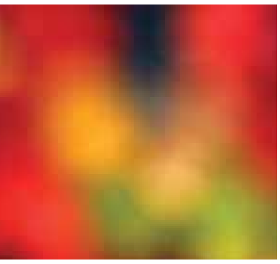
Title	Behavioural and psychological influences on boards
Authors(s)	Brennan, Niamh
Publication date	2013-09-03
Publication information	Keeping Good Companies, 65 (8): 457-461
Publisher	Governance Institute of Australia
Link to online version	http://www.governanceinstitute.com.au/knowledge-resources/journal/?categoryid=15221
Item record/more information	http://hdl.handle.net/10197/4975



Behavioural and psychological influences on boards

By Niamh Brennan, Chartered Accountant and Chartered Director; Professor, University College Dublin[1]

- Corporate culture and psychological factors are major influences on boardroom decision-making
- Cognitive biases, rather than corruption, are the most common source of distorted judgment
- Role of chair of board is central to ensuring that subconscious biases do not influence decision-making

Most 'rogue' firms were found to have adopted best practice governance standards, as disclosed in their annual reports. Clever penmanship can make governance look good in annual reports, with governance disclosures being merely ritualistic, symbolic and lacking substance in reality.

The global financial crisis points to something more than the best practice 'usual suspects'[2] — for example, separation of chair and chief executive officer (CEO), independent boards — as required for good governance. Is there too much emphasis on the technical and not enough on behavioural issues? There is increasing recognition of the importance for good corporate governance of hard-to-regulate features of organisations and their boards.

This article examines the role of culture, behaviour and psychological biases in boardrooms, drawing particularly on Lloyd's Report[3] on risk and the Walker Report[4] published after the banking crisis in the UK.

Influence of culture

Official organisational policies specify what management wants to happen (laws and rules on the books). Corporate culture determines what actually happens — which rules are obeyed, bent or ignored ('laws/rules in practice'). Lloyd's[5] observes that 'studies of disasters often indicate that the problem was not with the processes but that [the processes] were ignored or over-ruled'.

Highlighting its importance, Justice Owen's Report[6] on HIH commences with a discussion of culture.

> A cause for serious concern arises from the group's corporate culture. By 'corporate culture' I mean the charisma or personality — sometimes overt but often unstated — that guides the decision-making process at all levels of an organisation. In the case of HIH, the culture that developed was inimical to sound management practices. It resulted in decision making that fell well short of the required standards.

Who is responsible for culture, the tone-at-the-top, in organisations? Many would point to the board's role here. However, in practice, employees will tell you that the CEO has the greater influence. Lloyd's consider the internal communications and behaviour of senior managers to be critical in setting the tone.

Table 1 summarises some key words commonly used to describe organisational culture, which in turn influences interpersonal relations, including communications. What terms would you use to describe the culture, interpersonal relations and communications in your organisation?

Communication is critical to good governance, not only what is said but also what is not said, as illustrated by one line from TS Eliot's epic poem 'The Rock': 'Knowledge of speech, but not of silence'. The importance of this kind of knowledge to boards has been referenced in the Walker Report[7] as follows.

Table 1: Terms that can be used to describe the culture, interpersonal relations and communications in organisations

Culture	Interpersonal relations	Communications
• Collegiate • Passive, disengaged, resigned • Risk averse • Confused • Lacks direction, leadership • Chaotic, over-trading • Clash of cultures • Secretive • Managerialist • Materialistic, money-orientated • Competitive • Likes risk • Aggressive	• Friendly • Supportive • Warm • Trusting • Loyal • Unfriendly, cold • Polarising: in-group out-group polarisation • Competitive • Narcissistic • Hubristic • Domineering • Aggressive • Bullying	• Full, frank open communication • Speaking up • Guarded • Superficial • Information overload • Obfuscation • Weasel words • Silence • Whistleblowing

> The chairman, [executive directors and non-executive directors] need to be experts in the ability to observe, interpret and draw conclusions from what people are giving clues about, but not talking about; that it, interpreting what lies just below the surface.

This quote illustrates just how difficult it can be to be a board director, especially a non-executive director (NED).

Features of boardrooms conducive to behavioural and psychological influences

Boards and board behaviour cannot be regulated; nor can they be managed by structure and controls. Behaviour is dynamic; it evolves and depends on the organisational situation, strategic context and group dynamics. Our desires strongly influence our behaviour. Human beings are susceptible to social influence. As the Walker Report comments: 'Susceptibility to social influence is not a trait of those who lack willpower; it is hard-wired into all of us'[8], going on to say 'Board members need to be schooled in group relations, power dynamics and the behaviours and processes that are required to maximise the intellectual capacity of the group'.[9]

A number of boardroom features affect behavioural and psychological influences, including board size, the chair and board relationships.

Board size

Board size is important because of our cognitive limitations: there are a limited number of people with whom we can maintain stable relationships. Eight to 12 people can know each other well enough such that a group's potential to integrate thinking is enhanced and the potential for dislocation (feeling of not belonging) is reduced. Conversely, large boards increase the opportunity for leadership to be controlling and political.

Large boards are more likely to suffer from:

- passive free-riding
- dislocation and
- groupthink.

Passive free-riding might manifest in the form of silence with some board members not speaking at meetings.

Large boards may suffer from coalition building, with alliances forming and factions developing. Selective channelling of information may be more likely on large boards. Finally, a divide-and-conquer approach may be adopted by more powerful board members such as the chair and the CEO. Board members may experience a feeling of dislocation on larger boards such that their participation and commitment decreases.

Finally, groupthink may manifest on larger boards such that group members focus more on trying to minimise conflict in order to reach consensus, rather than critically testing, analysing and evaluating ideas. Groupthink increases with larger groups, as groups' motivation to achieve unanimity overrides their motivation to appraise alternative courses of action.

Another problem is group polarisation. This refers to the tendency for groups following discussion to make decisions that are more extreme than the initial inclination of their members.[10] These more extreme decisions are towards greater risk if individuals' initial tendencies are to be risky and towards greater caution if individuals' initial tendencies are to be cautious.

In addition, in large groups individuals can become committed to a group position, feel a sense of cabinet responsibility or are reluctant to speak out when they disagree.[11]

Large boards are often justified on the grounds of resource-gathering. For example, it is not unusual to find large

numbers of wealthy individuals on charity boards, where gathering financial resources for the charity is a key imperative. The Walker Report contracts this view of the role of boards, saying that resource gathering is not the function of boards — boards' function is stewardship.[12]

Chairs of boards

Chairs of boards are critical to board effectiveness.

> [The chair's behaviour] is both the source and the result of an ability to mobilise others to share a vision of an anticipated future state of affairs, and a willingness to collaborate to bring it about...[13]

Board chairs have to integrate boards' collective thinking, have to be empathetic and promote openness in board members, have to facilitate interaction and have to develop others. Another trait of effective chairs is communication of complex messages succinctly. The Walker Report[14] divides the qualities required of chairs of boards into:

- behavioural elements, which are classified as learnable components, and include facilitation, empathy, coaching, strategic thinking, influencing, building confidence, communication
- traits which are intrinsic and innate components and include physical vitality, stamina, eagerness to accept responsibility, need for achievement, courage, self-confidence, assertiveness and openness to new ideas.

Board relationships

The Walker Report[15] also makes observations on board relationships arising from group psychological effects, identifying three types:

- denial — boards' discomfort arising for example from a lack of knowledge about a subject or from a need to rely on experts. This discomfort may be 'denied' and rationalised
- splitting — relying on specialists for board decisions may result in splitting such that the board distances itself intellectually and emotionally from difficulties. This reliance on specialists may also lead to mistrust ('Will the specialists try to pull the wool over our eyes?')
- projection — attribution of feelings, qualities and intentions to others that truly belong to oneself (or to the board).

Cognitive biases

In 2011, the UK Financial Reporting Council implied the existence of bias in the boardroom for the first time using the phrase 'distorted judgment', acknowledging that flawed decisions can be made with the best of intentions and that competent individuals may believe passionately they are making sound judgments.[16] Judgments of even the most well-intentioned experienced leaders can, in certain circumstances, be distorted.

Behavioural theory tells us there are many unintended filters which distort the way we think about risk. Human beings misjudge risk. Subconscious thoughts cloud judgments. Being aware of these biases will lead to clearer thinking and a better management of risk.[17]

Perceptions drive behaviour. For example, more attention is given to events which people dread, events which affect a lot of people, unfamiliar events. Emotion is also a driver of behaviour. Positive feelings and anticipated benefits associated with risk diminish the perception of that risk. Fear affects the ability to predict. In turn, personality affects perceptions. Impulsiveness (venturesomeness) leads to a reduced perception of risk. Some people think they have a better than average ability to control risk.

Desires influence risk appetite. Lack of observable downside increases belief in our abilities to avoid danger. Risks which confer benefits on people are ranked lower even when contrary evidence is available.[18]

Our attitude to risk also depends on how it is presented or framed. Risk descriptions phrased in positive language leads to an underestimation of risk.

Nature of subconscious biases

It is important to understanding social psychology. Desires powerfully influence the way we interpret information. When we are motivated to reach a particular conclusion, we usually do.

Bias is an inclination to present or hold a partial perspective at the expense of (possibly equally valid) alternatives. Subconscious or unconscious bias is hidden bias, implicit bias. Do you suffer from subconscious bias? You can test yourself! You can take the Implicit Association Test.[19]

Table 2: Cognitive biases in judgment and decision-making

Cognitive bias	Explanation of bias
Pattern recognition biases	We do not anticipate events outside the pattern
Saliency biases	We focus on the person we see, not forces acting on people we don't see
Overconfidence biases	We underestimate risk
Stability (inertia) biases	We stick with the status quo
Anchoring bias	We rely too heavily on a past reference or on one trait or piece of information when making decisions
Sunk cost fallacy	We are unwilling to accept our decision was wrong, to accept losses and we throw good money after bad
Commitment bias	We remain committed to lost causes
Confirmation bias	We persist with the same beliefs, discounting contrary evidence
Groupthink	This bias is a particular feature of boards (also of juries: see Henry Fonda in Twelve Angry Men) as boards make decisions in groups
Representation bias	The past does not predict the future
Hindsight bias	We have a tendency to think events are more predictable than they are
Availability bias	We make decisions influenced by events/experiences that immediately come to mind
Cognitive dissonance	We hold two conflicting beliefs; we take actions at variance with our opinions

Compared with deliberate conscious corruption, subconscious biased judgments cannot be regulated or deterred by threats of sanctions. Rooting out bias, or tempering its effects, will require more fundamental changes to the way boards operate. We need to recognise the existence of bias, and moderate its effects.[20]

Our tendency to engage in self-deception can be key to distorted judgment. There are four enablers of self-deception[21]:

- language and euphemisms
- slippery slope of decision-making
- errors in perceptual causation and
- constraints from representations of the self.

Examples of self-deception in the use of language and euphemisms include the use of:

- 'aggressive' for 'illegal' accounting/tax practices
- 'creative' for 'false, deceptive' accounting
- 'pro forma' for 'false, deceptive' earnings
- 'collateral damage' for 'civilian deaths' and
- the Catholic Church's 'mental reservations' for 'lying'.

The slippery slope of decision-making may involve 'psychic numbing' where repeated exposures to ethical dilemmas may produce a form of ethical numbing (this is highly relevant to the discussion of organisational culture at the beginning of this article). The slippery slope of decision-making may also involve induction mechanisms (routinisation): 'If what we were doing in the past is OK, and our current practice is almost identical, then it must be OK.'

Errors in perceptual causation involve:

- a focus on individuals rather than systems, which may result in overlooking more likely causes of a problem. Therefore, when things go wrong, it is not unusual for someone to be the 'fall guy'
- self-interested motivations in the assignment of blame — to deflect blame from oneself. To make themselves look good, boards often sack the CEO rather than addressing more fundamental, systemic issues
- blurred moral responsibility involving acts of omission — whereas lies of commission are direct misstatement of the truth, lies of omission are acts of deception that occur because someone withholds information that deceives the target. Failure to disclose the truth makes it harder to assign responsibility.

It is self-deception to believe we are objective. Our inability to have a truly objective view of the world means we cannot evaluate the effect of our behaviour on others. Table 2 summarises some of the cognitive biases from which we suffer.

The causes of bias arise from our cognitive limitations in decision-making. We use heuristics (rules of thumb) to simplify decision-making in our everyday lives. For example, we often use intuition to make a quick decision. Our decision-making processes are heavily influenced by emotion.

Features of boardrooms conducive to bias

Sitting on a company board is fertile ground for self-serving biases. There are a number of features of boardrooms that make them particularly conducive to bias.[22]

- *Ambiguity* — Directing is an art, not a science and requires constant exercise of judgment.
- *Attachment to company or management* — One of the roles of NEDs is to oversee and monitor management on behalf of shareholders. In many boards, the NEDs do not meet the shareholders, but are interacting with, getting to know, establishing relationships with managers which makes monitoring more difficult.

- *Approval* — Boards endorse or reject management's choices. Self-serving bias becomes even stronger when endorsing others' biased judgments.
- *Familiarity* — People are more willing to harm strangers than individuals they know.
- *Discounting* — People are more responsive to immediate consequences than delayed ones. Boards may hesitate to implement tough decisions because the adverse consequences are immediate.
- *Escalation* — People conceal or wave away minor discretions. Board biases may lead them to unknowingly adapt over time to small imperfections in management practices.

Factors inhibiting effective decision-making in the boardroom include dominant individuals, conflicts of interest or self-interest, poor ethical standards, emotional attachments, inappropriate reliance on previous experience and previous decisions, reluctance of management to involve NEDs or to bring matters to the board and complacent attitudes.[23]

Mitigating the risk of subconscious biases

There are ways of mitigating or overcoming bias. 'If we can accept the fact that the human mind has an infinite, creative capacity to trick itself, we can guard against irrational, unethical decisions.'[24] The Financial Reporting Council[25] recommends some steps to counteract distorted judgment.

- Executives should put their case at earlier stages, well in advance of the point of decision, so that directors have the opportunity and the time to share concerns and to challenge assumptions.
- Inform boards of the pre-boardroom processes adopted to arrive at management proposals.
- Inform boards of the pre-boardroom processes to challenge management proposals.
- Commission independent review of management proposals
- Seek advice from experts.[26]
- Take large decisions in stages, for example:
  (a) concept
  (b) proposal for discussion
  (c) proposal for decision.
- Introduce processes that allow time for reflection.
- Consider the possibility that it might be the wrong decision.
- Find reasons not to agree with management's proposals.
- Allocate different roles within boards.
- Deliberately introduce a devil's advocate to provide challenge.
- Introduce automatic stops in decision-making in the form of circuit breakers, mental breakers or calling for time-outs (an increasingly common feature of surgical theatres).
- Establish a sole-purpose committee; convene additional meetings.
- Record the pros and cons of the decision in the minutes.
- Remove management more quickly after problems emerge.

Concluding comment

In requiring boards to bring in outside independent NEDs with limited terms of appointment, and requiring regular refreshment of boards, an implicit objective of codes of governance is to reduce the tendency towards subconscious biases. A challenge for chairs of boards is to ensure that the dynamic in the boardroom enhances the quality of decision-making by reducing the effects of subconscious bias.

Chairs of boards should ensure that the boardroom atmosphere allows or encourages critical discussion. Board members may need training on how to challenge.[27] Consensus for its own sake should not be the order of the day.

Niamh Brennan is Michael MacCormac Professor of Management at University College Dublin. She is Academic Director of the UCD Centre for Corporate Governance (www.corporategovernance.ie) which she founded in 2002 to provide training to company directors and to conduct research on the 'black box' of the boardroom.

Notes

1 This article was written during a research visit funded by Queensland University of Technology, for which I am grateful
2 Finkelstein S and Mooney AC, 2003, 'Not the usual suspects: How to use board process to make boards better', *Academy of Management Executive*, Vol 17 No 2, pp 101–113
3 Walker Report, 2009, A *Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations*, Annex 4: Psychological and Behavioural Elements in Board Performance, Her Majesty's Treasury, London
4 Lloyd's, 2010, Behaviour: Bear, Bull or Lemming, Lloyd's, London
5 ibid, p 5
6 HIH Royal Commission, 2003, The Failure of HIH Insurance, Commonwealth of Australia, Canberra
7 Walker Report, op cit, p 142
8 Walker Report, op cit, p 139
9 Walker Report, op cit, p 142
10 Isenberg DJ, 1986, Group polarization a critical review and meta analysis, *Journal of Personality and Social Psychology*, Vol 50 No 6, pp 1141–1151
11 Lloyd's, op cit, p 5
12 Walker Report, op cit, p 145
13 Walker Report, op cit, p 141
14 Walker Report, op cit, p 140
15 Walker Report, op cit, pp 145–146
16 Financial Reporting Council 2011, *Guidance on Board Effectiveness*, Financial Reporting Council, p 8
17 Lloyd's, op cit, p 4
18 Lloyd's, op cit, p 4
19 See https://implicit.harvard.edu/implicit/demo
20 Bazerman MH, Loewenstein G and Moore DA, 2002, 'Why good accountants do bad audits', Harvard Business Review, November, pp 97–102, at p 97
21 Tenbrunsel AE and Messick DM, 2004, 'Ethical fading: the role of self deception in unethical behaviour', *Social Justice Research* Vol 17 No 2, pp 223–236
22 Bazerman et al, op cit
23 Financial Reporting Council, op cit, p 8
24 Messick DM and Bazerman MH, 1996, Ethical leadership and the psychology of decision making, *Sloan Management Review*, Vol 37 No 2, pp 9–22, at p 22
25 Financial Reporting Council, op cit, p 9
26 See Trautwein M and Quartullo D, 2012, 'Ask an expert — but take care', *Keeping good companies*, Vol 64 No 8, pp 458–463
27 See Norden-Powers C, 2013, 'The inquisitive mind — asking the right questions adds value', *Keeping good companies*, Vol 65 No 4, pp 244–247