herein. On the final assessment, students were asked to use the concepts presented in The Leadership Challenge to explain why the instructor chose to emphasize leadership skills (as opposed to leadership theory) and to use a team-based learning approach. Some excerpts from student responses follow:

“With this approach, each leadership skill was learned in a hands-on way. Each team got very good experience by leading the workshops. We had to challenge the normal way of learning and learn by teaching. You learn more by teaching than by just sitting in your chair and listening to a lecture”.

“This approach was chosen because leadership isn’t something you can obtain, or improve upon by learning theories. Leadership is something that is experienced…A lot of the concepts we learned in [the text], we had to actually use in order to develop our workshops”.

“As pointed out by the authors, all of the experiences shared with them were those of someone doing something; not just sitting there telling others what to do. And the authors’ 5 Practices of Exemplary Leadership help magnify that point. The class not only taught about those practices, but put us in situations where we learned how to identify and develop those practices in ourselves and those around us. And by learning how to develop those ideas, we will become better leaders, not necessarily great leaders, but better than we were before”.

“The process in which the class was structured was different than any class I’ve had before and in many ways I learned more and had fun doing it”.

“…and I think through delivering workshops and practicing all of the leadership skills is an excellent way to obtain real change in our normal behavior and form of thinking. In particular, I liked very much to be in this course and follow the instructions from the different teams and practice the leadership skills. I believe that now I can be a better leader than when I start the semester…”. [NOTE: this was written by an International Exchange Student]
“When putting us in teams and giving us a large task of teaching a workshop for 2 ½ hours, we were forced to practice and use all of the concepts in [the text] or our team would fail. Each of us had to Model The Way by acting through the values that we defined as a team. We had to Inspire A Shared Vision by getting the rest of the team on board and ready to go when one of us came up with an idea about the workshop. We had to Challenge the Process by thinking outside the box so that our workshop would be exciting and fun. We had to Enable Others to Act by giving our team members power to give their ideas and help out. And last, we had to Encourage the Heart and congratulate each other throughout the whole process so we all stayed positive and all felt like we succeed in the end and like we all had a part in it. By the way, I LOVED how the course was set up! Don’t change a thing; I learned sooo much”!

CONCLUSION

Certainly, all of the work on leadership theory over the past 50 or more years has contributed to our further understanding of what behaviors are most likely to be effective under the specific circumstances. Knowing the differences between, for example, transformational and transactional leadership and the circumstances under which each is most effective is all well and good. However, this does not mean that the individual who “knows” this can necessarily become a transformational or transactional leader when the situation calls for it. Leadership is an action. It implies that someone is doing something and that others have chosen to follow. Therefore, I would argue that the emphasis of most leadership courses should shift from “knowledge acquisition” to “skill development”. Instead of focusing on how much leadership information is “learned”, the focus should be on making each participant a better leader at the end of the course compared to when the course began.

As Instructors, most of us know that the lecture method is not very effective for real “learning” to take place. Yet, most of us rely heavily on this method in our courses. Perhaps some of us have introduced “group work” to break the monotony or spice things up a bit. Oftentimes, when not thought through or designed appropriately, these activities are simply a means by which the group members “divide and conquer” and in no way, shape, or form develop as a team. On the other hand, team-based learning transforms groups into teams. The onus for learning is placed on the students. The onus for creating learning opportunities is placed on the instructor as it requires a strategic approach to course development and administration. In this paper, the use of a TBL approach to teach leadership skills is encouraged. I have seen, first-hand, the positive impact it has on student learning. I have also experienced the positive impact it has on the instructor—I am having more fun in the classroom as a result of using this approach.

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Servant Leader, Spiritual Leader: The Case for Convergence

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The authors show how the concept of servant leadership can be enhanced by combining it with spiritual leadership. In fact, a true servant leader should also be a spiritual leader. The authors demonstrate that one of the earliest servant leaders, Moses, was also a spiritual leader. Abraham Lincoln is also used as an example.

INTRODUCTION

One valuable idea in leadership studies that has its roots in the Bible is that of servant leadership (Sendjaya and Sarros, 2002). Robert K. Greenleaf first introduced this concept in an essay he wrote in 1970 (Greenleaf, 1970). The servant leader is the antithesis of the autocratic, authoritarian, leader who is primarily concerned with power and wealth – one who believes in “leader first.” Servant leaders are not concerned with personal aggrandizement and self-interest. Rather, their focus is on others: they care about people, empower others and are facilitators, and want all of their subordinates to be successful (Greenleaf, 1978; Greenleaf, 1977). Barbuto and Wheeler (2006) developed a scale to measure the construct of servant leadership and found “strong relationships with positive outcomes such as employees’ extra effort, employees’ satisfaction, and perceptions of organizational effectiveness.” Van Dierendonck and Nuijen (2010) also developed an instrument to measure servant leadership. Hayden (2011) found that servant leadership did have positive effects on followers. The strongest effect found by Hayden was on health. Organizations headed by servant leaders will create an environment where followers feel and, indeed, are healthier.

Spears (2004) found ten characteristics in the servant leader:

- **Listening** -- Listening intently and receptively to what others say. This, of course, means that one has to be accessible.
- **Empathy** -- Having empathy for others and trying to understand them.
- **Healing** -- Possessing the ability of healing the emotional hurts of others.
- **Awareness** -- Possessing awareness and self-awareness.
- **Persuasion** -- Having the power of persuasion; influencing others by convincing them, not coercing them.
- **Conceptualization** -- Possessing the knack of being able to conceptualize and to communicate ideas.
Foresight -- Having foresight; which also includes the ability to learn from the past and to have a vision of the future.

Stewardship -- Seeing themselves as stewards, i.e., as individuals whose main job is to serve others.

Commitment to the Growth of People -- Being firmly dedicated to the growth of every single employee.

Building Community -- A commitment to building community in the institutions where people work.

Russell and Stone (2002) reviewed the literature dealing with servant leadership. They found that there are 20 attributes of servant leadership: nine are classified as functional attributes and 11 are accompanying attributes. The functional attributes are “the operative qualities, characteristics, and distinctive features belonging to leaders and observed through specific leader behaviors in the workplace.” The nine functional attributes are: vision, honesty, integrity, trust, service, modeling, pioneering, appreciation of others, and empowerment. Note that many are quite similar to Spear’s 10 attributes.

Vision — Conceptualization and foresight mentioned by Spears are related to vision. The servant leader has to develop a vision for an organization.

Honesty — Russell and Stone (2002) cited a huge number of sources that state that honesty and integrity are “integral parts of good leadership.” Without it, it is highly unlikely that one will be able to inspire followers.

Integrity — This is very similar to honesty except that “honesty relates more to truthfulness, whereas integrity reflects adherence to an overall moral code.” Integrity is also connected to ethics. Honesty and integrity are closely related to the accompanying attribute of credibility.

Trust — Followers are much more likely to rely on a leader that is perceived as being honest and having integrity. The accompanying attribute of competence is related to trust; without competence it is very difficult to establish trust.

Service— A servant leader must be willing to serve others. Stewardship, which also includes empowerment, is a key part of service.

Modeling— The servant leader is a role model via personal example for everyone in the organization. Modeling helps establish the vision of the leader. Visibility is an accompanying attribute since the servant leader has to be visible to followers in order to serve as a model and to inspire them.

Pioneering— Servant leaders have to be innovators and willing to take risks.

Appreciation of others— Servant leaders “visibly appreciate, value, encourage, and care for their constituents.” This is accomplished by listening to others and providing encouragement.

Empowerment— By empowering others, leaders are established at all levels of the organization. Servant leaders teach and coach others and delegate responsibility.

In addition to these nine functional attributes Russell and Stone (2002) listed 11 accompanying characteristics of servant leadership: communication, credibility, competence, stewardship, visibility, influence, persuasion, listening, encouragement, teaching, and delegation.

Despite the positive attributes often associated with servant leaders there still remains a serious problem with the concept itself. That is, it appears that it is quite possible to consider some undeserving leaders as servant leaders. These may be individuals who care about their organizations but disregard the needs of society. For example, a CEO may think of herself as a servant leader because she has a vision and makes money for everyone in her firm. This is not enough if, say, the organization is causing harm to others. Some firms make a great deal of profits by not considering broader societal needs and objectives. Companies might be using sweat shops in Asia, dumping pollutants into rivers in order to improve profits and selling either inferior or dangerous products in other countries all to boost profits.
One suspects that Lloyd C. Blankfein, CEO of Goldman Sachs, may have seen himself as a type of servant leader for a number of years. His company was making huge profits and employees shared in the bonuses. Later on it became clear that the firm may have been doing well but the firm made quite a bit of money betting against the very financial products it sold to its own customers.

There are also leaders who have been good for their own countries but wreaked havoc with other countries. This reminds one of the famous quote from Peter Drucker: “Leadership is all hype. We’ve had three great leaders in this century – Hitler, Stalin, and Mao.” Drucker also believed: “The only definition of a leader is someone who has followers.” It is scary to think that Hitler, Stalin, and Mao might partially fit the bill as servant leaders. After the swift German victory over France, Hitler may have been among the most popular leaders in history. Hitler was seen as someone who brought jobs to the people; there was full employment. Millions of German soldiers engaged in plundering the wealth of people (mainly Jews) living in the occupied territories and sending it back home (Aly, 2007: 28-29; Kershaw, 2008). Scholars may not agree on whether it was greed, full employment, anti-Semitism, revenge for the humiliation of World War I, or all of the above. One thing, however, is quite clear: Hitler was extremely popular with the German people almost until the end.

SHORTCOMINGS OF SERVANT LEADERSHIP CONCEPT

One of the shortcomings of the concept of servant leadership is that servant leaders might easily focus too much on the needs of followers rather than the needs of the organization. A servant leader might also be more concerned with the needs of followers without considering the needs of society. In fact, a servant leader might do what is best for his followers without necessarily considering the higher values of truth, justice, peace, compassion, and human dignity.

A servant leader who is obsessed with the needs of followers might not see any reason to be concerned about world poverty. One might even be able to rationalize dumping hazardous wastes into rivers and oceans in places where there is no regulation if it would allow a firm to provide bonuses for all employees and survive. One can easily argue that compassion has no place in a firm headed by a servant leader. Why should a firm go out of its way to hire, say, people with Down’s syndrome or other handicaps if it will make other employees uncomfortable and not help the bottom line? What happens when a firm has the opportunity to add to everyone’s bonuses but in order to do so must engage in legal, but immoral business practices? Google decided not to do business in China because of the way it treated its citizens. Of course, this kind of attitude can result in reduced bonuses for employees.

Unlike a servant leader, a spiritual or transformational leader focuses on the needs of the organization (Stone, Russell, and Patterson, 2004; Fry, Matherly, Whittington, and Winston, 2007). Fry (2003) believed that a spiritual leader “must primarily motivate workers intrinsically through vision, hope/faith, and altruistic love, task involvement, and goal identification. He felt that workplace spirituality involved:

1. creating a vision wherein organization members experience a sense of calling in that their life has meaning and makes a difference;
2. establishing a social/organizational culture based on altruistic love whereby leaders and followers have genuine care, concern, and appreciation for both self and others, thereby producing a sense of membership and being understood and appreciated.

The spiritual leader ensures that there will be spirituality in the workplace. Workplace spirituality has been defined as:

A framework of organizational values evidenced in the culture that promotes employees’ experience of transcendence through the work process, facilitating their sense of being connected in a way that provides feelings of compassion and joy (Giacalone and Jurkiewicz, 2003: 13).

Admittedly, the two concepts of spiritual leadership and servant leadership are close. Scholars have noted that the literature has little to say about motives, values, and conditions that cause one to become a servant leader (Yukl, 2010, Freeman, 2011). It has been suggested that spiritual individuals are much
more likely to become servant leaders than those who are not (Freeman, 2011). This theory is quite plausible given that that possessing spiritual values such as humility, integrity, and empathy/compassion are thought to facilitate servant leadership (Freeman, 2011).

Sendjaya (2007) developed and validated a scale for measuring spiritual leadership. Interestingly, interview questions used in the development of the scale included: “Does the term ‘spiritual leadership’ or ‘servant leadership’ mean anything to you?” “How would spiritual/servant leadership be different from other leadership approaches or styles?” and “Do you think the concept and practice of spiritual/servant leadership in organizations can contribute to better organizational performance? How?” Sendjaya appears to combine the two concepts of spiritual and servant leadership; after all, they do overlap somewhat.

Perhaps the concept of servant leader requires additional examination to make it a stronger and more useful concept; conceivably, to be a true servant leader, one also has to be a spiritual leader. To further examine spiritual and servant leadership, this paper draws on the Hebrew Bible, specifically the Five Books of Moses (the Torah), and the leadership of Moses an early paradigm of both approaches to leadership.

MOSES AS THE PARADIGMATIC SERVANT LEADER

Moses, arguably the greatest of Biblical leaders, is praised as being a “servant of God” (Deuteronomy 34: 5). Moses was the paradigmatic servant leader; he cared more for the people than for himself. Moses was not jealous of anyone and declared (Numbers 11: 29): “Are you jealous for my sake? I wish that all the Lord’s people were prophets and that the Lord would put His spirit upon them.” Moses would have been quite satisfied had all the Israelites become prophets and God communicated directly with them, even if this meant that he was no longer needed.

The Bible describes what happened when Moses became an adult and left the palace (Exodus 2:11): “And it came to pass, after Moses had grown up, he went out to his brethren and looked on their hard labor. He saw an Egyptian beating a Hebrew, one of his brethren.” Moses had a difficult choice to make. Should he ignore his brethren and remain a prince of Egypt or should he join the slaves and give up everything? The Midrash (Exodus Rabbah 1:26) believes that Moses was 20 years old when he went out to see his brethren. When he saw the backbreaking work they had to do he cried. He tried to help them with their burdens. God was very impressed with Moses and the fact that he cast aside his royal position to “share the sorrow of Israel” and treat them like a brother.

This characteristic of Moses defines the ultimate servant leader. This was a leader who felt the pain of his subordinates when they had to work too hard. Moses was a leader who identified with his people and tried to reduce their burdens. This is what Spears (2004) referred to as empathy. However, Moses had more than empathy. Moses gave up his privileged life as a prince of Egypt because of the harsh treatment of the Hebrew slaves (Exodus 1-2). He fled Egypt after killing an Egyptian taskmaster for viciously beating one of the slaves. In fact, he went from being a royal prince to a lowly Midianite shepherd.

Moses was deeply concerned with justice. The Bible (Exodus 2: 11-17) relates three different stories about him when he became an adult. First, he killed an Egyptian taskmaster who was striking a Hebrew slave. The next day he got involved when he saw two Hebrew slaves fighting with each other. When he fled Egypt and found himself in Midian, he interceded when he saw Midianite shepherds trying to steal water drawn by Jethro’s daughters for their father’s sheep. The Bible is showing us that Moses would not stand by when any injustice was being committed. His sense of justice was not only for his own people, the Hebrews. He was outraged by any injustice, even wrongs committed against strangers and women. One assumes that in ancient times women were not treated well, but Moses, a fugitive from Egypt, stuck his neck out to help Midianite women. Not a smart move for a fugitive that got into trouble for interceding on behalf of a Hebrew slave and barely escaped Egypt with his life.

Clearly, Moses was concerned about wrongs committed against strangers. Treating the stranger well and/or not oppressing him becomes an important law in the Torah and is mentioned no less than 36 times.
Moses had no problem standing up to God when he felt that an injustice had been committed. The first time Moses spoke to Pharaoh and asked him to let the people go in order to hold a feast in the wilderness, Pharaoh responded very harshly (Exodus 5:1-15). The slaves were told that the quota of bricks that they had to produce would remain the same but that they would have to find the straw; no one would bring straw to the slaves; they would have to go gather straw for themselves. Moses did not understand what God was doing and lashed out saying (Exodus 5:22): “My Lord, why have you harmed this people? Why have you sent me?” This is the way one expects a servant leader to speak when his flock is hurting.

Moses was much more than empathetic; he identified very strongly with his people even when they made serious mistakes. After the incident of the Golden Calf, God was ready to destroy the Israelites. Moses stood up to God and demanded (Exodus 32:32): “But now, please forgive their sin — but if not, then blot me out of the book you have written.” According to most commentaries, Moses was telling God to remove him from the book of life, i.e., kill him, if He did not forgive the people for the sin of the Golden Calf. That is what true servant leadership is all about: a great love for followers so that one is willing to die for them. We do not expect CEOs to be willing to die for employees but they should have this kind of passion. Moses’ love for his people was the kind of love a parent has for a child.

The Israelites made another serious blunder in believing the false report of the spies (Numbers 13-14). God made a very tempting offer to Moses (Numbers 14:12): “I will smite them with the pestilence, and disinherit them, and will make of you a greater nation and mightier than they.” Moses, a true servant leader, could not be enticed to abandon his flock with any offer, no matter how good. His people came first.

Moses was a humble man. We know that God had to plead with Moses to take a position of leadership (Exodus 3:7 – 4:17). Moses used five different arguments with God as to why he should not be the one to go to Pharaoh and lead the Hebrew slaves out of Egypt. Moses was 80 years old at the time and had been living in Midian and working as a shepherd for many years. The Bible attests to Moses’ great humility even after leading the Israelites. Scripture (Numbers 12:3) explicitly states: “Now Moses was a very humble man, more humble than anyone else upon the face of the earth.”

Moses did not use his position of power to enrich himself. He had clean hands and was able to say to God (Numbers 16:15): “I have not even taken a single donkey of theirs, nor have I wronged even one of them.” When Moses dies alone on Mount Nebo, he is buried by God Himself.

Feiler (2010) posited that Moses is an American icon; it is no surprise that many great Americans, including Abraham Lincoln and Martin Luther King Jr., have compared themselves and been compared to him. According to Feiler, Moses represents “the ideals of American justice” and reminds us that “a moral society is one that embraces the outsider and uplifts the downtrodden.” How many politicians and CEOs can make this claim?

WORKPLACE SPIRITUALITY

Based on the above discussion, one might make the mistake of thinking that a servant leader has such a great love for the people and the organization that they come first. Yes and no. The well being of the organization may come before the needs of the leader but there is something that comes before everything. A truly great leader is a “servant of God” first or, at least, a believer in spiritual values. Spirituality may have its roots in religion but it can be viewed as a separate concept. In fact, one researcher stated that “spirituality unites, but religion divides” (Hicks, 2002:380). Still, most scholars acknowledge the connection between spiritual leadership and religious theology (Sendjaya, 2007).

Spiritual values that are cherished by the Bible include compassion for the weak and helpless (the orphan, widow, and stranger mentioned in the Bible are usually the ones taken advantage of), love for peace, concern for human dignity, integrity, and justice for all. Isaiah (1:10) rebuked the leaders of Judah and Jerusalem and called them “chiefs of Sodom,” criticizing them for not pursuing justice and not taking care of society’s unfortunates; all they cared about was their own personal aggrandizement. Clearly, leaders such as Hitler, Mao, Stalin, and Genghis Khan did not have spiritual values and no sane person

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would consider them “servants of God.” Many feel that what they had was not even leadership since leadership is not about coercion.

Moses may have placed the needs of the people above his own but he was not only a servant of Israel, he was also a servant of God. Moses understood that his role as leader was to mold the people into upright, righteous individuals who would obey the core values of the Bible. In fact, the ancient Israelite kings were commanded to always have a Torah scroll near them as a reminder of what power was really about (Deuteronomy 17: 18-19). Much of Deuteronomy is about Moses telling the Israelites the consequences of not following the laws of the Torah (e.g., Deuteronomy 28: 15-69). The people were warned that they would be banished from the Promised Land if they did not obey God’s covenant with them (Deuteronomy 29:9-28). Moses made it clear to them (Deuteronomy 7:6) that they had to be spiritual and do what is moral: “For you are a holy people unto the Lord your God.” This idea is also expressed in Leviticus (19:2): “You shall be holy, for holy am I, the Lord your God.” Moses told them exactly what God required of them (Deuteronomy 10:12): “And now, Israel, what does the Lord your God require of you, but to fear the Lord your God, to walk in all His ways, to love Him, and to serve the Lord your God with all your heart and with all your soul.”

Of the 613 precepts in the Torah, more than 100 deal with honesty in business. These laws cover many different areas of business ranging from honest weights and measures to paying employees on time (Friedman, 2000). The Bible makes it clear (Deuteronomy 6:18): “You shall do that which is fair and good in the eyes of God so that it will be good for you.” If you act in a way that is not fair and good, the threat is quite clear. CEOs that run businesses have to ensure that a firm behaves in an ethical and socially responsible manner. Caring about employees is not enough.

A spiritual servant leader understands that the company and employees – albeit important – do not come first. There are certain core spiritual values that trump even a company’s existence. Moses warned the Israelites that the Promised Land was theirs but only if they obeyed the core values of the Torah. Indeed, the Israelites were warned by numerous prophets that they would be forced into exile if they did not abide by the spiritual values that were the pre-condition for living in the Promised Land. In a similar vein, a firm that does not abide by key ethical values does not have a right to exist. There are quite a few ethical/spiritual values that companies should make part of their mission statement. Friedman and Friedman (2009) provided a checklist for firms that are interested in becoming more virtuous.

Thus, the spiritual servant leader possesses two additional characteristics.

- **Sacrifice**—Having a willingness to give up everything including his job, wealth, and even his life for his subordinates.
- **Principles First**— An organization without values is not worth protecting. The true servant leader is not only a servant of the people; she is a servant of God or spiritual values. This means that virtue comes first, even before the organization. An organization must be virtuous to be worth defending.

In the workplace, the spiritual servant leader has to be a proponent of workplace spirituality.

- **Workplace Spirituality**—The servant leader is committed to including spirituality in the workplace. People want their jobs to provide a sense of meaning and fulfillment.

Unfortunately, over the past several years, we have seen many counterexamples to the spiritual servant leader. Most CEOs today are quite happy to shut down factories, putting hundreds of people out of work, to save relatively small amounts and collect their own outrageously high salaries. One cannot imagine a CEO crying because of the burdens of his or her employees. Most CEOs would not shed one tear for closing down a factory and turning a thriving town into a place filled with despair and misery. The Great Recession of 2008 would not have occurred if corporate leaders cared more for their own employees than for their bonuses. It is now clear what happened in that debacle. In order to earn huge bonuses, CEOs took inordinate amounts of risk. After all, why not risk the jobs and pensions of millions of people for millions of dollars in bonuses? Politicians were just as guilty. They sacrificed the country in order to obtain money from the special interest groups (e.g., in this case, Wall Street). What mattered most to them was obtaining political donations so that they could finance their campaigns and stay in
office. The action of these politicians can be easily compared — negatively— to those of the American political icon Abraham Lincoln.

ANOTHER EXAMPLE: ABRAHAM LINCOLN

Abraham Lincoln, who has been compared to Moses (Feiler, 2010), is an example of a leader who put principles before his own needs. In the summer of 1864 the war was going poorly for the North; the Democrats nominated General McClellan for president on a peace platform. It appeared quite likely that the Republican Party might split among several candidates. President Lincoln was visited by a "radical" Republican who warned him he might lose the election since the country was tired of the war. Lincoln replied, "You think I don't know I am going to be beaten, but I do and, unless some great change takes place, badly beaten" (Waugh, 2001: 267). Despite this, Lincoln was more concerned about doing what was best for America (not allowing the South to secede) than winning the election. Lincoln would probably have lost the election had not Sherman's burning of Atlanta and march to the sea done wonders for Lincoln's campaign. Sherman’s victory damaged the claim of the Democrats that the war could never be won (Waugh, 2001: 296-297).

CONCLUSION

Servant leadership is a valuable approach in politics and industry. Adding the spiritual component — striving to build a spiritual workplace and working to improve society — completes the paradigm and makes it more valuable as a leadership theory. Another Biblical figure offers an important lesson for all leaders. God appeared to King Solomon in a dream and offered him anything that he wanted (1 Kings 3). Rather than asking for wealth, power, or long life, Solomon asked for the following: “Give therefore your servant an understanding heart to judge Your people, that I may discern between good and bad; for who is able to judge this great people of Yours?” Solomon understood what a leader needs to be successful: wisdom, a passion for justice, and concern for people. A concern for the people is not enough by itself.

The Psalmist (Psalms 15) describes some of the attributes of a virtuous individual. These attributes are just as important for leaders and organizations: “One who walks in total integrity, deals righteously, and speaks the truth from his heart. One who has no slander on his tongue, who has done his fellow human no evil nor cast disgrace upon his close one… Whoever does these things shall never falter.” The spiritual servant leader does no harm to “his fellow human”; it is not only about one’s own organization or country.

The Bible uses the metaphor of shepherd to indicate a leader (Numbers 27:17). This metaphor is also used by Ezekiel in Chapter 34. When leaders did not help the people but enriched themselves at their expense, the prophet Ezekiel exclaimed (34: 2-4):

Woe unto the shepherds of Israel that have tended themselves [and not tended their flock]! Should not the shepherds tend the sheep? You eat their fat and you wear their wool; you slaughter the healthy ones; but you tend not the sheep. The frail you have not strengthened; neither have you healed that which was sick; neither have you bound up those who were broken; neither have you brought back those who strayed or searched for those that were lost; instead, you ruled over them with force and rigor.

According to the Midrash (Exodus Rabbah 2:2-3), Moses was selected as a leader because of his gentleness and concern for the sheep when he worked as a shepherd for Jethro. Moses was also careful when grazing the sheep making sure they never strayed into private property. This Midrash (as well as the passage in Ezekiel) is describing the servant leader, i.e., one who treats his people with great compassion and tenderness. This is important since leaders that are despised for being uncaring or indifferent to the people are unlikely to have the ability to transform them into morally upright individuals.
The shepherd metaphor is also used to describe God in Psalms 23. “The Lord is my Shepherd, I shall not want…” Here, the Psalmist asserts that “He leads me on the path of țedek (righteousness and justice) for His Name’s sake.” The Shepherd has to do more than care for his flock. He needs divine help to ensure that the flock is on the right path and does not stray.

Hillel’s (ca. 60 B.C.E. – ca. 10 C.E.) statement (Ethics of the Fathers 1:14) could be a touchstone for a spiritual servant leader: “If I am not for myself, who will be for me? And if I am only for myself, what am I? The servant leader who is only for “myself,” i.e., focuses on his own needs, the needs of the organization, or needs of employees but is indifferent to spiritual values is not the model leader. The ideal leader must serve man and must also have the moral compass to be a spiritual servant leader.

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A Small Local Government Case Study: Did Mismanagement and Misuse of Resources Equal Fraud, Waste or Abuse?

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INTRODUCTION

This case concerns a small, county government hereafter identified as County that is not specifically identified because of the possibility of indictment regarding fraud, waste or abuse of governmental resources. This County governs a largely rural area. The County is within a couple hours drive to two governments, one is historic and very early well known: Williamsburg, VA. The other is our nation’s largest government, our federal government located in Washington DC. How a local government chooses to identify and market itself generally says something about the values of its citizens and how it wishes to be perceived, citizens and noncitizens alike. On its website this County’s most prominent statement is “…located in the beautiful countryside of South Central Virginia …. a warm friendly welcome for all.” The next most prominent statement is identification of the values to which it most aspires: “…family and community are central to our lifestyle. We work together to build and maintain a society where we can raise our families in an area offering an excellent quality of life, plenty to see and do, a wide range of opportunities, and safe friendly neighborhoods.”

The County was carved in 1746 out of a larger county that had originally been formed by George II of England. The County makes use of this very early formation in the United States as well as its eventual division, creating 9 other present day counties. It identifies itself as the “Mother of Counties.” The last census found 13,146 people living in the County’s 443 square miles; some of these people live in one of the several very small towns. The County’s rural setting is the basis of many of its citizens’ livelihood; agriculture is identified as the primary source of income. Tobacco provides the largest cash crop. The number and variety of possible employers other than agriculture have declined over recent years. The
national and local economic crisis of 2008 is believed to be largely responsible for the accelerated decline in the past two years. At present the two largest non-agricultural employers are the school system and a prison that is part of the state correctional system. A famous musician, in his seventies who was born in one of the small towns is probably the county’s most well known son of the last century.

Citizens living in the County enjoy relatively low local taxes: real estate is $0.33/ $100 and personal property is $3.60/ $100. A major metropolitan area in the same state has a base real estate rate of $1.09/ $100 (the base can be increased for several items); a city not in a metropolitan area has a $0.95/100 rate. Citizens of the County’s two incorporated, small towns pay additional taxes: real estate taxes of $.14/ $100 for one and $.38/ $100 for the other. Personal property tax rates for these two towns are about a third of the county’s rate. The county’s cost of living index, December 2009, as identified by city.data.com was 80.7, the US average is 100. The US Bureau of Labor Statistics’ reported the weekly wage as $533 with an employment of 2,610 for 2009; this can be analyzed in several ways but certainly places the County in the bottom third of counties of its state in the employment and wage category. In February of 2010, the representative of the county’s outside auditor in a formal meeting indicated that the county is in excellent financial state. The auditor highlighted that the County has $5 million in the bank, low debt per capita, and has recently constructed both new school and courthouse complexes – while maintaining a lower local tax rate than all but one local government in the state.

GOVERNMENT STRUCTURE

Governance is by an elected Board of Supervisors. For these positions, citizens run for election from one of the seven electoral districts. Supervisors’ terms are four years. Elections are staggered, every two years about half of the positions are up for reelection. The circumstances of this case came to light during 2009, an election year. This particular County has a custom, an historic pattern, of Supervisors serving for long terms up to and surpassing twenty years. Before the 2009 election there was one Supervisor whose service surpassed twenty years, four with more than ten, and two with more than five years of service. The election of 2009 occurred after the circumstances discussed in this case became public. These circumstances are believed by most, including the current Board of Supervisors, to be responsible for two supervisors with more than ten years of service being turned out of office by the voters and replaced by individuals who had never before been elected Supervisor. These two new individuals joined one returning member and four others who are not up for election until next year.

The County’s model of government consists of final authority for all government decisions resting with these elected Supervisors whose jobs are part-time. The day to day business of the county is run by full time employees. The position of executive for the general government is a County Administrator (CA) who reports directly to the Board. The County being a small rural government, the CA manages only about five full time employees. There are other specific, not general, executives. These executives, Treasurer, Commissioner of Revenue, Sheriff, Clerk of the Court and Commonwealth Attorney, are elected positions and are also Constitutional Officers. In this model of government, the Constitutional Officers have significant independence. The CA in reality “administers” only his/her staff, the Constitutional Officers administer their own staff and offices. The Board of Supervisors’ only real authority over the constitutional offices is budgetary. Even this budgetary authority is somewhat limited; the state government provides for the constitutional officers’ salaries. However, the Board of Supervisors does appropriate, from county resources, all other monies for running of the constitutional offices.

This structure of an elected Board of part-time citizens running the county in concert with the elected quasi-independent constitutional officers and the resulting relationship between all parties underlies this case study. One might suppose that this quasi independence provided to constitutional executives was intended to ensure that the essential services provided are shielded from manipulations, threats, attempts to influence, and intimidation by the part-time Supervisors, the CA, or others. The circumstances discussed in this article may suggest that the constitutional executives are indeed subject to threat or manipulation or they may be viewed as indicating that possibility and thus needs to be guarded against. The circumstances also can be viewed as indicating that a County Administrator is able to get away with
fraud the consequences of which are influenced by the personalities and beliefs of the individual seven members of the Board of Supervisors.

The circumstances that some believe indicate fraud or waste or abuse relate to actions by the assistant county administrator (ACA) that came to light just before the last election. Also under question, and not resolved to date, are the supposed actions or non actions by which the 0CA and individual members of the Board responded to the actions of the ACA. All agree that first line authority for the actions rests with the CA. Duties of the CA are specified in the state code. In addition, the CA had an employment contract with language indicating that additional duties may be assigned by the County; i.e. the Board of Supervisors. As a result, this CA’s duties had been broadened to include other positions in the county government, including budget director, clerk to the Board, planning director, purchasing agent and zoning administrator. This is one reason that the County was able to have only five full time employees in the general government. In the particular state, a CA fulfilling a variety of functions such as this is not unusual; particularly in small governments such as this one. Yet this responsibility for differing functions and a broad number of duties is relevant to this case study.

Chief Government Executive, the County Administrator (CA)

This CA originally began her relationship with the County as administrative assistant in 1992. She was promoted to the chief general government executive, the CA in 1997. Within a year of this promotion, the CA was presented with a major challenge. Her handling of this challenge won her the admiration and allegiance of several, including the longest serving, members of the Board. She was faced with a decision by the majority of the Board to purchase property for relocation of the county offices. However, the Chair voted nay and the CA shortly ran into a significant road block to fulfilling the Board’s wishes. The Chair and the County Attorney refused to proceed with the purchase. This is a difficult situation for a CA as the Chair’s duties include signing contracts for the county and usually the Chair is the Board member, with whom the CA works most closely. In this instance, the Chair refused to carry out the decision of his fellow Board members. The CA’s willingness to work out a solution and succeed with completing the purchase while contradicting her Chairman is considered one of the more notable acts of her tenure.

Many on the Board and community were impressed that the CA understood that she reports to the Board as a whole, rather than the individual serving as Chair. Of course, the Chair who remained on the Board including during the circumstances of this case may not have agreed. Also notable about the CA is a few months before the circumstances of this case became public, the CA had been recognized as outstanding and was the subject of a prominent feature article by the state’s Association of Counties. Within the same year and between the time that the article was published and the facts of this case became public knowledge, the CA’s husband lost a battle the couple had been waging with his cancer.

In 2000 the CA hired an Assistant county administrator (ACA) who is responsible for the acts discussed in this case study. Her previous position was an assistant payroll planner at a local department store. Her duties relevant to this case were accounts payable and payroll. She prepared and wrote checks for payroll and insurance. She also wrote checks for items prepared by other departments in the government. After the acts under consideration became public, it was mentioned by some that everyone had been impressed with the relationship between the CA and ACA, like Mother and Daughter. Both women were known to be struggling with husbands’ battles against cancer. The ACA was well regarded for being gregarious and sociable as well as a dedicated “soccer mom” while holding down a job and struggling with her husband’s cancer. “No one in any way dreamed that she was capable of misuse of her duties,” as a current Board member said recently.

THE DISCOVERY

In August of 2009 a county employee from Social Services was killed in a car accident. This accident precipitated the discovery of the ACA’s “misuse of duties.” The deceased’s beneficiary contacted the county to obtain a life insurance claim form for the $20,000 death benefit. The ACA delayed, claiming
that no forms were on hand. When the beneficiary requested forms, the ACA stated “we will get it but I don’t have it right now.” At about the time of the car wreck, the Treasurer “decided she had had enough” and went to the insurance carrier regarding four to five years worth of outstanding checks from the county to the insurance carrier; these checks were payment for the insurance coverage.

After the circumstances came to light, it was discovered that the Treasurer had been repeatedly asking the ACA about these outstanding checks that dated as far back as 2004. After repeated requests, the Treasurer had begun including the CA and “keeping her in the loop” regarding the outstanding checks. The Treasurer believes she began including the CA in about 2008. During the years of outstanding checks, the outside audit firm did not issue any formal comment as part of their yearly audit report. The Treasurer later stated that on several occasions the ACA promised to set a meeting with the Treasurer, CA, and insurance company representative; each time the ACA would inform the Treasurer that the insurance representative had a last minute conflict and would need to reschedule. The dates offered for rescheduling were often dates that were a conflict for either the Treasurer or the CA.

One evening of a day in which it is believed that the beneficiary had made another request, the ACA phoned the CA and said “you are going to have to fire me.” The ACA put her keys on the desk and as she vacated her office placed several large trash bags into the hall with the intent of carrying them herself to the dumpster. It happened that the Economic Developer was suspicious for reasons that have not been made public. This suspicion caused the Economic Developer to offer to take the bags to the trash for the ACA. In reality the Economic Developer kept the trash in which was found many documents. The documents included many stamped envelopes with properly negotiated checks which had never been mailed to the payees.

Within a short time many checks to the insurance company were found in files and hidden between hanging file separators. The Board of Supervisors did not suspect that the checks to the insurance company between 2004 to 2009 had never been mailed because they had been budgeted, approved, and negotiated. Only the Treasurer and the CA knew there was a problem with outstanding checks. It turned out that there had been a previous death of a county employee, the sheriff. Board members and others thought the beneficiary had received the proper benefit; none was received but this never became known because the deceased’s beneficiary did not know to ask for the death benefit payment.

The 2009 death and beneficiary claim for a county employee led to discovery of the “misuse of duties.” In the process of completing paperwork, notifying the retirement system and insurance carrier major problems were discovered regarding the county’s insurance. It had none! Investigation revealed that the insurance company had terminated the county for nonpayment. Examination revealed other problems with payables and also with receivables. It was discovered that the ACA had not been properly billing businesses for landfill use charges. A Board member had questioned in 2008 why landfill revenues were down 80%. The CA replied that the amount billed was received. Investigation revealed that the ACA’s father had a service station which used the landfill; the father’s business had not been billed nor paid fees for several years. Other businesses were never sent bills for landfill use.

As early as 2004 the assistant began a pattern of abuse regarding the checks to the life insurance carrier for employees of both the County government and the local Social Services. The assistant prepared the checks, had them signed, but never placed the checks in the mail. Thus the assistant continued to requisition a check each month for the premium due to the insurance carrier. Each month checks were issued by Accounts Payable, signed and returned to the assistant for mailing. The checks were not mailed.

Investigation to date has revealed that checks from July 2004 and February, March and April of 2005 were found in file folders and a file drawer. These checks were appropriately drawn and signed but never mailed. The checks in the file drawer had been hidden between hanging folders. This implies intentionality.

Additionally, letters from the insurance carrier were discovered. One was dated June 10, 2005 and was a “Special Late Payment Offer’ of 15 days to make payment and avoid cancellation of coverage. A letter dated August 11, 2005 acknowledged receipt of a payment but stated insurance coverage was terminated on April 30, 2005 for non-payment. Another letter dated September 15, 2005 acknowledged receipt of checks totaling $529 but contained the coverage was terminated as of April 30, 2005 and thus
the $529 was returned. A letter dated July 31, 2006 reiterated that the policy was terminated and included a refund to the County of $1,021.20. Both refund checks were discovered in a file folder; they had never been deposited to the County.

During the years of preparing checks and then not mailing them, the assistant continued to have new employees complete the required insurance paperwork. It would seem that employees, the County administrator, the Board of Supervisors and the Constitutional Officers believed the County was adequately insured. Yet investigation in 2009 revealed that when an employee died in April of 2006 his wife was not informed of any death benefit due and no claim was ever made; the wife received nothing. Apparently the wife did not know from any other circumstances that she should receive a benefit. So this incidence occurred with no one, except perhaps the assistant administrator, being aware of the lack of proper procedure.

Investigation also revealed that the Treasurer, a constitutional officer, had been complaining about outstanding checks to both the ACA and the CA for much too long to have been not rectified. In May 2009 the assistant responded to the Treasurer’s complaints by voiding 35 checks to the insurance carrier and issuing a replacement check for several thousands of dollars. This was returned to the County.

Refund checks to both the County from companies other than the insurance carrier for the disability benefits were discovered. A check payable to an employee by an insurance company was found; it had never been delivered to that employee. Other items were found in the files in locations where they did not belong. These include personnel records.

Investigation Regarding Insurance Payments

The CA disclosed to the Board of Supervisors that insurance payments had not been made and that the County, in reality, had been uninsured. The Board directed the CA to investigate with the County attorney. It was found that new employees had completed insurance paperwork and that checks had been prepared, signed, and prepared for mailing but never mailed as discussed above. The State Police also did an investigation after the CA and County attorney. After the circumstances became know by the Board and the public the outside auditor completed their yearly work and report. To date, there has been no formal investigation report from any party. Some believe that the amount of investigation that has been done so far shows no embezzlement by the ACA. Without formal investigation reports, it is not settled (in the author’s opinion) as to whether the County suffered financial harm. The death benefits due the two beneficiaries was paid by the County general fund and reimbursed by the County’s Liability carrier.

Concurrent and Other Problems

During the same time period, 2009, the County was sued by the state’s DMV. The DMV appointed a special prosecutor to investigate the County for fraud. About twenty years previously the County entered into an agreement with DMV that was designed to get junk cars removed from the County; many governments and citizens view junk cars as unacceptable eyesores. The agreement called an independent dealer to purchase the junk cars, remove them to a special junk location and then bill the County. The County next bills the DMV and the contract calls for a payment per car that the County allocated to itself and the junk dealer (the junk dealer got about $25 per car of the $50 sent by DMV).

The DMV claimed that the County’s receipt for these cars of about $45,000 a year represented far more cars that could be recovered in this rural County. It has been said that the special prosecutor sent by the DMV speculated that the CA got kickbacks for approving the junk dealers’ numbers and billings. Some believe this is politically motivated and also believe that the Board was told by the special prosecutor that the suit would go away if the CA resigned. This suit is still pending. Those who believe the DMV suit is politically motivated site the legal suit between the Clerk of the Court – who was the previous CA – and the Board of Supervisors.
CONSEQUENCES TO DATE

The 2009 election resulted in 2 new Supervisors on the Board. At their second meeting, the County administrator who one year previously was recognized as top County administrator in the state was fired on a 4 to 3 vole. She had anticipated this and presented the Board with her severance agreement which provides her with one year’s salary, $105,000, on termination.

It is interesting to note that during 2009 the County was also dealing with a legal dispute between the Board of Supervisors and the Clerk of the Court. Each side sued the other over the issue of whether the Board of Supervisors can deny a constitutional officer the right to allocate monies in his approved budget for a purpose with which the Board members as a majority do not approve. Shortly after the firing of the County administrator by the Board that resulted from the 2009 election, the suit with the Clerk was dropped on the County’s part and the Board agreed to pay the Clerk’s legal costs of $15,300. Within the same time period the County Treasurer resigned perhaps as a result of being told by the Chair of the Board of Supervisors to “be quiet. I will get to you next.” The Treasurer was replaced by the first deputy Treasurer who will serve until the next general election.

The County hired a consulting firm to help with finding a new County administrator. In the meantime, the Board of Supervisors will go through the budgetary process with an assistant who was promoted to acting County administrator and a new Treasurer. In a government as small as this one it is usual for one person to do many different jobs as was the case with the former County administrator. It is also usual for the remaining small staff to not be trained in any of those duties, particularly budgetary.

The outside audit report for the year of the discovery stated that the 2004 – 2009 outstanding checks to the insurance carrier were not discovered due to materiality. The audit report includes recommendations to prevent a reoccurrence of the circumstances of this case.

DISCUSSION

What harm in what types, and in what degree was suffered and by whom? Certainly, it is agreed that while the Board believed the insurance was in place during the years about 2004 through 2009, the reality was that the County was uninsured due to nonpayment. There is a question as to whether it was legal under the state code for the CA to request a closed session “to discuss actions” on the part of the ACA; i.e. the “misuse of duties.” It appears that the monies owed from the various refund checks to the County have all been collected from the payers.

The circumstances of this case came to light fairly recently. To date no charges of fraud, or waste, or abuse of governmental resources has been brought. Several of the Supervisors and some citizens believe that is appropriate. In their viewpoint the system eventually worked appropriately and the County should now move on to the challenge of managing a local government which has lost, inappropriately, a general executive (CA) who held many specific positions including budget director, clerk to the Board, planning director, purchasing agent and zoning administrator. The CA held a long institutional memory of many aspects of the government, all contained within the knowledge of just that one individual. The result represents significant damage to the County and a serious challenge that must be overcome.

Other Supervisors and citizens are unsatisfied that no charges have been brought. These wish to see further investigation regarding fraud, waste, and abuse. They cannot accept that the County government “permitted” the circumstances discussed above to occur and then continue for such a long period. These two very different views of citizens, and their elected representatives, results in an active group of concerned citizens split into two opposing camps.

Perhaps a viewpoint is available that they can agree upon while still maintaining their opinions about the circumstances of this case. That viewpoint is that this occurrence highlights the need for better and more specific accounting and finance procedures. Perhaps many years ago one could claim that a small government could not afford the resources necessary to put such procedures in place. In the year 2010 technology and software availability would seem to offer an avenue to obtain and implement new
procedures that would have highlighted, raised a red flag, years before the circumstances of this case came to light.

Besides improved, corrected accounting and finance systems, the citizen body ought to be able to agree that preventive measures and checkpoints must be put in place within the management, accounting and finance systems. Surely obstacles exist to investigating, designing, and implementing preventative measures. Years ago the rural nature of the County, the limited population and constrained financial resources would have been significant obstacles. Yet in this age of technology it would seem those ought no longer to be an obstacle. Local governments within in the state and across the nation share ideas and processes. Opportunity exists for both the governments and those who would develop governmental accounting and finance systems with a component which addresses management and early warnings as well as preventative measures.
Transformational Leadership in the Context of Punctuated Change

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Benedictine University

Empirical studies are just beginning to link the dynamics of transformational leadership to the context of organization networks, group dynamics, performance, and effectiveness. There still exist few studies that link transformational leadership to change management theories in order to discover which change environments are more receptive to transformational leadership. This literature review will examine transformational leadership and change management theories to identify leadership traits beneficial to continuous change and radical, punctuated change. Interestingly, punctuated change is juxtaposed to continuous change given its disruption of inertia, dismantling of deep structures, and ability to transform organizations. A transformational leadership model is developed that frames 6 transformational leadership traits conducive in punctuated, revolutionary change.

INTRODUCTION

“Today’s world is a rapidly changing environment that places demands on organizations to survive and prosper” (Porras & Silvers, 1991, p. 51). The effects of globalization, environmental catastrophes, social responsibilities, consumer markets and trends, and financial solvency, force organizations across every paradigm to review its current organizational structure and test itself for sustainability and competitiveness. Some organizations take a reactive approach to these issues which can result in rapid structural changes such as downsizing, reorganization, or reengineering of operations or markets. Other organizations take a greater pause, and view external challenges as opportunities to coordinate and execute holistic organizational transformation. The need for organizations to understand the change process is critical now more than ever given the dramatic alterations in every sector of the environment. Organizations, as open systems, are struggling to keep pace and respond to the ever changing political landscapes, failing economies, advanced technology, diversity, and social and moral adaptations (Figure 1). Regardless of the approaches to organizational change, managers are usually given the directive to lead employees throughout the process. Outstanding leadership is needed in today’s workforce due to diversity, rapid advances in technology, globalization and competition (Eisenbach, Watson, & Pillai, 1999).

Change management depends on strong leadership to be enacted in order to create new systems and institutionalize new approaches. No longer are managers able to perform the status quo, which includes monitoring and meeting outcome goals, but successful managers will have a broad shared vision of the future, have an identity and destiny, will be creative and inclusionary, and be open for personal and organization continuous learning. Managers have the increasing responsibility to build consensus, unite purpose, and maintain sustainability, all with the ultimate goal to gain a competitive advantage for the future. An effective manager will possess strong human value systems, have a charismatic ability to
motivate others, assist in self-efficacy discoveries, and connect employees to the mission of the organization and the external community that it serves. If successful, an effective manager will release the maximum potential in every employee and inherently transform the entire organization. The effective management leader will possess the characteristics of a transformational leader.

Transformational leadership is one step beyond effective management and transactional leadership. For leaders to become transformational, they must have the ability to create a collective vision, act in a sense of oneness, be more authentic and engaged, and loosen authority and control (Eisenbach et al., 1999). This type of leadership will create an environment for line managers and staff to maximize their creativity and energy which will lead to maximum performance.

**FIGURE 1**
**OPEN SYSTEMS MODEL**

Transformational Leadership and Change

The transformational leadership paradigm was first developed by James McGregor Burns who defined transformational leadership as an enduring relationship beyond exchanges and agreements that occur when individuals engage with each other in such a way that the leader and follower raise one another to higher levels of motivation and morality (Whittington & Galpin, 2010). Bass & Aviolo (1994) designed a transformational leadership style based on four characteristics traits called the four I’s; idealized vision, inspirational motivation, intellectual stimulation, and individualized consideration. For successful change processes to occur, transformational leaders will not only manage tasks and productions but can pull everyone in the same direction through leadership and create a culture of trust (Herrera, 2001). The leader will manage change systematically with sustained efforts and focus (Simons, 1999). There are numerous change management theories and models that examine almost every variable related to change. Research themes in change management theory encompass; content issues which largely focus on the substance of contemporary organizational changes; contextual issues, which principally focus on forces or conditions existing in an organization’s external and internal environments; process issues, which address actions undertaken during the enactment of an intended change, and criterion issues, which deal with outcomes commonly assessed in organizational change efforts (Armenakis & Bedeian, 1999). It is of note that the most famous and fundamental change management theory is Kurt Lewin’s model of planned change which involves a three step approach; to freeze,
unfreeze, and then refreeze change paradigms (Cummings & Worley, 2008). Lewin’s research further identifies the various processes to change; planned, directed, or spiral. Many theorists have developed other change models that support organization change related to downsizing, restructuring or reorientation. The soft dynamics of change has also been studied and includes the cognitive effects of change such as resistance, grief, and paradoxes to change. There also exists the study of the evolution of change. For example, Darwin’s model of evolutionary change states that change evolves through a slow stream of small mutations that shapes the environment in various forms (Gersick, 1994). In this type of incremental and continuous change, change is episodic as a result of event pacing. Other change theorist (Kuhn, 1970; Tushman & Romanelli, 1985, 1994) view change as long periods of stability in basic patterns of activity which are punctuated by short bursts of fundamental change (Figure 2).

**FIGURE 2**

<table>
<thead>
<tr>
<th>GRADUALISM CHANGE</th>
<th>PUNCTUATED EQUILIBRIUM CHANGE</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="http://www.palomar.edu/anthropology/" alt="Gradualism Change Diagram" /></td>
<td><img src="http://www.palomar.edu/anthropology/" alt="Punctuated Equilibrium Change Diagram" /></td>
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In the punctuated equilibrium model of change, there exists long periods of small incremental change which are interrupted by brief periods of discontinuous, radical change (Tushman & Romanelli, 1985; Gersick, 1994). Browne & Eisenhardt (1997) argue that organizational survival depends on a firm’s ability to engage in continuous change, in contrast to the rare, episodic phenomenon described by the punctuated equilibrium model. Their conclusions were the result of a study of multiple-produced innovation in the computer industry that revealed that firms are more competitive when they have the capacity to change continuously. In examination of continuous and punctuated change, which environment is more likely to be receptive to transformational leadership and which leadership traits are more pertinent for which type of change episode? (Eisenbach et al., 1999) believe that certain transformational leadership qualities are uniquely appropriate for leading certain types of change. Certain leadership qualities enable leaders to successfully enact certain organization changes.

In an environment of continuous change, the transformational leader will set high performance expectations and reward behaviors that are directed towards the vision. Kotter (1995), states that transformational leaders have the ability to effectively communicate how changes have led to better performance and can prepare new approaches. Brown & Eisenhardt (1997) identified three major characteristics of successful managers in continuously changing organizations:

1. Clear responsibility and priorities, extensive communication, and the freedom to improvise.
2. Exploration of the future low cost probes which is organization learning
3. Link current projects to the future with time paced intervals and transition procedures
In continuous change, organizations focus more on planned change strategies, and establish timelines for implementation, evaluation, and reconfiguration.

Punctuated change is substantially different from continuous change, because the need for this type of change is usually urgent due to external pressures, and the change itself is rapid, which involves the dismantling of the organization's deep structure to create a new paradigm (Gersick, 1994). These punctuations are considered revolutionary and are usually caused by the disruption of inertia within organizations. The two basic sources of disruption of an organization's deep structure are, (1) internal changes that pull parts and actions out of alignment and (2) environmental changes that threaten the organization's ability to obtain or retain resources (Gersick, 1991; Tushman & Romanelli, 1985, 1994; Gersick, 1991). In punctuated revolutionary change, a manager must possess some or all the transformational leadership traits in order to manage the cognitive and formative results that stem from the disruption of organization inertia. This study further identifies the specific leadership traits needed for leaders to successfully implement and sustain revolutionary, punctuated change within organizations.

How Punctuations Occur

The external environment can trigger disruptive changes in organizations. For example, changes in advanced technology can immediately change a firm's capacity and service, especially when the old technology becomes obsolete. If an organization cannot quickly transform its capacity, products or service to remain competitive and viable, the organization, just like the old technology will become obsolete. Several external pressures can result in the following transformational strategies;

1. Reconfiguration of their value stream to reposition the organization.
   (ex. develop partnering networks for service support)
2. Redefine the driving force of the organization. (ex. develop a new mission, strategy)
3. Redefine the value proposition to the existing and or new customer. (ex. new market opportunities that reach a new customer base), (Francis, Bessant, & Hobday, 2003).

The directions of a transformational strategy can sometimes result in discontinuous innovation. Discontinuous innovation is qualitatively different from improvement oriented strategies and is more likely to create transformational change opportunities (Francis et al., 2003). This type of change requires destitution of mind sets, entering the unknown and uncertainty, risks, and will likely face many trials and tribulations. These radical punctuated changes hold a sense of urgency and change in mission and strategy and processes.

Managing a radical transformation is confronting in the extreme for those who lead and manage organizations (Grove, 1998). Francis et al. (2003) equates this type of change to the way the government must change in the time of war. The leadership challenge in punctuated change events is to first break down the old equilibrium, manage the period of uncertainty about the future, and then create a new basis which to crystallize a new structure for the organization (Gersick, 1991). In this punctuated change, a set of different, distinctive new leadership capabilities need to be acquired to unleash the radical transformation. Top managers must have the skills to build coalitions of political will that does more than simply cause agents to grudgingly accept the need for a ‘new order’ (Kotter, 1996). Paware & Eastman’s (1997) research proposes that organizations in crisis will be more receptive to transformational leaders when adaptation vs. efficiency is the goal. Bass (1985) states that transformational leadership is needed in non-routine situations. This study examines the specific transformational leadership traits imperative for managers to lead radical punctuated change in organizations. A transitional leadership traits model for punctuated change (LTPC) is developed based on a literature review of change theory, transformational leadership, and punctuated change theory (Figure 3.)
LEADERSHIP TRAITS FOR PUNCTUATED CHANGE

Throughout the review of literature, a common trait evident in transformational leaders is their ability to create, articulate and implement a collective vision. Transformational leaders quickly engage in a process to recognize the need for change, create a new vision, and institutionalize the vision (Tichy & Devanna, 1990). A good vision will provide both a strategic and motivational focus and will be a clear statement of the purpose of the organization (Eisenbach, Watson, & Pillai, 1999). Change and leadership theories both indicate a leader’s perspective of articulating a vision; fostering ground and individual support; can change the basic values, beliefs and attitudes of followers and perform beyond the minimum levels specified by the organization (Yukl, 1989). In the time of punctuated change, the status quo is disrupted which can cause confusion and chaos among organization members (Van, Van, & Fitzgerald, 2003). At this particular juncture in the organizations transformation, the transformation leader has a vantage point to design a new vision and engage all members of the organization to do so. At the minimum, this event has the potential for organization members to discover a new purpose and new focus. A transformational leader can articulate a vision for an attainable future that is both attractive and engaging to followers. To support the commitment to the vision throughout the transformational change process, the leader should set high performance expectations and reward behavior that fulfills the vision (Eisenbach et al., 1999). This process is critical and should be the framework throughout the entire revolutionary change process.

In radical transitions that lead to organization transformation, leaders must have a formal methodical strategy to create the necessary stages of change implementation and management (Eisenbach et al., 1999). Unlike continuous or episodic change, revolutionary change is immediate and responsive. A transformational leader must have the ability to coagulate their vision with a strategic plan for design and implementation. Factors related to engagement, identification of resources, implementation phases, and desired outcomes, are extremely vital in punctuated change. Francis, Bessant & Hobday, (2003) examined 10 case studies of top performing organizations that experienced a radical transition. For each case, an organization’s biography was prepared to answer how management strategically facilitated the transformation and what leadership competencies were demonstrated. An analytical framework emerged that identified five key managerial competencies (Table 1.) The transformational leader will be skilled in developing a collective strategy and will manage smaller initiatives that can be connected to the overall transformational context.

Appreciative Inquiry as a Strategic Process

Appreciative Inquiry (AI) is a systematical discovery of individual and collective capacities that give life and strength to a living system and aims at crafting a process in which value and creation is viewed as one, and inquiry and change are related as a whole (Cooperider et. al, 2005). Inquiry has a goal of discovery, creativity and possibilities. The foundation of AI is the appreciation of the human value system. In recent literature, AI is mostly described as an action research tool; however, appreciative inquiry can be applied as a change agent technique (Cooperider et. al, 2005). In appreciative change, the focus is on a vision that reflects the desires of organization members instead of responses to impeding problems. The AI strategy involves the change in attitudes and beliefs about the present and future and takes a more positive, inspirational change lens (Cooperider et. al, 2005). Through this process, change can be viewed as more of an opportunity than as a response to stimuli. The transformational leader must believe in the people, the process, and welcome the unexpected outcomes of the change venture. This paradigm should be balanced with critical and strategic thinking to move the organization forward in a positive, productive, collective, and engaging direction. The potential of this type of engagement is to create an appreciative culture. This is the basis of building coalitions and teams that will result in synergistic outcomes. Also, AI can become a useful tool for the organization to solve the internal and external problems that will definitely exist in radical change.

Organization change has a number of residual impacts, the most obvious of which are uncertainty and turbulence. In punctuated change, these impacts can be heightened by the sense of urgency and the
dismantling of inertia and deep structures. A major factor in any successful change intervention is the follower’s adaptability to the extent where they are able to cope with the uncertainty of the change process and outcomes (Parry, 1999). The strategies and behaviors of the leader will directly affect the level of certainty and adaptability among its members. Even more so, transformational leaders will not only be capable of resolving uncertainty among their followers, but they themselves will be adaptable to uncertainty and turbulence through the change process. A transformational leader will not be risk averse, but will take the calculated risks necessary to advance the entire organization. A transformational leader’s own adaptability to change leads to enhanced manifestations of leadership to enable followers to change (Parry, 1999).

### TABLE 1
**ORGANIZATIONAL AND MANAGERIAL COMPETENCIES**

<table>
<thead>
<tr>
<th>Competency</th>
<th>Brief Description</th>
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<tr>
<td>(a) Recognize the challenge</td>
<td>The top management group recognizes the scope and scale of the challenges that the organization faces. They realize that radical change is essential and they believe that it can be achieved.</td>
</tr>
<tr>
<td>(b) Determine a transitional strategy</td>
<td>A clear transformational strategy is developed, although this may be tentative as ‘experiments’ may be needed as alternate strategies are explored</td>
</tr>
<tr>
<td>(c) Require extensive innovation</td>
<td>Many people in the organization are encourage to ‘think outside the box’ and take initiatives so that widespread innovation and internal entrepreneurship are developed and sustained</td>
</tr>
<tr>
<td>(d) Manage systemic change</td>
<td>Those parts of the organization that need to change are fully involved in a comprehensive change process</td>
</tr>
<tr>
<td>(e) Upgrade leadership process</td>
<td>Top management has the specific competencies to manage transformation.</td>
</tr>
</tbody>
</table>

The leader’s adaptability in revolutionary change, especially in discontinuous change, will likely result in an unavoidable management of paradoxes (Francis et al., 2003; Sastry, 1997). An example of a management paradox is when a leader will know when to listen with an open mind and when the leader must stop listening to make a decision. This adaptation and paradox management will be critical skills to move the organization forward.

Punctuated change is not a smooth trajectory with pre-set ends but is a radical event grounded in uncertainty and risk, with unpredicted ends (Gersick, 1991; Tushman & Romanelli, 1994). It is evident that this particular type of change has cognitive implications in a human system. Tushman and Romanelli’s review of literature concludes that there can be at least three barriers to punctuated radical change; the exercise of cognition, motivation and obligation by managers (1985). Levinson (1978) describes the emotions of the pain of loss, uncertainties and a perceived termination of lifestyle in punctuated change. There is also the fear of losing control, failing, and not being prepared to operate in the new paradigm. According to Bass (1995) charisma, attention to individual development and the ability to provide intellectual stimulation is critical to leaders in instituting change. Bass (1985) provides three factors needed in transformational leadership:

1. Charismatic leadership, based on admiration and respect;
2. Individual consideration for subordinates needs; and
3. Intellectual stimulation or encouragement for subordinates to view challenges in new ways.
Transformational leaders can change the status quo in their organizations by displaying the appropriate behaviors at the appropriate stage through the change process (Eisenbach et al., 1999). A charismatic leader will have idealized influences, inspiration, and ignites intellectual stimulation (Dionne & Yammarino, 2004). The ability to socially influence others through charisma enables leaders to successfully enact change. Researcher Pamela Tierney conducted an empirical study on social influences which showed the quality of relationships with supervisors and fellow team members can be used to create a favorable climate for change (Eisenbach et al., 1999). As part of the charismatic personality, leader’s behavioral integrity is also pivotal to successful navigation of organization change (Simons, 1999). Behavioral integrity is the convergence of values expressed by words and actions. Simons (1999) states that behavioral integrity is the foundation of trust and credibility in a leader.

**FIGURE 3**
**LEADERSHIP TRAITS MODEL FOR PUNCTUATED CHANGE (LTPC)**

Transformational leadership behaviors motivate followers to identify with the leaders vision and sacrifices their self-interest for that of the group or organization. Motivation is the primary mechanism to build followers self-efficacy and self-worth. Self-efficacy is the belief of one’s capability to organize and execute courses of action required in managing prospective situations (Pillai & Williams, 2004). Transformational leadership behaviors of role modeling, verbal persuasion and physiological arousal are determinates of self-efficacy.

To be successful in motivating through radical change, it is beneficial for managers to understand motivational strategies based on proven research and tested motivational theories. The path-goal theory identifies leadership styles that will motivate employees to achieve established goals. This theory was refined by House and Dessler to dissect four important qualities of a leader; directive, participative, supportive, and achievement oriented (Head, et al, 2007). The expectancy-theory is the presumption that people will be highly motivated when they believe that expected behavior leads to valuable rewards (Gallos, 2006). In Maslow’s need theory, the hierarchical needs of employees are interrelated and employers must seek to meet more than one level of need for maximum employee motivation and
engagement (Head et. al., 2007). Motivational strategies must be routinely practiced by transformational leaders throughout the punctuated change process.

CONCLUSION AND IMPLICATIONS FOR FURTHER STUDY

Punctuated change within an organization requires increased flexibility and responsiveness among all of its members, especially if the change will result in the transformation of the organization’s structure, product and service. More than likely, there will be interdependent networks within the organization that will resist this type of change. In order for change to move forward in this environment, the manager will have to dismantle these groups to form new productive networks. Research has shown that effective groups and teams can provide collaborative efforts to address complex task and expedite process and outcomes (Dionne et. al, 2004). Effective teamwork will have components of cohesion, communication, and team performance. Transformational leaders can create a consensual sharing of meaning (Bass, 1985) that may be a catalyst for higher levels of commitment and performance. Transformational leaders will loosen authority, delegate and motivate team performance. Empirical findings also suggest that transformational leadership is directly linked to team commitment (Dionne et. al, 2004). Transformational leaders can quickly navigate through conflict, keep teams on task, and keep focus of the organizations vision. Transformational leaders can create a culture that is inclusionary and encourages team decision making and behavioral control. It is through this teamwork that sustainable and appreciative change can occur throughout the organization.

Kotter’s study on transformative change most supports the theory of the leadership trait model in punctuated change (Figure 3.). In his book, The Heart of Change, Kotter presents case studies of 34 organizations throughout the world to discover why organizations fail in successful transformations (1995). His research revealed specific leadership barriers to successful transformative change. When managers do not establish a great sense of urgency; create a guiding coalition; lack vision; don’t remove impeding obstacles; provide no systematic planning, and changes aren’t anchored in the organization; the old adage of ‘this is the way we do things around here’ is very difficult to overcome and transformative change is unlikely to occur (Kotter, 1995). The transformational leadership trait model within this article identifies the essential leadership traits needed to manage successful organization transformation during punctuated change. Future studies can examine other pertinent leadership traits and more research can be conducted to test the model in various sectors and organization settings.

REFERENCES


Managing Public Sector Projects in Portugal: Meeting the Challenge Through Effective Leadership

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Using two-hundred eleven (211) Portuguese public sector project managers, this study examines the changing role of project leaders and its impact on a project’s success in challenging Portuguese public sector environment. Factors which include the characteristics of the project managers, managerial know-how and availability of information are studied for this purpose.

INTRODUCTION

As economic and financial difficulties globally persist, the public sector officials are being asked to do more and more with less. In this context, the Portuguese public sector is feeling the severe impact of the country’s financial problems. As such, projects are being cancelled, or put on hold for better times to come. For on-going projects, Portuguese public sector officials and project leaders are looking for ways to enhance the success of projects already in progress.

The success of projects in the public sector is a product of many factors. These factors include, among others, the characteristics and style of management of the project managers, familiarity of project managers with effective management practices, and the availability of information on key aspects of performance to gauge effectiveness.

Using a sample of two-hundred and eleven (211) Portuguese public sector project managers affiliated with city councils in Portugal, the current study has the following objectives:
1. Examining the relevant characteristics of project managers in the public sector.
2. Assessing the importance of management and organizational variables to project management in the public sector.
3. Investigating the availability of information on relevant variables and characteristics influencing the management of projects in the public sector.
4. Shedding some light on the factors contributing to the success of projects in the public sector.

BACKGROUND

In recent years, managers of for-profit private organizations have been under considerable market pressures to re-orient the strategies, operations and business models of their organizations. In a response
to these pressures, the organizational structures of these organizations have been steadily re-engineered from mechanistic, rigid and closed system-oriented to a more organic, flexible and open system-oriented structure (Gomes et. al., 2006). Cross-functional teams utilizing project management practices have been deployed effectively to smooth this re-engineering effort aimed at organizational changes (Box and Platts, 2005). This unmistakable rapid pace of organizational re-engineering and the organizational changes associated with it has made project management tools and practices a subject of great practical interest to the management of private organizations. The proliferation of change-based projects made “management by projects” (Partington, 1996, Smith and Dodds, 1997) a practical phrase, rather than a slogan in today’s business environment.

The traditional project management approach is based on a closed system perspective of organizations. However, some organizations are still adhering to this approach, even in today’s organizational open system environment (Yasin et al, 2002). Perhaps this may explain the relatively high rate of projects failure. In the context of organizational change, project and change initiatives must be approached based on a well-designed and multifaceted strategy, which not only adhere to time and budgetary constraints, but seeks achieving a competitive organizational advantage (Dietrich and Lehtonen, 2005). Toward this end, a broader organizational effectiveness-oriented strategy is required. Such strategy calls on project managers to utilize their technical competences, in planning for and controlling activities, with their leadership, communication, and other human resources management skills (Smith and Dodds, 1997; Zimmerer and Yasin, 1998; Muller, 2003).

The success associated with the movement of for-profit organizations toward a more open system-operational orientation encouraged students of management and organizational science to call for benchmarking the efforts of the private sector, in an effort to enhance the performance of public sector organizations. Some researchers referred to this benchmarking effort as “managerialism” (Uhr, 1990: cited in Yasin et al., 2004; Dixon et al., 1998). In this context, managerialism refers to the deployment of proven organizational and managerial philosophies and techniques, as utilized successfully by the private sector in public sector operational settings. The aim of this deployment is to make public sector organizations more effective and efficient open operational systems.

Through the years, public sector organizations have promoted the perception that their operational systems are too unique to be managed based on operational and organizational practices found in the private sector (Dorsch and Yasin, 1998; Yasin et al. 2004). As such, it was argued that public sector operational systems have distinct constraints which characterize their inputs, processes and outputs. These constraints included, among other factors, budgetary constraints, unmotivated employees, rigid operating procedures and the influence of internal and external politics (Ward and Mitchell, 2004; Brown, 2001). Due to these operational characteristics and constraints, organizational effectiveness in the public sector has been traditionally compromised in favor of operational efficiency.

This operational view of public sector organizations was consistent with a closed organizational system orientation. In this context, the closed system operational orientation is characterized by an internal-focus, absence of a clear customer-orientation, and lack of organizational flexibility (Yasin et al., 2000). Thus, the main concern of such system was, at best, the efficiency of its subsystems (input, process, and output). Therefore, organizational effectiveness was often mistakenly equated with the operational efficiency of the closed system.

Although public sector organizations are not under the same market pressures as their private-sector counterparts, they have also been subjected to pressures advocating fundamental organizational changes. These pressures have mainly been exerted by western governments since 1980s (Wisniewski and Ólafsson, 2004). The motivation behind such pressures is to streamline the size of the public sector, eliminate non-value-added activities and promote organizational effectiveness (Brunetto and Farr-Wharton, 2003). With these pressures in mind, a broader emphasis has emerged toward the complete transformation of public sector management. This broad management transformation trend has been labeled “New Public Management” (NPM). This “New Public Management” philosophy has advocated the promotion of profound changes in the roles, management, staffing and delivery of public services (Lawton, 2005). Therefore it is considered an important component of managerialism.
The NPM reforms refer to the adoption of market-based philosophies and practices within the public sector. These reforms involve the systematic use of strategic planning, program budgeting, risk management and increased use of accountability to achieve measurable outcomes (Brunetto and Farr-Wharton, 2003). Overall, the NPM philosophy promotes systematic changes in the delivery of public services (Hood, 1995). As such, NPM reforms have focused on the complete re-orienting of organizational thinking in the public sector from the input mode to the output mode (Emery e Giauque, 2003). The NPM culture has, in recent years, left its marks on the cultures of many public sectors in different countries.

Due to the complexity and the multifaceted nature of stakeholders in public operational context, difficulties can arise when attempting to apply standard project management practices to promote organizational change (Crawford et al., 2003).

METHODS

Instrument
The research instrument used in this study was utilized previously in Portugal in an earlier study by Gomes et al. (2008). The instrument utilized forced-answer questions that applied a traditional 5 point-Likert scale. The instrument included four sections.

In the first section, the respondents were asked to classify the relevance of 30 project managers’ characteristics/behaviors. In the second section, the importance level and the information availability of project management-related variables were assessed. In the third section, the respondents were asked to classify the sources of influence on the successful completion of a project. In the fourth section, the respondents were asked to specify the relationship between the project manager’s leadership and the project effectiveness. The research instrument also collected description information related to the respondents.

Sample and Procedure
The research instrument was distributed during several classes of public management programs offered by the Fundação CEFA (Foundation for municipal studies and training). The participants were public sector officials at the middle-level and senior-level management rank. They represented eighty-seven different local public institutions, mainly city halls. The participants represented all the eighteen Portuguese mainland districts. The research instrument was distributed to 235 participants at six classes conducted in five cities in Portugal. Two hundred and sixteen (216) participants completed the research instrument. However, five questionnaires were not usable. This resulted in a sample of two hundred and eleven (211) answers and a response rate of 90%.

Based on the obtained responses, seventy-two percent (72.0%) of the respondents worked in the public sector for more than five years. On the other hand, about twenty-seven percent of the respondents (26.5%) were involved in more than 10 projects. Only about three percent (3.3%) of the participants never served as a project leader (Table 1). Almost thirty-seven percent (37.4%) of the undertaken projects were classified as routines projects, while almost twenty-six percent (26.0%) were classified as innovative projects.

RESULTS

Characteristics of Project Managers
In order to identify the most relevant project managers’ characteristics/behaviors, the participants were asked to classify (1-less relevant; 5-most relevant) 30 behavior-related characteristics of project managers. The overall average for the thirty (30) project managers’ characteristics/behaviors studied was calculated. The characteristic with an average of .25 standard deviation above the overall average was classified as part of the most relevant group. On the other hand, a characteristic with an average of .25 standard deviation below the overall average was classified as part of the less relevant group. The average
category included the rest of the characteristics. Table 2 shows the results. The most relevant group includes characteristics/behaviors which have to do with motivation, loyalty, and ability to deal with others.

TABLE 1
SAMPLE PROFILE

<table>
<thead>
<tr>
<th>Item</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Years in public organizations</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>[0-2]</td>
<td>0</td>
<td>0,00</td>
</tr>
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<td>19,43</td>
</tr>
<tr>
<td>[11-15]</td>
<td>52</td>
<td>24,64</td>
</tr>
<tr>
<td>[16-20]</td>
<td>40</td>
<td>18,96</td>
</tr>
<tr>
<td>&gt;20</td>
<td>19</td>
<td>9,00</td>
</tr>
<tr>
<td>Didn't answer</td>
<td>24</td>
<td>11,38</td>
</tr>
<tr>
<td>Total:</td>
<td>211</td>
<td>100.00</td>
</tr>
<tr>
<td><strong>Type of projects undertaken by the public organizations</strong></td>
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<td></td>
</tr>
<tr>
<td>At the routine type</td>
<td>79</td>
<td>37,44</td>
</tr>
<tr>
<td>Structured but not routine</td>
<td>94</td>
<td>44,55</td>
</tr>
<tr>
<td>Innovative projects</td>
<td>55</td>
<td>26,07</td>
</tr>
<tr>
<td>Substitution projects</td>
<td>25</td>
<td>11,85</td>
</tr>
<tr>
<td>Didn't answer</td>
<td>16</td>
<td>7,58</td>
</tr>
<tr>
<td><strong>Number of projects each respondent were evolved</strong></td>
<td></td>
<td></td>
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<tr>
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<td>0,00</td>
</tr>
<tr>
<td>[1-5]</td>
<td>50</td>
<td>23,70</td>
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<tr>
<td>[6-10]</td>
<td>24</td>
<td>11,37</td>
</tr>
<tr>
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<td>13</td>
<td>6,16</td>
</tr>
<tr>
<td>[16-20]</td>
<td>8</td>
<td>3,79</td>
</tr>
<tr>
<td>[21-25]</td>
<td>2</td>
<td>0,95</td>
</tr>
<tr>
<td>&gt;25</td>
<td>23</td>
<td>10,90</td>
</tr>
<tr>
<td>Many</td>
<td>10</td>
<td>4,74</td>
</tr>
<tr>
<td>Didn't answer</td>
<td>81</td>
<td>38,39</td>
</tr>
<tr>
<td>Total:</td>
<td>211</td>
<td>100.00</td>
</tr>
<tr>
<td><strong>Number of projects each respondent served as project leader</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>7</td>
<td>3,32</td>
</tr>
<tr>
<td>[1-5]</td>
<td>68</td>
<td>32,23</td>
</tr>
<tr>
<td>[6-10]</td>
<td>23</td>
<td>10,90</td>
</tr>
<tr>
<td>[11-15]</td>
<td>7</td>
<td>3,32</td>
</tr>
<tr>
<td>[16-20]</td>
<td>4</td>
<td>1,90</td>
</tr>
<tr>
<td>[21-25]</td>
<td>0</td>
<td>0,00</td>
</tr>
<tr>
<td>&gt;25</td>
<td>13</td>
<td>6,16</td>
</tr>
<tr>
<td>Many</td>
<td>7</td>
<td>3,32</td>
</tr>
<tr>
<td>Didn't answer</td>
<td>82</td>
<td>38,85</td>
</tr>
<tr>
<td>Total:</td>
<td>211</td>
<td>100.00</td>
</tr>
</tbody>
</table>
The average category includes characteristics which relate to organizational skills and strategic thinking. The least relevant category includes characteristics such as, desire for power, individualistic, and accepts the flows of others. These characteristics are personality-specific, rather than task-related.

**TABLE 2**
THE RELEVANCE OF CHARACTERISTICS OF PROJECT MANAGER

<table>
<thead>
<tr>
<th>Relevance</th>
<th>Characteristics</th>
<th>Mean</th>
<th>St. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most relevance</td>
<td>High levels of personal motivation</td>
<td>4.48</td>
<td>0.64</td>
</tr>
<tr>
<td></td>
<td>Open to new ideas/innovative behaviour</td>
<td>4.39</td>
<td>0.61</td>
</tr>
<tr>
<td></td>
<td>Goal setter</td>
<td>4.36</td>
<td>0.66</td>
</tr>
<tr>
<td></td>
<td>Effective resources allocator</td>
<td>4.34</td>
<td>0.71</td>
</tr>
<tr>
<td></td>
<td>Demonstration of trust</td>
<td>4.33</td>
<td>0.70</td>
</tr>
<tr>
<td></td>
<td>Accept responsibility</td>
<td>4.33</td>
<td>0.63</td>
</tr>
<tr>
<td></td>
<td>Inter-disciplinary teams builder</td>
<td>4.32</td>
<td>0.67</td>
</tr>
<tr>
<td></td>
<td>Loyalty to the organization</td>
<td>4.27</td>
<td>0.71</td>
</tr>
<tr>
<td></td>
<td>Loyalty to subordinates</td>
<td>4.21</td>
<td>0.74</td>
</tr>
<tr>
<td></td>
<td>Consensus builder</td>
<td>4.19</td>
<td>0.69</td>
</tr>
<tr>
<td></td>
<td>Honest in all dealings</td>
<td>4.17</td>
<td>0.84</td>
</tr>
<tr>
<td></td>
<td>Focuses on results</td>
<td>4.16</td>
<td>0.72</td>
</tr>
<tr>
<td></td>
<td>Long-term orientation</td>
<td>4.12</td>
<td>0.76</td>
</tr>
<tr>
<td></td>
<td>Manages priorities</td>
<td>4.09</td>
<td>0.78</td>
</tr>
<tr>
<td></td>
<td>Empowers subordinates</td>
<td>4.08</td>
<td>0.76</td>
</tr>
<tr>
<td></td>
<td>Effective delegator</td>
<td>4.05</td>
<td>0.76</td>
</tr>
<tr>
<td>Least relevance</td>
<td>Strategic thinker</td>
<td>3.98</td>
<td>0.74</td>
</tr>
<tr>
<td></td>
<td>High levels of skills</td>
<td>3.97</td>
<td>0.67</td>
</tr>
<tr>
<td></td>
<td>Effective organizational politician</td>
<td>3.91</td>
<td>0.74</td>
</tr>
<tr>
<td></td>
<td>Risk taker</td>
<td>3.90</td>
<td>0.78</td>
</tr>
<tr>
<td></td>
<td>Driven by values</td>
<td>3.88</td>
<td>0.92</td>
</tr>
<tr>
<td></td>
<td>Utilizes a network of contacts</td>
<td>3.71</td>
<td>0.82</td>
</tr>
<tr>
<td></td>
<td>Visionary</td>
<td>3.70</td>
<td>0.92</td>
</tr>
<tr>
<td></td>
<td>Highly self-esteem</td>
<td>3.53</td>
<td>0.96</td>
</tr>
<tr>
<td></td>
<td>Intuitive</td>
<td>3.49</td>
<td>0.82</td>
</tr>
<tr>
<td></td>
<td>Charismatic personality</td>
<td>3.46</td>
<td>0.84</td>
</tr>
<tr>
<td></td>
<td>Accept flaws of others</td>
<td>3.39</td>
<td>0.85</td>
</tr>
<tr>
<td></td>
<td>High level of administrative skills</td>
<td>3.36</td>
<td>0.91</td>
</tr>
<tr>
<td></td>
<td>Desires Power</td>
<td>2.49</td>
<td>1.03</td>
</tr>
<tr>
<td></td>
<td>Individualist</td>
<td>1.82</td>
<td>0.85</td>
</tr>
</tbody>
</table>

Based on the results in Table 2, it is interesting to note that characteristics pertaining to technical expertise are absent from the most relevant group. It appears that leadership skills and people-related skills of the project manager are more relevant to the participants than personality-specific characteristics or technical skills. It is also very important to note that accepting the flaws of others was not considered as relevant characteristic of a project manager. This perhaps reflects the rigidity of the public sector operational environment, where people are expected to confirm to a pre-determined pattern of behavior. Thus, there is very little tolerance for deviations and flaws. Perhaps this is an organizational culture, where one acts as expected, rather that run the risk of being penalized for thinking.

The average category includes characteristics which relate to organizational skills and strategic thinking. The least relevant category includes characteristics such as, desire for power, individualistic and accepts the flows of others. These characteristics are personality-specific, rather than task-related.
Based on the results in Table 2, it is interesting to note that characteristics pertaining to technical expertise are absent from the most relevant group. It appears that leadership skills and people-related skills of the project manager are more relevant to the participants than personality-specific characteristics or technical skills. It is also very important to note that accepting the flaws of others was not considered as a relevant characteristic of a project manager. This perhaps reflects the rigidity of the public sector operational environment, where people are expected to confirm a pre-determined pattern of behavior. Thus, there is very little tolerance for deviations and flaws. Perhaps this is an organizational culture, where one acts as expected, rather than run the risk of being penalized for thinking.

Project Management Variables and Information Availability

To shed some light on the relative importance of some key project management related-variables, the participants were presented with 23 variables. The methodology utilized in the previous section was applied to classify these variables into three categories. The first category includes the most important variables. As can be seen from Table 3, this category includes some key variables. These variables include leadership, technical competencies, communication, and integration management. The average category includes variables, such as, scope management, cultural sensitivity, and environmental regulations. The least important category includes variables related to organizational policies and to international dimension.

<table>
<thead>
<tr>
<th>Importance</th>
<th>Variables</th>
<th>Mean</th>
<th>St. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most importance</td>
<td>Leadership ability</td>
<td>4.32</td>
<td>0.73</td>
</tr>
<tr>
<td></td>
<td>Cost management</td>
<td>4.20</td>
<td>0.88</td>
</tr>
<tr>
<td></td>
<td>Technical competence</td>
<td>4.20</td>
<td>0.78</td>
</tr>
<tr>
<td></td>
<td>Time (Schedule) MGT</td>
<td>4.14</td>
<td>0.84</td>
</tr>
<tr>
<td></td>
<td>Quality management</td>
<td>4.13</td>
<td>0.81</td>
</tr>
<tr>
<td></td>
<td>Technical Requirements</td>
<td>4.10</td>
<td>0.80</td>
</tr>
<tr>
<td></td>
<td>Communication</td>
<td>4.07</td>
<td>0.88</td>
</tr>
<tr>
<td></td>
<td>Top management support</td>
<td>3.98</td>
<td>0.94</td>
</tr>
<tr>
<td></td>
<td>Standard/codes (quality, safety, etc.)</td>
<td>3.93</td>
<td>0.85</td>
</tr>
<tr>
<td></td>
<td>Integration Management</td>
<td>3.93</td>
<td>0.84</td>
</tr>
<tr>
<td></td>
<td>Project Organization Chart</td>
<td>3.93</td>
<td>0.91</td>
</tr>
<tr>
<td></td>
<td>Organizational skills</td>
<td>3.93</td>
<td>0.82</td>
</tr>
<tr>
<td></td>
<td>Risk management</td>
<td>3.88</td>
<td>0.89</td>
</tr>
<tr>
<td>Least importance</td>
<td>Scope Management</td>
<td>3.76</td>
<td>0.88</td>
</tr>
<tr>
<td></td>
<td>Cultural sensitivity</td>
<td>3.65</td>
<td>0.83</td>
</tr>
<tr>
<td></td>
<td>Environmental regulations</td>
<td>3.62</td>
<td>0.91</td>
</tr>
<tr>
<td></td>
<td>Organizational policies</td>
<td>3.57</td>
<td>0.88</td>
</tr>
<tr>
<td></td>
<td>Organizational Constraints</td>
<td>3.55</td>
<td>0.95</td>
</tr>
<tr>
<td></td>
<td>Leadership by example</td>
<td>3.53</td>
<td>0.85</td>
</tr>
<tr>
<td></td>
<td>International Law/Regulations</td>
<td>2.98</td>
<td>0.91</td>
</tr>
<tr>
<td></td>
<td>International Economics</td>
<td>2.96</td>
<td>0.98</td>
</tr>
<tr>
<td></td>
<td>International Marketing</td>
<td>2.70</td>
<td>0.98</td>
</tr>
<tr>
<td></td>
<td>International finance</td>
<td>2.69</td>
<td>1.00</td>
</tr>
</tbody>
</table>

It is interesting to note that while the participants tend to believe that leadership ability is important, they did not think that leadership-by-example is important. Perhaps the participants do not believe in leadership-by-example, since it is not practiced by senior administrators in their organizations. Thus, this facet of leadership appears to be ignored as a facet of public sector leadership practices.
To gain a better understanding of the relative practical importance of these project management related variables, participants were asked to classify these variables based on their availability of information. The results in Table 4 appear to shadow the results in the Table 3 pertaining to the level of importance. Thus, the availability of information, or lack of, may explain the relative importance of these variables as perceived by the participants. An exception to this rule is the risk management variable, classified as most important, and included in the least information availability group.

**TABLE 4**

INFORMATION AVAILABILITY ON KEY MANAGEMENT-RELATED VARIABLE

<table>
<thead>
<tr>
<th>Availability</th>
<th>Variables</th>
<th>Mean</th>
<th>St. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Most availability</strong></td>
<td>Technical Requirements</td>
<td>3.56</td>
<td>0.85</td>
</tr>
<tr>
<td></td>
<td>Leadership ability</td>
<td>3.54</td>
<td>0.83</td>
</tr>
<tr>
<td></td>
<td>Technical competence</td>
<td>3.49</td>
<td>0.81</td>
</tr>
<tr>
<td></td>
<td>Environmental regulations</td>
<td>3.48</td>
<td>0.87</td>
</tr>
<tr>
<td></td>
<td>Standard/codes (quality, safety, etc.)</td>
<td>3.46</td>
<td>0.93</td>
</tr>
<tr>
<td></td>
<td>Communication</td>
<td>3.44</td>
<td>0.83</td>
</tr>
<tr>
<td></td>
<td>Quality management</td>
<td>3.39</td>
<td>0.92</td>
</tr>
<tr>
<td></td>
<td>Cost management</td>
<td>3.38</td>
<td>0.92</td>
</tr>
<tr>
<td></td>
<td>Scope Management</td>
<td>3.33</td>
<td>0.85</td>
</tr>
<tr>
<td></td>
<td>Time (Schedule) MGT</td>
<td>3.32</td>
<td>0.97</td>
</tr>
<tr>
<td></td>
<td>Project Organization Chart</td>
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<td>1.00</td>
</tr>
<tr>
<td></td>
<td>Organizational skills</td>
<td>3.31</td>
<td>0.85</td>
</tr>
<tr>
<td><strong>Least availability</strong></td>
<td>Top management support</td>
<td>3.23</td>
<td>0.91</td>
</tr>
<tr>
<td></td>
<td>Integration Management</td>
<td>3.20</td>
<td>0.84</td>
</tr>
<tr>
<td></td>
<td>Cultural sensitivity</td>
<td>3.11</td>
<td>0.77</td>
</tr>
<tr>
<td></td>
<td>Leadership by example</td>
<td>3.09</td>
<td>0.86</td>
</tr>
<tr>
<td></td>
<td>Risk management</td>
<td>3.07</td>
<td>0.96</td>
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<td></td>
<td>Organizational policies</td>
<td>3.06</td>
<td>0.84</td>
</tr>
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<td>International Law/Regulations</td>
<td>3.01</td>
<td>1.00</td>
</tr>
<tr>
<td></td>
<td>Organizational Constraints</td>
<td>2.99</td>
<td>0.86</td>
</tr>
<tr>
<td></td>
<td>International Economics</td>
<td>2.88</td>
<td>0.98</td>
</tr>
<tr>
<td></td>
<td>International finance</td>
<td>2.66</td>
<td>0.96</td>
</tr>
<tr>
<td></td>
<td>International Marketing</td>
<td>2.61</td>
<td>0.99</td>
</tr>
</tbody>
</table>

**Effectiveness and Leadership**

In order to understand the factors which the participants associate with project effectiveness, a set of variables was utilized to assess the factors influencing the success of a project. Utilizing the classification methodology used in the previous sections, Table 5 reports the results. The participants select, in the first place, the decisions by the project team. In second place, they select the decisions made by upper manager. The next two most influential project success factors are desire to excel on the project and internal politics, reflecting the strong influence of bureaucracy and organizational constraints on project success. The existence of bad luck is selected by the participants as the least influential project success factor. It is to be noted here that the values for the mean and standard deviation for this variable (2.45; 1.01) tend to indicate that this choice was not a consensual choice. The next two less influential factors selected were external politics and pressures from outside the project, meaning a close system approach.
TABLE 5  
KEY FACTORS INFLUENCING PROJECT SUCCESS

<table>
<thead>
<tr>
<th>Influence</th>
<th>Factor</th>
<th>Mean</th>
<th>St. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most influential</td>
<td>Decisions by the project team</td>
<td>4.10</td>
<td>0.71</td>
</tr>
<tr>
<td></td>
<td>Decision made by upper manager</td>
<td>4.09</td>
<td>0.75</td>
</tr>
<tr>
<td></td>
<td>Desire to excel on the project</td>
<td>3.98</td>
<td>0.89</td>
</tr>
<tr>
<td></td>
<td>Internal politics</td>
<td>3.88</td>
<td>0.81</td>
</tr>
<tr>
<td>Least influential</td>
<td>Decisions by the client</td>
<td>3.58</td>
<td>0.81</td>
</tr>
<tr>
<td></td>
<td>Unforeseen technical problems on the project</td>
<td>3.47</td>
<td>0.87</td>
</tr>
<tr>
<td></td>
<td>Responding to changing client request</td>
<td>3.42</td>
<td>0.83</td>
</tr>
<tr>
<td></td>
<td>Pressure from inside the project</td>
<td>3.41</td>
<td>0.80</td>
</tr>
<tr>
<td></td>
<td>External politics</td>
<td>3.31</td>
<td>0.87</td>
</tr>
<tr>
<td></td>
<td>Pressures from outside the project</td>
<td>3.06</td>
<td>0.91</td>
</tr>
<tr>
<td></td>
<td>Inexistence of &quot;Bad luck&quot;</td>
<td>2.45</td>
<td>1.01</td>
</tr>
</tbody>
</table>

To shed some light on the impact of the project manager’s leadership on project success, participants were asked to quantify the relationship between the project manager’s leadership and project effectiveness. Based on the results, the participants tended to believe that sixty-eight percent (68%) of project success can be attributed to good leadership from the project manager. On the other hand, participants tended to believe that fifty-two percent (52%) of all projects fail due to poor or bad leadership of the project manager. In this context, effective leadership appears to be needed in order to make decisions which incorporate the objectives of the project and the unique realities of the organization.

CONCLUSION

Given the current financial difficulties of Portugal, managing public sector projects is becoming a serious challenge. In such an environment, the effectiveness of public sector projects is dependent on the characteristics of the project manager, knowledge of effective managerial practices, and availability of information. Using a sample of two-hundred and eleven (211) Portuguese public sector project managers, this study attempted to investigate these factors. Based on the results of this study, the following are in order.

First, to manage public sector projects under the current difficult financial constraints, project leaders are being called upon to use their strengths in motivation and loyalty to effectively motivate others. In addition, they are approaching projects with long-term, strategic thinking, rather than tactical and technical details. Perhaps technical expertise is taken as a given, while the relevance of being a leader is increasing.

Second, projects leaders are being forced to utilize a managerial approach which emphasizes leadership, communication, quality, as well as technical requirements. In this context, emphasis on risk management and the international dimension are still relatively lacking. Risk management is especially noted, as it should be given more considerations in an uncertain Portuguese financial environment.

Third, while Portuguese public sector organizations have improved their informational infrastructure in recent years, such organizations are still emphasizing readily available technical information. This appears to be at the expense of information related to important, yet softer concerns. These concerns include risk management, the international dimension, and integration management. The lack of information availability on these managerial aspects may be hindering the success of public sector projects.

Finally, leadership appears to be the most significant factor in determining the success or failure of projects in the public sector. As such, Portuguese public sector organizations must choose their project leaders carefully. In such an environment, the effectiveness of public sector projects is dependent on the
characteristics of the project manager. Such training will afford project leaders the opportunity to make decisions which are consistent with the complexity of the Portuguese public sector organizations.

REFERENCES


