Channelling Corporate Behaviour

– Project briefing –

Foreword

ACCA, the UK based global professional accounting body, with financial support from the academic research funding body ESRC (UK's Economic and Social Research Council), is investigating corporate culture and what influences individuals' conduct in organizations.

Specifically the project will look at how behaviour can be influenced for the long-term benefit of the company, its owners and other stakeholders.

The project will be in two phases:

In the first phase, we will attempt to understand what drives humans and how companies can channel behaviour so that it is more functional and less is dysfunctional.

> By functional we mean contributing to long-term organisational success and by dysfunctional we mean undermining ability to be successful over the long-term.

The first stage will conclude with a report in **June 2014** setting out our findings, suggestions for practical steps that can be taken to improve functional behaviour together with suggestions for further research.

The second phase will respond to the suggestions for further research.

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INTRODUCTION

ACCA believes that a healthy culture is a prerequisite of good governance and risk management. We think it is also essential for good long-term corporate performance.

Enron in 2001 showed that a firm could appear to be a model company with fine ethics, good governance and a reputation for innovation but in reality be something very different. Other corporate scandals, in the US, Europe and Australasia, came to light soon after Enron sparked a flurry of regulatory action.

This led to new and more detailed legal and governance measures. The aim of these new measures was to ensure that such scandals would not happen again.

Background note

When the financial crisis unfolded in 2008, it revealed how regulatory frameworks and governance best practice failed to prevent rogue behaviours from spreading through the banking sector. Scandals and public inquiries have become regular features of the news. The LIBOR case of manipulation of interbank lending rates by traders is certainly one of the most striking illustrations of undesirable behaviour. There are plenty more. There has been mis-selling of a wide range of financial products to businesses and individuals, and market manipulation was not confined to financial services but extended to energy markets. In other sectors there have been phone hacking, a political expenses scandal, ill treatment and unnecessary deaths of hospital patients and cover-ups in the public sector. Recently, there have been allegations that banks exacerbated the difficulties of some of their business customers so as to bankrupt them enabling the banks to acquire their assets cheaply.

Regulation versus Culture

Extensive rules, procedures and compliance systems have not created the conditions to ensure appropriate conduct. Is more regulation the answer? Culture has reached the top of the corporate, regulatory and policy agendas. There now is widespread recognition that something about culture needs to be done. But what exactly?

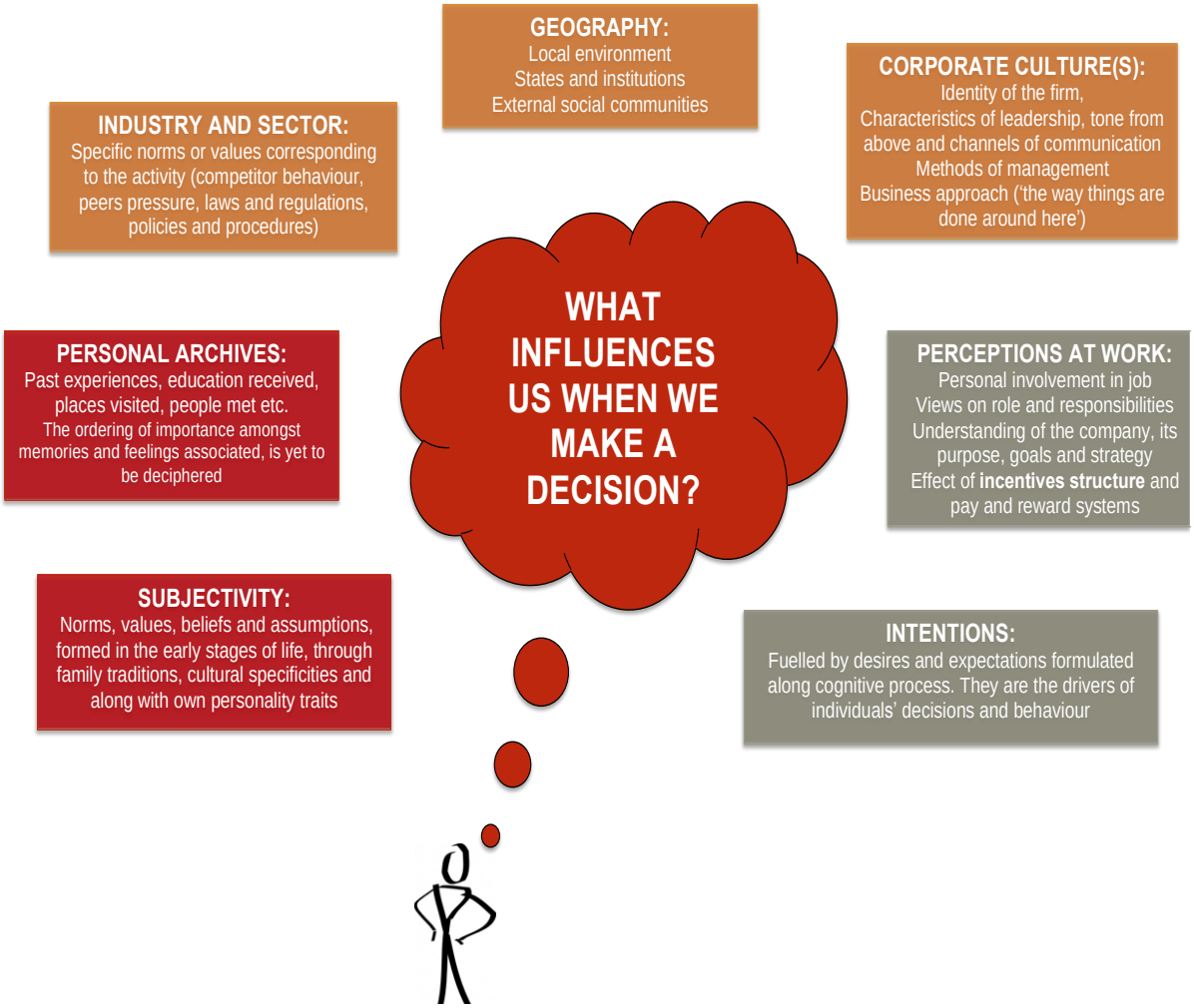
The word ‘culture’ means many things to many people and is now being used in so many contexts that it is in danger of becoming meaningless. It is clear that companies, particularly in financial services, and regulators are expected to do something about culture but there is little understanding about what to do.

Knowledge of what drives corporate behaviour seems poor. Knowledge of how to influence, or channel, behaviour so that everyone in a company really works to

achieve the company's objectives for its long term success, rather than their own, seems poorer still.

ACCA has been interested in culture and what drives behaviour for many years. We now want to understand better what influences behaviour in organizations, how individuals respond to corporate and other incentives, and why some forms of dysfunctional behaviour are so common. We also want to learn how culture in companies can usefully be assessed and improved so that behaviour is more functional.

Framework of decision-making



METHODOLOGY

Literature review

The project is based on research of academic and other documented evidence and on various forms of consultation. Part of the literature base will include previous ACCA publications [see annex].

Exploratory phase

The first stage of consultation is to hold exploratory roundtable discussions to test and inform an initial set of hypotheses [detailed below]. An initial report will be prepared setting our preliminary findings based on the documented evidence and discussions. This report will advance views on the drivers of behaviour that are most relevant for boards and offer suggestions for how culture can be assessed and positively influenced.

Wider consultation

The second stage is to discuss and explore the views and suggestions in the initial report with a wider audience. This will include small group discussion meetings internationally, interviews and a web based survey. Besides two roundtables held in London at the fall of 2013, we have hosted in January two sessions in New York City while a team of collaborators ran for us a debate in Bangalore (India) and another one in Dubai. In February, we will be in Brussels and in March, we will expand our reach to Asia and organise similar types of exercises in Singapore and Hong Kong.

We are interested in obtaining the views of business people, individuals in corporations, investors, executives, board members, people from financial services, regulators, accountants, academics and consultants. We would like to hear from both senior and junior positions and are keen on promoting diversity in our contributors. We will also gather examples of case studies of how organizations assess culture and seek to improve functionality.

Publication

The outcome of these consultations is to come up with practical suggestions on how corporate behaviours could be channelled in order to foster performances as well as encourage the creation of long-term sustainable value in businesses.

Summary of project steps

Literature Review

Study of significant analyses and documented evidence of what could be driving human behaviour, in the fields of:

- Organisational theories
- Behavioural sciences and genomics
- Socio-psychology

Exploratory Roundtables

Initial consultation held primarily in the UK and designed to:

- Test and inform our initial set of hypotheses – formulated upon the literature review
- Refine our approach and prepare an interim report

Interim Report
New Year

Initial report setting out our preliminary findings, based on the documented evidence and discussions. It is aimed at:

- Advancing views on the drivers of behaviour that are most relevant for boards
- Offering suggestions for how culture can be assessed and positively influenced

Wider Consultation

Discuss and explore the views and suggestions made in the initial report with a wider audience, in the forms of:

- Small group discussion meetings in the UK and internationally (New York, Brussels, India or Singapore)
- One-to-one interviews and web based survey
- Case studies

Publication
June 2014

The outcome of these consultations is to:

- Come up with practical suggestions for how to avoid dysfunctional behaviour
- Explore how to foster performances as well as encourage the creation of long-term sustainable value in businesses
- Suggest directions for further research

INITIAL HYPOTHESES

Set out below, are seven hypotheses or assertions and a number of questions. We think these are the issues, which need to be addressed in order to promote more functional cultures. We will be discussing these in the exploratory roundtable meetings:

1) **The incentives and interests of people drive their behaviour more than procedures and rules.**

   - Do we know how incentives work and are there any that work against achieving organizational objectives?
   - Who within an organization understands how incentives (deliberately devised or not) determine behaviour?
   - What does the board or management do (a) to understand the incentives that influence behaviour throughout the organization, and (b) attempt to ensure that incentives support organizational objectives?

2) **Regulation and codes on governance and risk management seem not to have had a positive impact on creating a healthy culture – particularly in financial services.**

   - Does regulation improve culture or undermine it?
   - How do corporate governance requirements influence culture?
   - How can we recognize a healthy culture?
   - What are organizations doing to assess, change, or manage culture? Does it work?

3) **What gets measured gets managed; what is not measured is not. But often measures get gamed.**

   - Does any measure, as soon as it is used as an instrument of management, lose its managerial efficacy?
   - How can we ensure that measures are not gamed and work to the organization's advantage?

4) **Tone at the top is key – as everyone knows**

   - But what is it? Whose job it is – the board or executives? Can you measure it and how can boards know if they have got it right?
   - What can or should organizations do to set, influence or assess the tone at the top?

5) **Cognitive biases and groupthink can impede good decision-making**

   - To what extent are people aware of this?

- What impact does it have on decision-making and performance?
- Can we identify our own biases? Can a board do so?
- How can we deal with cognitive biases?

6) **The imperative to maximize shareholder value makes it harder for boards and companies to take into account the interests of other stakeholders such as staff, customers, the community, and the environment, and makes them over focused on short-term gains.**

- Is this true?
- Does it matter?
- What could be done?

7) **Trust is essential to any healthy business and to healthy economy**

- What most undermines trust?
- How can trust be fostered and sustained?
- Can we measure trust? Should we?
- How can we ensure that people behave ethically when no one is looking?

EXPLANATION OF HYPOTHESES

The examples below illustrate why these issues are important. Although these draw particularly on UK experience, the researchers would like to extend these to include examples from other countries, particularly from North America, Europe and Australasia, and would welcome other examples.

Incentives and interests

The incentives and interests of people drive their behaviour more than procedures and rules.

This is formed upon the presupposition that individuals are rational actors driven by their self-interest in the sense that they want to make themselves better off. This thinking is grounded in the ideas developed by Adam Smith, Jeremy Bentham or John Stuart Mill. The period of the Industrial Revolution brought about a new era of technologies accompanied with an intellectual shift that placed great faith in human reason and rationality. To Bentham and others, the modern liberal state, freed from all forms of authoritarianism and protectionism, would guarantee the greatest happiness of the greatest number, through automatic market adjustment (the 'invisible hand').

In reality, and in business in particular, many, but not all, individuals are indeed driven by their own interest, but this does not seem to result in what liberals had envisioned, which is why regulatory frames developed.

In our modern sense, self-interest is about more than survival. It concerns social attributes and conditions such as prestige. It means keeping a job, maintaining a standard of living, repay a mortgage or loan, or living up to certain standards so as to remain part of a certain social community and saving for old age.

The primacy of individual 'utilitarianism' can be exemplified with the current affair over the manipulation of interbank lending rates (LIBOR/EURIBOR). Last year, the UK Treasury Committee launched an inquiry into fraudulent practices within the banking sector when it became clear that certain traders rigged the foreign currency market to their own benefit or to the one of the bank they were operating for. Investigation particularly focused on one bank, but the report concluded that:

> 'This attempted manipulation of LIBOR should not be dismissed as being only the behaviour of a small group of rogue traders (...). Such behaviour would only be possible if the management of the bank turned a blind eye to the culture of the trading floor. The incentives and control systems of [the bank] were so defective that they incentivized traders to benefit their own book irrespective of the impact on shareholders and the bank's overall performance (…). The standards and culture of [the bank], and banking more widely, are in a poor state. Urgent reform, by both regulators and banks, is needed'[i].

Outcomes of regulation

The above suggests that:

Regulation and codes on governance and risk management seem not to have had a positive impact on creating a healthy corporate culture – particularly in financial services.

As regulation of governance and risk management increased, corporate 'culture failure' does not appear to have diminished and may have increased. An unhealthy culture was at the heart of much of what went wrong in scandals in the early 2000s and again in contributing to the financial crisis. Regulation and codes failed to create a healthy corporate culture, and the role of boards must be questioned. It seems clear that regulations will remain powerless in influencing behaviours until corporate governance and risk management improves. This is discussed in detail in ACCA latest consultation paper 'Creating Value Through Governance – towards a new accountability'[ii].

A change in corporate and political values and culture, with priority given to ethics, culture and leadership, may be necessary to recreate genuine prosperity.

Gaming measures

If what gets measured gets managed, and what is not measured is not, we could also deduce that, often, measures get gamed.

It has been widely recognized that executive performance pay schemes influence behaviour. The intention is that executives are motivated to perform in shareholders' long-term interest. The reality tends to be rather that they perform better in shareholders' short-term interest and better still in their own interest. Earnings per share (EPS) is a common performance measure affecting pay but EPS can easily be boosted by buying back shares but has no direct impact on performance but may adversely affect longer term performance if it means the company becoming over borrowed to cutting back investment. EPS can also easily be boosted by cutting or deferring essential costs such as repairs and maintenance.

Targets have a more pernicious affect further down in organizations. In March 2008, the UK Healthcare Commission began to probe the Mid-Staffordshire hospital after reports indicated apparently high mortality rates in patients admitted as emergencies. Parliamentary investigations followed, and a full public inquiry started in 2010. In his final remarks, Chairman Robert Francis QC argued that the hospital was dominated by target-driven priorities and reliance on external assessment since it became a Trust. This performance culture seemed to have resulted in marked bullying of staff, disengagement from the management, lack of openness, isolation from other organizations and deficient self-criticism, rather than sustainable good care to patients. To Francis, these 'symptoms' were the product of a long-standing lack of positive and effective direction at all levels, one that allowed poor behaviours to surface and persist[iii].

The Mid-Staffs example showed that pressures to meet performance and financial targets resulted in a culture where measures had the primacy over individual experiences laying behind numbers and statistics. As a result, measures got gamed.

The inquiry extensively mentioned the waiting-time target of four hours in the Accident & Emergency, as a measure that ought to get managed, as it would increase performances and returns, ultimately. Francis' investigations uncovered how this measure got gamed when nurses fabricated records to show compliance, hence matching performance levels required within the NHS national community. The two women incriminated were then put on leave for two weeks but were then reinstated at their original position. The manager said in the inquiry that 'in their absence, breach times had gone through the roof (…), and they were the only ones that could run the department effectively and efficiently'; afterwards, little clarity had been made on actions taken by the hospital to investigate the records' fabrication, and the internal report on it was not disclosed to the inquiry (Francis, 2010: 178).

Tone at the top

Tone from the top appears to be the key – but what is it? Whose job it is? Can we measure it? How do we know if we have got it right?

There is a broad literature on boards in organizational theory. From corporate governance to moral responsibility, board members are designated as the corner stone of every company. They must set the tone and diffuse it throughout the chain of command so that bottom and up are always connected. The top must learn from the rest of the pyramid, while making sure that decisions are appropriately transmitted all the way back. This implies an intense network of internal communication, a feature that probably deserves improvement in many organizations today. The more global do businesses grow, the more interconnected and complex they become. For companies with multiple foreign offices, exchanges over different countries or continents condition the packaging of messages from the head office, as it must be clear, concise and easy to forward in an email.

Decision-making processes are also dependent on the dynamics within this group (see the Harvard experiment described below)

Cognitive biases

Groupthink, conformity and dissent

Human beings are prone to many cognitive biases, which influence their decision-making and actions. These include availability, anchoring, hindsight, confirmation, optimism and pessimism biases. In a group, all these biases can coalesce into groupthink.

Groupthink would seem to explain why non-executive or outside directors do not hold executives to account. 'According to Janis, groupthink stands for an excessive form of concurrence-seeking among members of high prestige, tightly knit policy-making groups. It is excessive to the extent that the group members have come to value the group (and their being part of it) higher than anything else. This causes them to strive for a quick and painless unanimity on the issues that the group has to confront. To preserve the clubby atmosphere, group members suppress personal doubts, silence dissenters, and follow the group leader's suggestions. They have a strong belief in the inherent morality of the group, combined with a decidedly evil picture of the group's opponents. The results are devastating: a distorted view of reality, excessive optimism producing hasty and reckless policies, and a neglect of ethical issues'[iv].

Conformity and self-suppression of dissent are common human biases, and could probably be linked to an inherent fear of the unknown. This tendency becomes particularly manifest along with the rapid pace of changes and the high degree of uncertainty associated with business in today's interconnected world. The amount of risk in the daily corporate environment means that now, some employees are in a position to wipe out a company virtually overnight.

The Harvard experiment

The human inclination to conform to the group and refrain from differentiation is striking in a study of group pressure conducted in 1955 by the Laboratory of Social Relations at Harvard University. Seven student subjects were asked by the experimenter to compare the length of lines between two cards, one containing one line, and the other displaying three different lines. Subjects were asked to determine which of the three lines were similar to the one pictured on its own.

Six of the subjects had been coached beforehand to give unanimously wrong answers. The seventh had merely been told that it was an experiment in perception. When instinctively giving what seems like the most rational answer, the seventh subject faces a unanimous majority of wrong answers by a group of peers (all were student at Harvard at the time). As a result, seventy-five per cent of experimental subjects shifted to the opinion of the majority, regardless of their intimate convictions[v].

Group dynamics and cognitive biases might be the hardest problem to be dealt with when thinking of corporate culture. Indeed, no matter how hard anyone might try, individuals' own assumptions, beliefs, fears and habits will always compete with the external inputs that a board intends to spread across the organization.

The alignment of the company's values with those of the employees appears therefore crucial. Mechanisms of immediate feedback and intense internal communication are also attributes that can strongly inform on this alignment, the interpretation of the organization's strategy, the risks being faced, and the optimal behaviour to engage with in response.

Shareholder value

The imperative to maximize shareholder value makes it harder for boards and companies to take into account the interests of other stakeholders such as staff, customers, the community, and the environment, and makes them over focused on short-term gains.

This arises from the fact that there is not symmetry in the risk and reward balance between shareholders and other stakeholders particularly where gearing or leverage is involved. As explained in a worked example in 'Creating Value Through Governance', shareholders are more exposed to the upside of risk taking – a share worth £1 can become worth £3 while all that they could lose is £1. Other stakeholders may see little benefit from a strategy which triples the share value yet could mean that the company fails meaning employees lose their jobs and creditors do not get paid.

Trust

Finally, at the risk of stating the obvious:

Trust is essential to any healthy business and to a healthy economy.

The tremendous economic and industrial expansion that took place in Europe and North America in the 18th and 19th centuries could not have happened without investment and a convenient means of transferring money. People and businesses would not have been willing to lend, invest or give credit without trust.

The financial system froze in 2008 when banks stopped lending to each other. The dependence of developed society on the financial system was clear for all to see.

Many studies have suggested that levels of public trust in business and in institutions have declined in recent years. Economies will struggle to grow if trust is lacking.

FURTHER READING

ACCA publications

- CFO Asia (2006), 'Corporate Governance, Business Ethics, and the CFO', *ACCA and CFO Research Services*, June
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[iii] Francis, Robert QC (2010), 'Independent Inquiry into care provided by Mid Staffordshire NHS Foundation Trust, January 2005 – March 2009, *The Mid Staffordshire NHS Foundation Trust Inquiry*

[iv] Hart, Paul't (1991), 'Irvin Janis' Victims of Groupthink', *Political Psychology*, vol. 12, no. 2, pp. 247-78, June

[v] Ash, Salomon (1955), 'Opinions and Social Pressure', *Scientific American*, vol. 193, no. 5, pp. 31-35, November