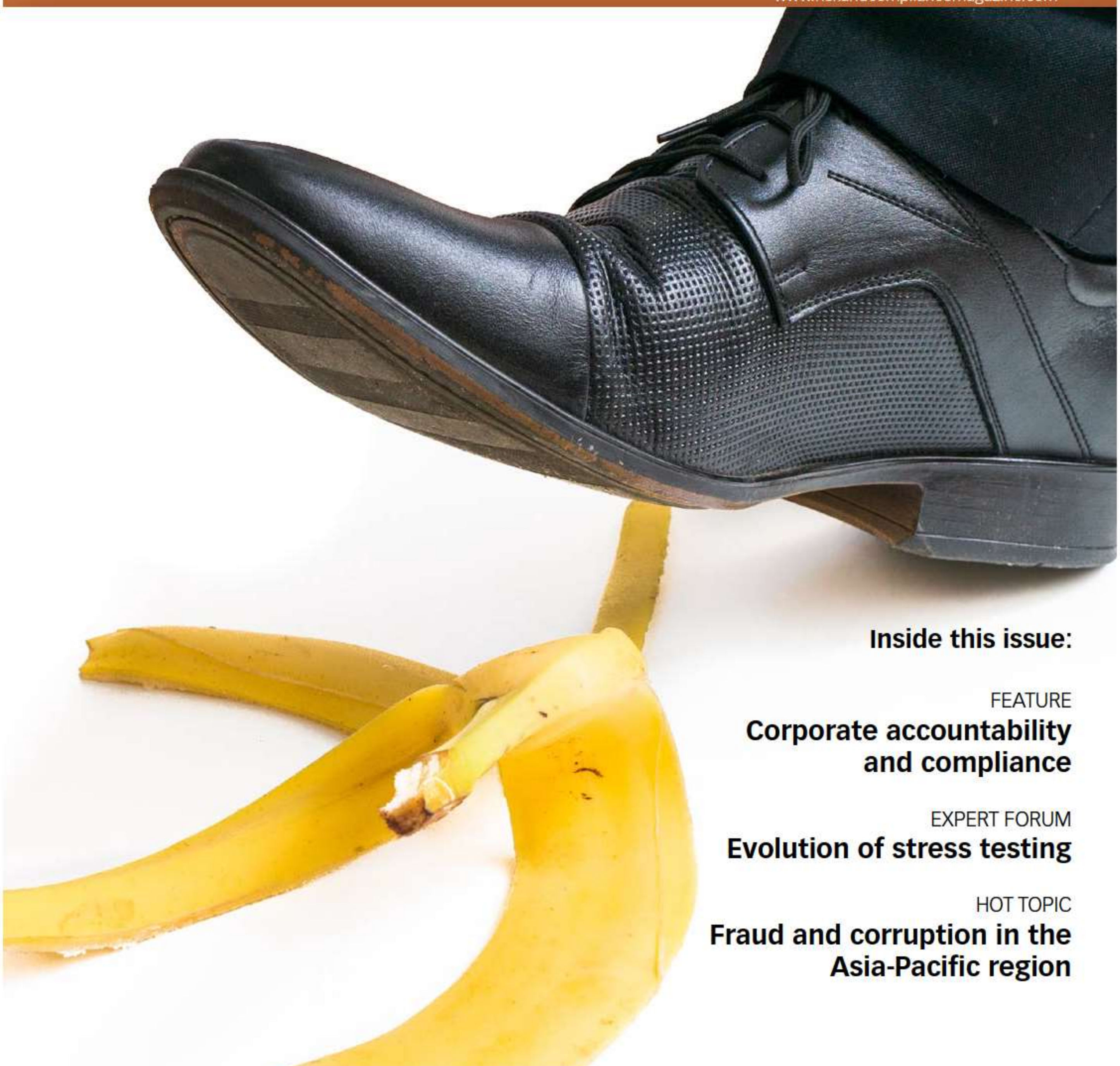
R&C risk & compliance

JUL-SEP 2018

www.riskandcompliancemagazine.com



Inside this issue:

FEATURE
Corporate accountability and compliance

EXPERT FORUM
Evolution of stress testing

HOT TOPIC
Fraud and corruption in the Asia-Pacific region

PERSPECTIVES

BOARD COMPOSITION AND CULTURE CAN HELP REDUCE DECISION RISK

BY **KAPILA ANAND AND SUSAN ANGELE**
> WOMENCORPORATEDIRECTORS

The strategic, financial, operational, legal and reputational risks that companies face continue to increase, and new risks are emerging every day. Businesses face competitive business disruption, executive misconduct and business continuity challenges, and they are threatened by geopolitical risk and natural disasters. Given the scale of the challenges companies are facing, a greater focus on decision making can make a difference and, as discussed in this article, boardroom composition and related board culture is an important enabler of sound decision making.

In a global survey of senior executives, reported in the June 2017 McKinsey Quarterly, 72 percent of respondents said that bad strategic decisions were either about as frequent as, or more frequent than, good decisions in their own organisations. A 2010 McKinsey study of executive decision making found a strong correlation between top quartile decision-making processes and business results. The study found that while quantity and detail of analysis were important, the decision-making process mattered more than analysis, by a factor of six. As the study's authors wrote, "Superb analysis is useless unless the decision process gives it a fair hearing".

The tougher and more significant the issue, the more likely it is to be a topic of discussion and decision in the boardroom. In collaboration with KPMG's Board Leadership Center, we recently issued a report on this topic – 'Decision-Making in the

Visionary Boardroom'. One of the key findings of this report was the importance of a diverse, thoughtfully-constructed board as a necessary foundation to quality decision making.

Innate tendencies and mental shortcuts may create barriers to sound decision making

Board members rely on their background, experiences and judgment when analysing information and addressing issues in the boardroom. The best board members provide value and wisdom in doing so. Yet even the best board members benefit from awareness and management of the innate tendencies and mental shortcuts that may lead to blind spots and decision bias. Some barriers to a sound decision process include the following. First, confirmation bias. This natural tendency places greater weight on information that validates existing views while discrediting information that contradicts existing views. Second, anchoring. The 'anchor' may be the first opinion on an issue expressed in the boardroom, or the prior year's budget when capital allocation is assessed. In each case, the anchor often serves as a touchstone, whether or not it is well-founded. Third, confidence bias. Overconfidence can cause board members to overestimate the capabilities of the CEO, the organisation and the board, and it can cause board members to underestimate the potential disruptive impact of external forces and risk. Finally, groupthink. Boards suffer when they are too 'cliquey', as they lose the benefit of different perspectives.

> **"Given the scale of the challenges companies are facing, a greater focus on decision making can make a difference and boardroom composition and related board culture is an important enabler of sound decision making."**

Board decision making benefits from diverse perspectives

Consider the environment in which boards make key strategic decisions today. Competitive disruption can come as easily from a start-up on the other side of the world as it can from a known competitor. An emerging technology can offer significant opportunities if the company is aware of the technology and its potential implications, and a single social media post can go viral and pose significant reputational risk if not handled swiftly and appropriately.

To say that different perspectives around the table are beneficial in this type of environment is to state the obvious. Those executives who are best equipped to add value in a boardroom discussion of these issues may well include those who come from roles other than the CEO, and once boards broaden their lens, the talent pool for them to choose from is also more likely to include a higher proportion of highly experienced, diverse candidates with non-traditional board backgrounds, with skills such as cyber security or digital marketing.

Diversity of background and quality decision making go hand in hand

Boards benefit when they are able to tap into diversity of experience. There is a second and independent consideration supporting the importance of diversity: there is evidence that the existence of diversity of backgrounds in a group has a positive impact on group dynamics. In various academic experiments designed to measure the impact of diversity, groups were asked to solve a problem in which all the information needed to arrive at the right answer was available and distributed among the members of the group. In study after study, diverse groups came to the right conclusion more frequently than homogenous ones. Columbia Business School Professor Dr Katherine Phillips, who led much of this research, wrote about this phenomenon: "[The benefit of diversity] is not only because people with different backgrounds bring new information. Simply interacting with individuals who are different forces group members to prepare better, to anticipate alternative viewpoints, and to expect that reaching consensus will take effort."

In the article, Dr Phillips explains the reason for this beneficial effect: "Members of a homogeneous group rest somewhat assured that they will agree with one another; that they will understand one another's perspectives and beliefs; that they will be able to easily come to a consensus. But when members of a group notice that they are socially different from one another, they change their expectations. They anticipate differences of opinion and perspective. They assume they will need to work harder to come to a consensus. This logic helps to explain both the upside and the downside of social diversity; people work harder in diverse environments both cognitively and socially. They might not like it, but the hard work can lead to better outcomes."

Diverse groups assess their effectiveness more accurately

Continuous improvement is important for boards, and homogeneous boards may lack the self-awareness necessary to identify decision-making weaknesses. The work of Dr Phillips sheds light on this issue. In a study, she asked groups of participants to determine the answer to a problem that had only one correct answer, and then asked

those same groups to evaluate how well or effectively they worked together, and how confident they were that they had the right answer. Some of the groups were homogenous and some were diverse. Not only did the diverse groups do better, but the results also displayed a difference between perception and reality in the homogeneous groups.

In this study, the homogenous groups made the right decision just over half the time, while the diverse groups made the right decision three-quarters of the time. The perceived effectiveness and confidence in the decision in the diverse groups was fairly consistent with their actual performance. In contrast, the average level of confidence of the homogeneous groups was not only higher than their performance merited, it was also higher than the perceived effectiveness and confidence of the diverse groups. As Dr Phillips says, "[Based on the data] homogeneous groups [can be] delusional". She continues, "In the real world, we often don't know what the right answer is and all we have to go off of is the confidence and feelings of the group. If homogeneous groups are more confident and feel better about their group experiences we might easily be lulled into believing that they are more effective groups". This particular risk may be the most significant of all. While the pace of change is slow, the move toward more diverse boards, at least from a gender perspective, is continuing. As indicated on the Equilar Gender Diversity Index, a quarterly measure of the number of women in the boardrooms of Russell 3000 companies, nearly a third of new board seats went to women, and the number of all-male boards dropped below 20 percent in the first quarter of 2018.

Re-evaluating board composition and culture can add value and mitigate risk

Board members are commonly recruited by reference to a board matrix – a list of desired skill sets that are considered important to help guide the company as it moves forward. For example, boards may need directors with financial expertise, management expertise, global perspectives and industry knowledge, and an understanding of how technology impacts growth opportunities. Expertise in risk and culture are also becoming more and more important. The matrix, a grid that includes the desired skills along one axis and the board members along the other axis, provides a helpful way for the board to quickly identify gaps in the overall mix. Board matrices commonly address diversity as well.

Individual decision styles must also be considered in the context of the board composition mix. Different individuals have different decision styles. For example, some make their decisions and use gut feelings before they enter the boardroom and may use the board discussion as a forum for convincing others of their opinion; others prefer group discussion, due diligence and testing of assumptions prior to settling on a point of view. With the right board culture, one of inclusiveness and respectful challenge, a mix of decision types can make for a board that provides a healthy balance of vision and orientation toward action, tempered by thoughtfulness and risk awareness. A board chair who takes these tendencies into consideration is better prepared to manage the differences and lead the board through a sound decision-making process.

As changes in strategic direction or other market forces challenge existing business models and board dynamics, board refreshment becomes increasingly important. An objective re-evaluation of a board's skill gaps, culture and tenure becomes just as critical, as do well-constructed individual board performance assessments that highlight refreshment opportunities.

Building a well-constructed board

A diverse, well-constructed board can bring a range of perspectives, experiences, fresh thinking and decision styles around the table and can help reduce decision risk through a balanced mix. Building a well-constructed board has a number of requirements. The first step should see companies implement board refreshment policies to ensure that the board is relevant and accountable. As the strategic needs of companies change, the composition of the board should keep pace with those needs. Board members should continue in their roles only as long as their skill sets and feedback are relevant. They should also construct a thoughtful board matrix, aligned with company strategy. Consider not only skill sets and knowledge but also gender, race, ethnicity, sexual orientation, age, tenure on the board and decision style to build a board with a strong culture that maximises value through a diverse mix of styles and perspectives around the table. Companies should also employ a wide lens to recruit new board members. Boards that do not have access to diverse directors within their networks have many resources, including diverse director membership and advocacy organisations that can help.

The right board composition, leadership and culture will create a board dynamic where each board member is contributing to the fullest and the board, as a whole, provides maximum value. Open and frank communication, objective evaluations of the board, committees and individual directors, and accountability for continuous improvement, will help maintain the effectiveness of the board over the long term. RC

Kapila Anand
Lead Director
WomenCorporateDirectors
T: +1 (312) 665 5094
E: kkapur.anand@gmail.com

Susan Angele
Member
WomenCorporateDirectors
T: +1 (201) 307 8198
E: sangele@kpmg.com