PERFORMANCE MANAGEMENT

AVOIDING FLAWED DECISIONS

As recent business history shows, good leaders are still capable of making flawed decisions which drag their organisations down. **Jo Whitehead** and **Andrew Campbell** explain why that happens, and what finance can do to help prevent it.*

FEATURES

* The following article is based on their newly published book: *Think Again: Why Good Leaders make Bad Decisions and How to Keep It From Happening to You*, co-authored with Sydney Finkelstein of Tuck School, Dartmouth. Further ideas are discussed in *Think Again* and at www.thinkagain-book.com

Jo Whitehead is a director of Ashridge Strategic Management Centre.
jo.whitehead@ashridge.org.uk

Andrew Campbell is a director of Ashridge Strategic Management Centre.
andrew.campbell@ashridge.org.uk

Finance managers traditionally play an important role in making strategy decisions, since they are often seen as guardians of the numbers and, by implication, of rational and objective thinking.

However, they are also aware – or should be – that rational and objective thinking is not the only influence on the decision process. Biases in the minds of senior executives can have a bigger influence than rational calculations of return on investment (ROI). Moreover, even the return on investment calculations can be skewed as a result of biased assumptions.

So, could finance be savvier at managing not only the rational thinking – but the inevitable personal biases too? We think so.

Sources of bias in decision making

Our research has revealed two types of bias (each comprising two possible elements) tending to cause errors of judgment in even the most rational decision making process. These are:

- misleading experiences and/or misleading prejudgments; and
- inappropriate self interest and/or inappropriate attachments

'If our interests and motivations are aligned with those of the organisations we belong to, then our emotions motivate us to choose and act appropriately'

To understand how these biases come into play, we first need to explain how the brain works. Decision neuroscience reveals that the brain depends primarily on two hardwired processes for decision-making:
1. 'pattern recognition'; and
2. 'emotional tagging'.

1. Pattern recognition can lead to flawed decisions...
Pattern recognition is a complex process that integrates information from many parts of the brain. Faced with a new situation, the brain makes assumptions based on prior experiences and judgments that have been stored in memory. In most cases that works well. Executives are hired because their experience is relevant and useful for the job in hand.

However, if these experiences and judgments are not relevant to the current situation then this may lead to the decision maker making a flawed decision. This can frequently be the case in strategic decisions because such decisions often involve new challenges and opportunities.

...through misleading experience, perhaps...
For example, RBS's erstwhile CEO Sir Fred Goodwin had a strong track record for aggressively acquiring companies where he had spotted synergies and subsequently cutting costs ruthlessly with pleasingly profitable results. It earned him the nickname 'Fred the Shred'. However, this experience was derived during a period characterised predominantly by smoothly functioning capital markets, whereas the ill-fated ABN Amro deal was negotiated by RBS as the global economy entered the credit crisis. Could Sir Fred's previous good experience of acquisitions have subconsciously predisposed him towards erroneous 'pattern recognition' of the ABN Amro deal as one 'bound' to succeed? Could he have underestimated the importance of analysing the quality of ABN Amro's balance sheet and the need for liquidity to carry RBS through the troubled waters that lay ahead?

...or misleading prejudgement
Another example – this time of a misleading prejudgement – is that of Steve Russell, the CEO of Boots between 2000 and 2004. Russell had a strong prejudgment that Boots needed to grow and that healthcare services were an attractive opportunity. In his own words: "I had been formulating this ambition for Boots since I was merchandising director in the late 1980s. So, when I became CEO, I was determined to make it happen." With hindsight, he commented: "We did not have the know-how to make these services work. We should not have tried to do so much of it ourselves." Other managers suggested that many of the services Boots tried to enter were inherently low-margin businesses. A turbulent trading period ensued and Russell resigned in 2004.

2. Emotional tagging can lead us astray...
Emotional tagging is the process by which emotional information attaches itself to the thoughts and experiences stored in our memories. This emotional information tells us whether to pay attention to something or not, and it tells us what sort of action we should be contemplating (immediate or postponed, fight or flight). As with pattern recognition, emotional tagging helps us make most decisions. If our interests and motivations are aligned with those of the organisations we belong to – and they often are – then our emotions motivate us to choose and act appropriately. However, emotions can also lead us astray.

...into inappropriate self-interest...
This happens when those emotions produce inappropriate motivations. These can arise when our self interest becomes mis-aligned. Consider, for example, the controversies over bankers' bonuses, MPs' expenses or the collapse of Enron. Less dramatic, but perhaps more important, is the way in which self interest can be a powerful and unconscious influence even among professionals who pride themselves on being objective and highly ethical. Our findings suggest that even people who are aware of the dangers of self-interest, and want to control it, are actually incapable of doing so.

For example, in research of particular interest to finance professionals, Max Bazerman of Harvard Business School conducted an experiment involving 139 experienced auditors. One half were told that they were working for company A and asked to determine if the accounts they were given were in compliance with GAAP. The other half were asked for their opinion on the same set of accounts,

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but were told that they were working for company B who was considering trading with company A. Bazerman found that those told that they were being employed by company A were 30% more likely to find that the accounting behind firm A’s financial reports complied with GAAP. Similarly, prescriptions that doctors write have been shown to be influenced by the favours they have received from drug companies, even when doctors felt they were being objective.

...or other inappropriate attachments

Self interest is only one form of emotional attachment that can distort decisions. Decision makers can also form attachments to people, organisations or things. A striking example of inappropriate attachments is that of Sir Derek Rayner, who acquired Brooks Brothers, the iconic US retail chain famous for its button-down shirts, when he was CEO of Marks & Spencer in the 1980s. In the four years of his leadership, M&S had modernised, transformed itself from a family-run company, doubled earnings per share, and grown revenues from £2.9bn to £4.6bn. And yet he paid $750m for Brooks Brothers despite his team valuing it at only $450m. When he announced the deal, M&S’s share price fell sharply. Why did he do it? As Judi Bevan describes in her book *The Rise and Fall of Marks & Spencer*, Rayner was enamoured of Brooks Brothers clothing, which was in large part aimed at men of Rayner’s age and taste. Although his advisers had presented six possible acquisition targets, Rayner went straight for the preppy, upmarket Brooks Brothers chain.

Making erroneous judgments would not be a major problem if we were good at revisiting our initial assessment of a situation. However, the opposite is true. This was reinforced by our fieldwork: in 80% of the cases listed in our book the decision maker made a choice without careful weighing of the options. By nature our brains do not lay out options and evaluate alternatives. We rely on unconscious processes to bring a plan of action to our consciousness and then assess that plan to see if it makes sense, before considering others. If we imagine that our first plan will work, we do not normally consider alternatives.

Flawed decisions almost always have, at their heart, one or two decision makers who make errors of judgment. However, such errors are not in themselves enough to produce a flawed decision – that will only result when the decision process that supports and challenges the key decision maker(s) also fails. Hence there is an important role for the finance manager in making sure that the decision process is robust enough to offset any biases that exist in the minds of senior executives.

PRACTICAL TIPS FOR THE FD

So what should such a finance manager do?

First he or she needs to spot the potential biases – what we term the ‘red flag conditions’ – such as:

- misleading experiences;
- misleading pre-judgments;
- inappropriate self interest; and
- inappropriate attachments.

If any of these conditions exist, the next step is to review the decision process and decide whether additional safeguards are needed to counterbalance any distorted thinking that might arise.

Most safeguards are well known – the challenge is to pick the right ones for the particular red flag condition. For example, a presentation from an expert consultant might be a suitable safeguard for a decision maker who has misleading experiences about a new market entry. However, if that decision maker is a CEO with strong prejudgments, the process might need a stronger safeguard – possibly a market expert should be invited to become part of the decision team or the chairman might put in extra time to form an independent opinion about the market.

Safeguarding decisions

Safeguards can be grouped into four categories, as set out below:

1. Experience, data, and analysis

In business, there are many ways data can be collected and experience broadened. A discussion with a key customer can provide valuable feedback on a proposed new product. Market research or a consultant study can be commissioned. Large organisations sometimes employ two firms of lawyers to get contrasting views for very important decisions, such as major acquisitions.

2. Debate and challenge

Creating a debate which challenges biases need not involve an elaborate process. It could mean simply chatting through an issue with a friend or colleague. However, in large organisations a typical approach is to form a decision group. The choices of who is in the group, the leader of the group and the process for the group to follow are all important. While many such groups operate with simple guidelines, there is a host of more elaborate approaches – such as splitting the authoriser, evaluator, and proposer roles, allocating ‘hats’ to different people (as suggested by the lateral thinker, Edward de Bono) and role-playing; or the devil’s advocate method (in which a subgroup attacks the proposed option).

‘Implementing red flags and safeguards thinking will be more effective if there is an effective risk management culture within the business, and a strong board of independent-minded directors’

3. Monitoring

When there is a risk that a strategy decision may be wrong, it may be sensible to beef up the monitoring process – for example, by setting clear milestones, monitoring performance and adjusting the strategy accordingly.

4. Governance

Someone with power and strong prejudgments is often resistant to many of the safeguards described. Believing that he knows what the right answer is, the powerful chief executive can become impatient with processes that slow down the decision or question previous judgments. Therefore, it is vital that there be a level above the decision-maker – be it the board or an executive committee – that has real power and insight. In certain cases a special expert might be added to the board for some meetings – for example, one Australian retailer flies in former Asda boss Archie Norman for a few board meetings, to get a more ‘outside in’ perspective on retailing issues.

An important role for finance

What role can finance professionals play in strengthening the decision process? The finance function runs up and down the layers of the organisation, providing an excellent network for understanding the red flag conditions that may be at play in any decision. Finance also has involvement in all four types of safeguard. It has a role in suggesting data and analysis to collect. Finance managers are typically part of the decision making group, hence they can generate extra challenge and debate. Finance also frequently has the lead responsibility in monitoring performance. And, finally, the CFO is typically one of the most important executive officers sitting on the governance board. In short, there are many opportunities for the finance function to support and sponsor ‘red flags and safeguards’ thinking.

So what might a finance function do in an RBS-ABN Amro type decision? One option would be to propose the creation of a ‘red team’ – a group tasked with developing the case against the deal. It could be staffed with insiders or outsiders and be used to ensure sufficient analysis of the risks and sufficient debate of the assumptions. It would also provide a rallying point for dissenters and might give them the courage to speak up.

If it was a similarly major deal, the CFO might suggest to the chairman that the red team presents its case to the full board – so that both sides of the argument can be weighed by the non-executive directors.

Another way of strengthening the governance might be for the CFO to suggest the creation of a subcommittee of the board, which would put extra time into understanding the deal and challenging the assumptions.

Finally, since a major deal would require the energetic support of a large number of managers, the CFO could suggest that it would be helpful to tap the ‘wisdom of crowds’ with a secret ballot of those likely to be affected.

Of course, there are limitations to this approach. Implementing red flags and safeguards thinking will be more effective if there is an effective risk management culture within the business, and a strong board of independent-minded directors has been appointed, with advanced succession-planning in place, so that there are individuals with the confidence and commitment to speak up and challenge the decision maker.

So, a second potential role for finance professionals is to take the lead in ensuring that the decision process is ‘fit for purpose’: capable of spotting red flags, and implementing the necessary safeguards. Such a role could fit well with finance’s traditional role of ensuring objectivity. The finance function is typically responsible for defining the financial tools to be used to evaluate investments, and ensuring that managers are trained in the use of such tools. Could they not also ensure that managers are trained in identifying red flags and selecting safeguards? Getting fit requires a sustained programme of review and improvement – it does not occur overnight. It needs a sponsor – perhaps the finance function can play that role.

Conclusion

We believe that significant progress can be made if management teams adopt red flags and safeguards thinking. The objective is a rational decision. But, this also means being more aware of the innate subjectivity of the decision-making process – to identify where red flag conditions exist and the need for any consequent extra safeguards.

FACULTY WEBLINKS

- ‘Decision making – how rational are you?’ – *FM131* icaew.com/index.cfm/route/129113
- ‘How to improve the decision-making process’ – *FM105* icaew.com/index.cfm/route/118479

FINANCE & MANAGEMENT FACULTY

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