Channelling Corporate Behaviour

– Roundtable Briefing Pack –

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INTRODUCTION

Dear delegates,

This pack is designed to update you on the Channelling Corporate Behaviour project and what we plan to do in our roundtable discussion.

Since the first project briefing we sent you, we now have a draft review of the academic literature on organisational culture, human behaviour and its drivers in a corporate environment. The review needs updating for the latest academic literature on the subject and relevant recent non-academic literature such as from inquiries into bank failures. We think that nevertheless it makes interesting reading and we have attached this document with this delegate pack.

Two exploratory meetings took place in London, one in September and one in December 2013. In January 2014 we hosted two discussion meetings and a consultation panel in New York, while a team of colleagues simultaneously ran two sessions in Bangalore (India) and in Dubai. Last February, we held another discussion in Brussels (Belgium).

So far we have involved more than 80 representatives from the public and private sectors, from financial services, from consultancies and from related academic fields. They included executive directors, chairman and non-executive directors, internal auditors, risk managers, researchers from international organisations and board information consultants.

At each one of these, the starting point was the set of hypotheses and questions displayed in the project briefing you have already received. Delegates were invited to introduce themselves and briefly set out their views and interests in the topic.

Discussions now account for more than fourteen hours of tape and the full transcripts of these sessions add up to over 30,000 words. What follows is therefore a brief summary of some of the most prevalent themes discussed.

One key finding was that our set of hypotheses appeared to be very much in line with the growing debate, in the UK as well as in the United States, over the failure of regulation to channel functional behaviours in organisations. Many of our hypotheses were therefore generally agreed, or strongly agreed to, during these debates.

Nevertheless, it appeared that some of them should be revisited in terms of wording. We are thus currently working on amendments but would welcome any comments or suggestions from our roundtable' attendees.

We have also turned the related questions into a **form attached to this pack** and we would be grateful if delegates could fill it after the session and return it via email to pauline.schu@accaglobal.com with Corporate Culture – Questionnaire as subject line.

THE ROUNDTABLE DISCUSSION

During our meeting, we would like to focus on four questions:

1) How do boards influence culture and drive behaviours and is there anything they should do differently?

2) How well do performance targets drive optimum (for the organisation) behaviour?

3) Do incentives trump regulation, and when?

4) How can culture most usefully be assessed and, having done so, what actions should follow?

We have two hours for this discussion and the topic is enormous. We will begin by asking each participant at the roundtable discussions to introduce themselves and briefly (in less than 3 minutes) give their views on any or each of these three topics.

We wish to encourage as informal a discussion as possible. The chairman will endeavour to ensure everyone can contribute and keep the discussion reasonably focused. We are aware that there will not be time to go into as much detail as some would like. The research team would be pleased to follow up on discussions with anyone who is interested by email, phone or web meeting.

The meetings will be held under the Chatham House rule, meaning that we will all agree not to speak or write externally about what any individual may have said without specific permission. However, we propose to record the meetings purely so we can have an accurate note and so we can review what was said to better pick up the mood of the discussion. We undertake that no remark will be attributed to anyone. We want to report the generality of the discussions in our final report. It is possible that the report would benefit from quoting a person. Should we want to quote anyone, we will of course seek their permission and ensure they understand the context in which the quote might be used.

SUMMARY OF FINDINGS SO FAR

Two recurrent themes within our discussions concerned the board and its structure, its dynamics and its impact on the culture of the organisation. The group also looked more closely at the role of incentives and the conflicting interactions between the pursuit of individual self-interest and the optimum corporate behaviours promoted for the creation of long term sustainable value by the organisation.

The discussions generated more questions than answers: what kind of behaviours should be encouraged by the organisation? When misconduct occurs, was that in line with the incentives given to the individual by its organisation, or was this the result of the individual's own internal motivational drivers or cognitive biases? It was said that ethics codes only work for people who follow ethics codes. What can we reasonably expect a code of ethics, or conduct, to do?

Broadly, these points lead to the issue of how should an individual adapt when s/he moves from a personal, social or family environment into the work place? In a corporate setting for instance, everyone comes with their own set of beliefs and values and has to adapt with to the one(s) in the workplace.

In one meeting, it was argued that any rules create a penalty for breaking it. While this received general agreement, the efficacy of regulation and sanction mechanisms in discouraging unlawful or unwanted conduct was a major question throughout these debates. Were regulatory frameworks effective? To what extent does a penalty of any form actually foster compliance to rules and procedures?

Repeated sanctions applied after corporate failures or banking scandals tend to prove the opposite and suggest that the more complicated the legislation, the more time and money are devoted to finding loopholes. Moreover, and this is particularly true in the banking sector, while it should be expected that financial penalties would foster change inside an organisation, it actually appears that large fines are applied and paid off, no significant decisions are taken regarding those in charge of these misbehaving organisations – JPMorgan Chase paid over $20bn of penalties just over the past year but its current chairman and CEO does not seem to be suffering any adverse consequences from the many scandals that hit this institution, nor does his senior management. It may be that chairman and CEO may have done nothing wrong and could not have prevented such things to happen, but it does highlight the issue of is anyone actually accountable for what happens.

How do boards influence culture and drive behaviours and is there anything they should do differently?

Boards certainly have a role to play in directing the corporate spirit of their organisations. Many participants agreed to this but pointed out that as businesses expand, it is more difficult to adequately sustain influence from the top. While tone at the top of an organisation is important, the tone at the top of each team, department, section etc. is also important. There are multiple tones. The fact remains that these multiple tones should reflect the tone at the very top. In practice they may be different and boards should be aware if this is the case. To what extent should the tone at the top be influenced or informed by people at the bottom? For example, would it be wise to involve the people at the bottom in helping prepare a new code of conduct or ethics.

This called for the development of better communication channels within the business, with better and constant feedback between all levels, and up to the boardroom. Board members have a role to play in remaining appropriately informed. It was suggested that in some organisations a management 'damp proof course' exists which blocks or filters communication, in both directions, between the board and the people lower down.

Boards can influence the culture of their organisations through their strategy and incentive structures; ideally, this would not only be through fear and sanctions.

In theory at least boards set the firm's strategy, which is determined inter alia by the firm's business environment, its business model and the resources available. The board sets, or has oversight of, objectives and the means and incentives to reach them. It can therefore be inferred that boards substantially influence the way things are done in the firm; in other words, boards do influence corporate culture.

Considering that decisions at the top do substantively impact the rest of the organisation (what one could call the 'trickle-down effect'), it was widely agreed in both London roundtables that board members should better understand and evaluate the quality of their decision-making process – including assessing their proneness to **cognitive biases** such as optimism, confirmation bias or group think, as such biases harm good decision-making and hinder innovation and progress.

It was generally agreed in one meeting that, in many cases, **achieving consensus was of higher importance for boards and managers than reaching the optimum or best decision**. This would seem to be a sign of poor decision-making abilities, at board level, with worrying implications for the company. Unfortunately, no suggestions were made for how to address cognitive biases other than encouraging constructive disagreement.

Can boards be trained in better decision-making? What is the best way for the chairman or individual board members to encourage constructive challenge?

It was suggested that board members should write down their opinions before voicing them, so that individuals give an 'honest answer' to a question, and are not influenced by others around the boardroom table. Challenge in the boardroom is obviously vitally important. Participants in one meeting said that challenge is taking place. It may be that this is helping decision-making and the examples recently of bad decision making were isolated instances where challenge was insufficient at a critical time. Challenge may be easier in some situations than in others, and it might be easier to challenge in some countries than in others.

The role of **non-executive or outside directors** was also greatly debated. It was thought that their responsibilities and liabilities are often disproportionate to their actual awareness of day-to-day activities. It was felt that expectations on them are much too high.

Boards have a duty of care and should make sure that they remain aware of what is going on in their organisations. Throughout our sessions, delegates agreed to the fact that information to, and from, boards can get heavily distorted. This is partly due to cognitive biases, partly by mistake, and partly as a result of a wish by managers to manage the information flow. This may be well intentioned or it may be motivated by a desire to pursue a particular personal or team agenda. Such group dynamics can also lead to mistreatment of whistle-blowers, a desire to conform and self-suppression of dissent; all of these representing significant impediments to deciding the firm's strategy and the means to successfully accomplish it. ACCA research of its membership has also highlighted a disturbing incidence of dysfunctional behaviour in organisations where, for example, forecasts or budgets get massaged to suit people's self-interest.

To what extent should strategy and objectives, and the incentive arrangements to achieve them, be **understood and acknowledged by different** stakeholders (shareholders, employees, clients, customers, suppliers etc.)?

Some felt that chief executives should be more aware of the **'psychological pact'** which exists between senior executives and their work forces. Employees who feel they are supported by senior management are probably more likely go the extra mile and make sure they do not let their chief executives down, particularly if they feel their chief executive is concerned about them.

Should companies set out a **"socially useful purpose"** that staff would identify with, allowing for stronger commitment on their part? If so, boards should articulate this clearly and lead by example. Empty rhetoric will breed cynicism.

The case of large businesses

As mentioned earlier, as businesses expand, it is more difficult to adequately sustain influence from the top.

Large companies can contain many different sub-cultures, sometimes perceived as conflicting rather than seen as being complementary or supportive of one another. Sub-cultures can be understood as alternative ways of doing things, which if not appropriately approached, can result in undesirable behaviours. As one delegate put it, the culture on the trading floor has nothing to do with the one of the back office.
Nevertheless, sub-cultures are also vital drivers of change and adaptation. Research on this topic suggests that openness and flexibility are decisive features of sustainable businesses, and being able to incorporate new techniques and practices (these ‘sub-cultures’) allows for greater innovation and performance.

A possible elephant in the room is that many companies are actually too big for boards to manage. Are our expectations of boards set too high? The view in New York from several people was that companies are not too big to manage but management is not the role of the board anyway. Management is the CEO’s role but no one can expect the CEO to know everything that is going on. The ‘management damp proof course’ is a problem. It was suggested that the CEO should ensure there are appropriate feedback loops in the organisation so that s/he better knows what is going on lower down.

How well do performance measures and targets drive optimum behaviour?

One factor that seems to affect most organisations across all sectors is the primacy of **performance measures and targets**.

In the UK, issues once again hit the news, after the National Audit Office uncovered in a recent inquiry that some NHS hospitals are ‘fiddling waiting time data in order to avoid breaching the key target that 95% of patients have to be treated within 18 weeks of being referred’[1]. Currently a Parliamentary Committee is investigating the manipulation by police authorities of crime statistics and, giving evidence to the committee on Tuesday, the police watchdog said: "The fact is in anything that gets

[1] See ‘NHS waiting time data riddled with errors’, *The Guardian*, January 23, 2014 http://www.theguardian.com/society/2014/jan/23/nhs-waiting-time-data-errors . This is the latest twist in an old problem. A few years previously some hospitals started waiting lists to go on a waiting list to avoid having people on a waiting list for too long.

measured, once those who are being measured, whose performance are being measured, work out how the system works, there's an incentive, resisted by many, to manipulate the process as to make your own performance look good"[2].

In our initial project briefing, we also mentioned another inquiry started in 2008 after reports showed apparently excessively high mortality rates in patients admitted as emergencies to the Mid Staffordshire NHS Foundation Trust since April 2005.

The investigation revealed how priorities were driven by targets requirements rather than safety procedures or rules. Among other things, this resulted in a culture of bullying, a net disengagement from the management, low staff morale, isolation, lack of candour and openness, and overall, an acceptance of poor behaviours.

Boards may be unaware how the policies and procedures that they approve can influence what happens lower down in a company. A focus on performance measures can lead to measures being gamed by managers and staff and both groups may be unsure how to act when faced with seemingly conflicting aims or objectives such as whether to give priority to safety or to profit. From the roundtable discussions this is one of the key issues that need to be addressed as the **performance management or performance measurement** has become firmly embedded in organisational life. It is also one of the main tools used by those in governance and in management to monitor corporate progress. It would seem though that there are **serious unintended consequences**.

A further problem is that, often, targets or measures are only proxies for the outcomes. It is often difficult to identify a simple measure for the outcomes that are desired, but if the performance management system requires a measure then one of two things can happen:

1. An inappropriate measure is used which encourages actions that may or may not contribute to what was wanted or
2. No measure is used and management lose interest in or sight of the desirable outcome

[2] See 'Police crime figures being manipulated, admits chief inspector', The Guardian, December 18, 2013. http://www.theguardian.com/uk-news/2013/dec/18/police-crime-figures-manipulation-chief-inspector

It would seem that performance measures work better if the people (a team or teams) involved in making things happen are involved in identifying the best measures to use. But this will not always be the case especially if there is a link between performance measures and pay or individual performance appraisal. In such cases there is an incentive for individuals to come up with measures they can easily achieve. ACCA's own research of its members on the prevalence of dysfunctional behaviours seems bear this out and it is obviously a matter of concern to them. Academic research on gaming seems to be relatively undeveloped.

Is there a better way to manage than the widely accepted philosophy of performance measurement? How could we come up with better measures or use them in a better way so they do not get gamed?

Do incentives trump regulation, and when?

Both London meetings considered which is more important in influencing behaviour out of incentives and regulation. The real issue is which will prevail if there is a conflict between complying with policies and procedures, or pursuing the incentive? The way incentives work in practice can mean that individuals become motivated to flout the spirit of regulation and apply their imagination to how they can comply yet still make money or whatever goal they are incentivized towards.

Some financial institutions have departments of people whose job it is to find ways of getting around, or profit from, regulation. What is needed is compliance but compliance with common sense. There may be times when there are perfectly good reasons not to comply with something and common sense must be applied at all times. It was pointed out that an NHS hospital is subject literally to thousands of regulations and orders and some are bound to contradict with others, meaning that it is impossible to comply with all of them all the time. This suggests that less but better regulation would be more efficacious. The challenge is to work out what 'better' is.

Many, in the UK and the US, now think of 'compliance' as a dirty word. This is understandable but very unfortunate as organisations need people to comply with the law, regulation and sensible business procedures.

In one meeting, an attendee declared that many individuals in organisations see incentives as implied rules that cancel out or override other rules and procedures.

Incentivising an **entrepreneurial conduct** in contrast with a more 'administrative' one can promote the taking of risks and thus increase the probability of going off limits (see literature review). In some cases, incentives therefore conflict with regulations and some people assume that breaking rules is a way to 'add value'. Being an entrepreneur is usually seen as a good thing but 'entrepreneurial behaviour' within large organisations seems to be seen increasingly as pejorative (i.e. arousing contempt or disapproval).

While one delegate claimed that in some large listed companies corporate and social responsibility was only a PR exercise, others asked whether most people were good – and wanted to be and do good – while only a few bad ones in an organisation could have a disproportional impact on dysfunctional behaviours[3].

Another view is that most of us are mostly good but, in some circumstances, most of us will also behave badly. In this line, one participant suggested that instead of trying to deal with a few rotten apples we should aim to **shift the 'bell curve'** and make the 'vast middle' all behave a little better.

It was widely acknowledged that targets, measures and performance management could encourage dysfunctional behaviour. And so can regulation. It was suggested that the process of **regulation** (and, as suggested above, designing performance management systems) should be **made more collaborative**. If people are involved in designing regulation and measures they may be more inclined to apply their spirit and less inclined to game them. But, as discussed above, this will not

[3] By 'dysfunctional behaviour' we mean behaviour which leads to an organisation being less able to fulfil its purpose (normally that purpose would be to create long term value). Ie the dysfunctional behaviour makes the organisation less functional. It should be noted that a team or department within a large organisation may consider a particular behaviour both desirable and functional and be rewarded accordingly when in fact that behaviour is dysfunctional and possibly catastrophic for the organisation as a whole. A good example would be derivative trading activity, prior to 2007, of mortgage backed securities by traders at a large Swiss bank.

necessarily hold if there is a strong link for individuals between compliance and their pay or performance appraisal.

In most businesses, and particularly in financial services, material **rewards** are seen as the prime motivator for people. Yet academic research on motivation suggests that pay is not a motivator except as a hygiene factor if pay is felt not to be enough. Arguably other motivators such as challenges, recognition, responsibilities and personal growth should be promoted to foster desirable behaviour.

As suggested in the Review of Academic Literature in the annex document, to get people to **behave purposefully** they need to feel in control, with a clear direction to which they want to sign up, and a sense of development and improvement. In this regard, the importance of internal communication channels and functioning **feedback loops** was repeatedly flagged up.

Everyone acknowledges that ethical behaviour is a good thing in its own right and many feel, or want to believe, that ethical behaviour will make businesses more successful over the long term. There is a paucity of academic research in this area.

How can ethical behaviour be incentivized? Could it be rewarded? Or contrarily, can unethical conduct be convincingly sanctioned?

How can culture most usefully be assessed and, having done so, what actions should follow?

With one exception, none of the participants claimed experience in, or any significant awareness of, practices or methods to assess culture. The exception pointed out that there is much in the academic field. However, in practice, it seems that few if any organisations assess their culture in any systematic way.

Particularly in our New York roundtables, all participants recognised that, however useful it could be to assess corporate culture, this task is very difficult if not impossible. It was suggested that this is not possible to get anything like a direct view of culture. The best that can be achieved is to come up with proxies, which give, as it were, sideways views of culture.

Managing or measuring culture is therefore likely to be more problematic than performance measurement (as discussed above).

So we could seek to find proxy measures that would give an indication of whether or not there is ‘a good corporate culture’. But should we do this? Could trying to assess culture make matters worse? The meetings were short on practical ideas in terms of proxies. There is a warning of attempting to assess culture with a view to making a binary satisfactory or unsatisfactory conclusion. If this is the aim then the question actually remained the same as with performance measures: how can we make sure that these will not also be gamed to assure compliance with what would then be gold standards of organisational culture.

One delegate suggested that rather than trying to find answers, the project should come up with better questions. In order to avoid box-ticking mechanisms, questions must be set out in a way that people cannot simply answer ‘yes’ or ‘no’, but also explain why and how.

This is something to bear in mind when trying to build a framework to assess culture. Evaluation of culture might be more fruitful if it was done with the aim of making improvements rather than giving a pass fall assessment.

REVISITING THE HYPOTHESES[4]

Based on the discussions to date and the review of academic literature, the initial hypotheses outlined in the project briefing have been helpful. However, there are some changes which are appropriate and a slightly modified set of hypotheses and questions is set out below.

The subject is very important but hard. The research might be better directed at trying to ask better questions about culture rather than coming up with answers about culture or suggested actions for rule makers to make rules for organisations to implement.

[4] We recognise that some of what we call hypotheses may contain more than one issue but they are not intended to be used for scientific testing but to stimulate discussion.

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There is probably a need to more reflection, particularly among rule makers, before action.

- Is our set of hypotheses asking the right questions?
- Should we focus on identifying better questions rather than suggestions which could prove counter-productive?

1) People's incentives and interests may cause them to override procedures and rules.

- Do we know how incentives work and are there any that work against achieving organisational objectives?
- When will extrinsic factors override intrinsic motivation factors – and vice versa?
- 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 do not tap into the intrinsic motivations of individuals so will not help create a healthy culture.

- 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?
- Do regulation and/or codes work?

3) What gets measured gets managed; what is not measured is not. 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 organisation's advantage?
- To what extent are individuals motivated more by intrinsic than by external measures?

4) Tone at and action by the top are key.

- But what tone and action do we want? Whose job it is – the board or executives?
- Can tone at the top be measured and how can boards know if they have got it right?
- What can or should organisations 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 this have on decision-making and performance?
- Can we identify our own biases? Can a board do so?
- How can we best address our cognitive biases?

6) The imperative for companies to maximize shareholder value makes it harder for boards to take into account the interests of other stakeholders such as staff, customers, the community, and the environment.

- Is this true?
- Does it matter?
- Does it ensure short termism?
- 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?