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From blind-spots to sweet spot

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Contents

Introduction

In the understandable desire to measure the relationship that is assumed to exist between 'good' governance and high performance, many assumptions have been made and corners cut.

These include an excessive focus on publicly-available information which has meant that the research has focused on listed companies at the expense of private, public and not-for-profit entities. The desire for quantification has also meant that rather than working systematically to identify the underlying factors that drive organisational effectiveness and performance, crude proxies for performance have been adopted. Often the bulk of this prior research has focused on a narrow set of indicators, assumed to be predictors of performance because they are hypothesised to be so by agency theory. This has largely been at the expense of alternative theories regarding the relationship between the quality of decision making and organisational outcomes. These three factors combined have resulted in a profusion of research which has been unable to provide reliable evidence of a relationship between quality of governance and performance.

Supported by the Australian Institute of Company Directors (AICD), the research we have conducted over the past two years has been different for two key reasons. Firstly, we went back to square one, putting aside assumptions regarding the role of the board and executive, the way performance is conceived, and how the two relate. Secondly, we sought the perspective of those who were best placed to offer insights on this matter: one hundred chairs of Australian private, listed, government and not-for-profit boards.

This paper presents a book-ending to this stage of the research, and attempts to bring together what we have found so far. However, it seeks to do so in the context of a changing world, looking forward to describe not just the challenge good governance presents, but the way this challenge may evolve if it is to continue to support the performance of our organisations.

A growing problem

Over the next 20 years, futurists tell us society will face unprecedented levels of disruption and change. In many ways this is nothing new. There has always been disruption and change, the navigation of which has filled volumes of journals and business books. There is something about today's circumstances, however, that gives cause for pause. Historically, disruption in its various forms has been limited in scope to relatively narrow spheres of attention or activity. Technology disruption, for example, has been a constant for decades, and while triggering significant variance to multiple spheres of life, change can often be limited to a single sphere of activity at a time.

This situation has mostly ended. Today society is experiencing significant disruption across multiple spheres simultaneously: social (overpopulation/mass migration/aging), technological (industry 4.0/artificial intelligence), environmental (climate change/mass extinction), economic (systemic failures/global financial crisis) and political (failure of democracies). The range and nature of disruptions we can currently perceive suggests that the future we face will be more uncertain than ever. Disruption itself is being disrupted, with far-reaching implications for the role of governance and the ongoing management of high-performing organisations.

Historically, weak signal detection has been a critical capability in dealing with disruption. Well-functioning boards have been able to sense the polarity or form of disruptions and enact strategies to manage their impact. Christensen's well-known low-end and new market forms of disruption (Christensen and Raynor, 2003) for example, have now become strategic set-plays in some organisations. Executive teams are engaging in sophisticated scenario-planning activities, actively searching out new technologies and examining alternatives business models in the pursuit of new sources of growth for either offensive or defensive reasons. Yet even these approaches are now becoming more challenging in the face of multi-sphere disruption.

For example, while it is widely discussed that by 2050, the human population may reach nine billion, with significant challenges in terms of the availability of resources to support such a population, it is less regularly observed that, based on current demographic projections, the global population will contract sharply after this period (Pearce, 2011). This is due to the record low birth rates the world has experienced over the last couple of decades. Acceptance of these projections is complicated by disruptions in other spheres. The year 2050 is a fair way off and advances in medical science could plausibly determine how to slow or arrest aging by that time. The range of potential outcomes is vast.

While a rapidly growing (and changing) population presents challenges, those challenges may be less significant than the ones associated with rapidly contracting populations. Whilst change always presents opportunity, a ubiquitous contraction in buyers across all markets does suggest a challenge to ongoing growth and some accepted measures of performance as a result.

However, it is not necessary to look as far as 2050 to see massive changes. Within the next 10 years, the development of the Internet of Things will give rise to the Fourth Industrial Revolution (Industry 4.0), a disruption that will completely change the way in which products are designed, manufactured and managed. This has wide-reaching implications for the skill profile of the workforce. In the past, technology-based disruptions have created large job losses in some occupations. However, these have been offset by the generation of new jobs in other parts of the global economy (Miller and Atkinson, 2013). While there is some evidence the same will be true of the next disruption (Ruthven, 2015), there is significant evidence that the profile of the workforce and the types of skills that are valued will change. Economic data produced by the Reserve Bank of Australia (Heath, 2016) shows a clear rise in non-routine cognitive roles as a proportion of the economy, with commensurate falls in the proportion of roles characterised by routine tasks. Despite ongoing attempts at reform, the education system is failing to deliver against basic skills, let alone the higher order skills increasingly demanded by the changes described below. As recent events in the United Kingdom and United States attest, those who feel that they are being left behind can mount significant political influence and we can expect much more of this in the future.

All of the above suggests that the role good governance plays in the performance of our organisations will become more challenging rather than less, more dynamic than stable and be subject to a wider range of outcomes. Commonly-accepted notions of superior performance may be questioned and with that, the most effective forms of governance to achieve them will need to evolve. But what options are available to boards to consider?

Shaping versus adapting

In 2012, we conducted a CEO study that explored different conceptions of organisational resilience. The CEOs interviewed for the study identified three levels of resilience, each dependent upon the one that came before.

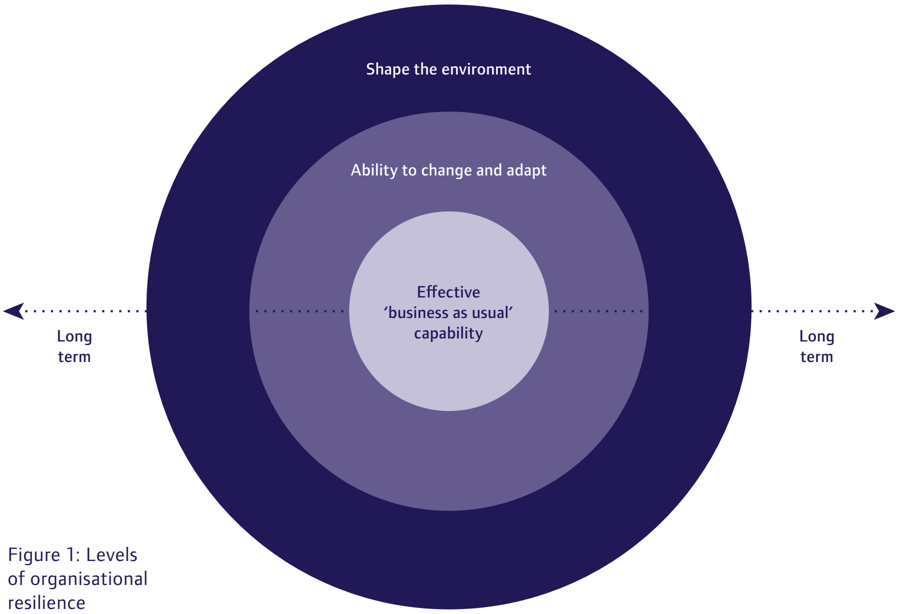


Figure 1: Levels of organisational resilience

The first level, 'an effective business as usual capability', assumed that in order for an organisation to maintain good performance during periods of stress, it must first be able to operate effectively when the situation was benign. This ability was not associated with being high-performing organisation, rather an entry ticket to the game in terms of pursuing that objective. This 'effective business as usual capability' provided the basis for the second level of resilience: 'the ability to change and adapt'. In this conceptualisation of resilience, the ability to maintain performance in the long term was critically linked to the organisation's ability to rapidly sense and respond to changes in its environment. Significantly, 90 per cent of the CEO sample identified with this conceptualisation of resilience, and it is important to note approximately 95 per cent of the chairs we subsequently interviewed for the AICD study (Kay and Goldspink, 2015), also described this view in relation to good governance. A key feature of 'change and adapt', however, was that it was completely responsive in outlook. It assumed that competitive advantage, and the resilience arising from that was a function of how effectively the board and executive's capacity for weak signal detection could be translated into effective organisational responses. As one CEO said, "In the short-term can you take the punch, in the long-term can you dodge it". The assumption was that the organisation's environment was more or less a given over which their organisations had little influence.

This contrasted significantly with the views of those who ascribed to the third concept of resilience: the ability to 'shape the environment of the organisation'. From this perspective, "...the focus of the organisation is to actively create the environment it operates in, either through the innovation of new categories of products and services, the influence of regulation, or fundamental reinvention of the industry in which it operates" (Kay and Goldspink, 2012: 18). This is a paradigmatically different approach to that of 'change and adapt'. It assumes change as the natural state, rather than something that happens between periods of stability. It assumes that part of the role of governance is to actively create the environment of the organisation, and in the words of the people interviewed, it assumes that the core capability giving rise to performance is the organisation's ability to continuously reinvent itself.

Given the proportions in which the CEOs (10 per cent) and chairs (5 per cent) ascribed to a 'shaping approach', these ideas may be challenging to some directors who are deeply wedded to a 'business as usual' and/ or 'change and adapt' outlook.

If governance is thought of as an essentially conservative role i.e.– reducing downside volatility in the performance of the organization; shaping will appear a high-risk approach. It places innovation at the core of the organisation, rather than 'something we should be doing more of' when we've completed our compliance and efficiency efforts. The challenge put forward in this paper is that in a world characterised by multi- sphere disruption, a 'change and adapt' approach is probably too slow. The magnitude and speed of change brings with it the potential for too many blind spots, even with a well-functioning governance team (i.e. board and executive team). This has a direct flow-on effect to performance, leaving the organisation continuously on the back foot, chasing the lead of its competitors.

To characterise the problem in a different way, historically a 'change and adapt' approach may have delivered good governance outcomes most of the time. In the new world of multi-sphere disruption, this is significantly less likely. A 'shaping' approach it may be argued, is more arguably more compatible with the new world, however, for many boards it would require a paradigmatic shift in how they think about what constitutes good governance.

The Good, the Bad and the Ugly

If we are to understand the relationship between good governance and performance, we first need a scale against which to judge what 'good' versus 'poor' governance looks like. At its core, this scale would be based on factors supporting high-quality decision- making. When human judges make decisions, they essentially make a choice among several alternatives…It turns out that these choices are "predictably irrational" (Ariely, 2009).

Our biases mean we regularly experience outcomes that deviate from what is normatively predicted by classical probability and utility theory to be the optimal outcome of those choices (Hilbert, 2012). These biases are pervasive, influencing all domains of human decision-making (Kahneman, 2011), and when made at the highest levels of corporations and governments, they can have a significantly negative impact on performance outcomes (however performance may be perceived).

Estelle Metayer (2013 :3) argues "... biases can impact a board's oversight in two ways. First, boards can end up overlooking risks, be they financial, operational, or reputational. Secondly, blind-spots can prevent boards from recognising new opportunities, such as failing to spot a new trend or identify a counter intuitive market segment." This is of course why all these systems have checks and balances built in to them and why we seldom rely only on the judgements of individuals, preferring to 'test' individual perceptions within the context of groups. In short, the natural state of human decision- making is to be subject to errors and omissions.

The role of governance is to compensate for these limitations. The chairs interviewed for the AICD study collectively argued and gave examples of how decision-making biases could be better managed where there was an effective decision-making team. This team, controversially (from the perspective of agency theory), comprised both the board and the executive. The chairs, argued ¬better decisions – and therefore good governance – resulted when this team exhibited:

- Diversity of view and experience;
- Independence of mind; and
- Openness to alternatives.

Bringing these aspects together depended on having individuals with a range of skills, experiences and the right personal attributes. Above all, however, it required high levels of trust. The role of trust is particularly challenging from an agency theory perspective, agency theory tends to assume distrust of the executive as the starting condition for good governance. This is not without some justification due to the well-known emergence of 'group-think' (Howard, 2010) amongst individuals with high levels of trust and familiarity.

The emergence of group think, as a form of social bias, may also be a contributing factor to why sustaining good governance over the long-term is seemingly so difficult to achieve in practice. Many of the factors that support trust simultaneously support the production of biases as well.

The greater the extent to which the governance team is able to manage these conflicting forces, the greater the possibility that individual and collective blind-spots may be mitigated or reduced, improving the quality of decision-making outcomes and arguably delivering better performance as a result.

In terms of defining a continuum that encompasses the extremes of 'good' to 'poor' governance, the challenge is to identify the social dynamics that minimize, manage or possibly remove the biases in human decision- making as the 'good' end, and social dynamics that allow or potentially accentuate those biases as the 'poor' end.

The chairs interviewed in 2014 spoke of what they described as a 'sweet spot', where the social dynamic created through the combination of the different directors' personalities, experience and the circumstance of the organisation resulted in the quality of decision-making, displayed by the governance team, being superior to that which any of them individually could have achieved.

"The natural state of human decision-making is to be subject to errors and omissions. The role of governance is to compensate for these limitations."

Achieving and sustaining this dynamic would appear to be very difficult.

Many said it only occurred rarely and when it did was only transient, with boards seemingly unable to sustain it as a mode of operating in the longer term. In other words, the 'sweet spot' was a highly-delicate social dynamic that enabled members of the 'governance team' to critically evaluate and challenge each other while at the same time building and maintaining trust. It is a state balanced on a knife edge. For the chairs who described it, this sweet spot constituted the ultimate in terms of good governance. It also raises a number of fairly fundamental questions in terms of understanding the relationship between governance and performance.

If high performance (however it is defined) is predicated on the governance team's ability to sustain an inherently unstable social dynamic, is this dynamic something that can be practised? Can it be orchestrated by an experienced chair? Is it something that can be taught? Secondly, is there a significant difference in dynamic between boards that adopt a 'change and adapt' outlook, compared with a 'shaping' one.

Given only a very small percentage of the chairs described a 'shaping' outlook in their interviews, it may be possible that the sweet spot described above only applies to a 'change and adapt' point of view.
If that is true, then what is the social dynamic needed for a 'shaping' approach, and how feasible is it that this could be developed?

Perhaps answering some of the questions above is dependent on our concept of performance. Literature on the topic has always focused on listed companies, due to the easy availability of financial performance data in its different forms. However, is financial performance the best and only measure we should be concerned with?

Reanalysing the data from the 2014 interviews, we examined the different performance outcomes the chairs were concerned to influence, looking for similarities and differences between sectors. The results will be discussed in the next section.

"If high performance (however it is defined) is predicated on the governance team's ability to sustain an inherently unstable social dynamic, is this dynamic something that can be practised? Can it be orchestrated by an experienced chair? Is it something that can be taught?"

What constitutes effective performance varies by sector and by context

Analysing the interview data by sector suggests that how performance is conceptualised could vary significantly, depending on the type of organisation and its stakeholders.

Table 1

Performance outcomes	Description
Ethical outcomes	Performance outcomes are judged by the ethicality of the organisation's (and its individuals') actions and decisions.
Financial outcomes	Performance outcomes are considered in terms the financial results arising from a decision.
Reputation	Performance outcomes are judged in terms of how decisions and actions affect the organisation's on-going impact and credibility within the wider community.
Relational outcomes	Performance outcomes are considered in terms of the effect on organisational relationships with stakeholders (e.g. customers, staff, shareholders, members, regulators).
Resilience	Performance is considered in terms of the organisation's ability to survive various forms of disruption.

Table 1 above describes the different aspects of performance the chairs emphasised in the interviews. These were drawn from stories of positive and negative governance events in their organisations. Other models, for example, the triple bottom line, were also mentioned from time to time. However, the five factors described in Table 1 were present across all sectors. Whilst there is arguably nothing particularly controversial about these factors, what's interesting is that the factors the chairs focussed on in relation to positive performance was not the opposite of what they focussed on as negative performance. The following charts show the apparent emphasis or importance of an outcome as gauged by the relative frequency with which it was mentioned during interview.

Figure 1 illustrates the difference in focus for publicly listed company chairs between positive performance outcomes and negative performance outcomes. When retelling a positive performance story, the chairs were concerned with a balance of the different factors. However, emphasis changed considerably in relation to negative performance outcomes, with a dramatic increase in the focus on financial outcomes. In other words, good performance is characterised by a focus on all aspects of performance, while negative performance is characterised in terms of the financial outcomes. This should not be interpreted as a causal relationship, in the sense that a focus on financials leads to a negative outcome, but rather that negative outcomes will be described in terms of the financial outcome, with considerably less attention given to factors like reputation and resilience. It is interesting to note that the emphasis on both relational and ethical performance outcomes remained basically the same, regardless of circumstance.

Perhaps unsurprisingly, the results for private (for-profit) companies were very similar to the publicly listed ones. When negative situations were being discussed there was a narrowing of the overall performance focus to financial and relational aspects. There was, however, a greater concern with the impact of reputation in this sector, based on the interviews.

Figure 1: Performance characterisation – Publicly listed

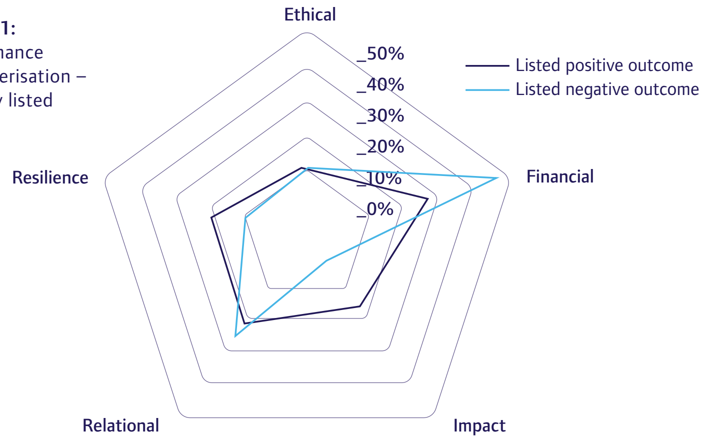


Figure 2: Performance characterisation – Private (for profit)

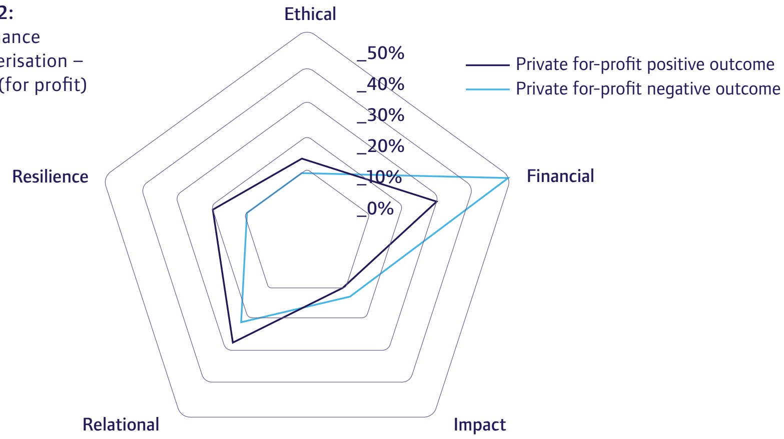


Figure 3: Performance characterisation – Public sector

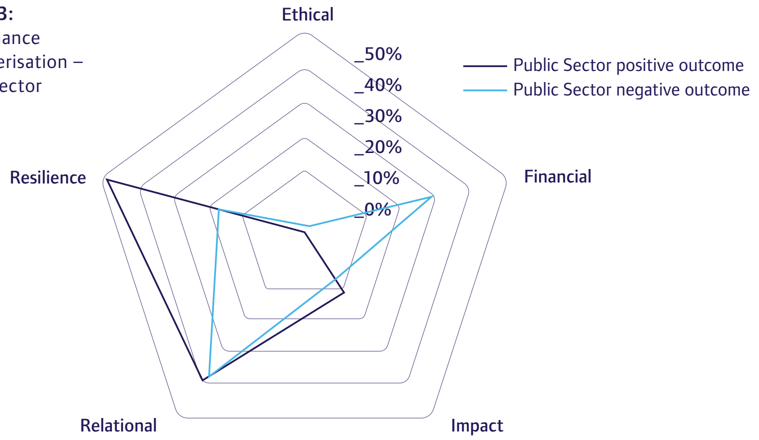
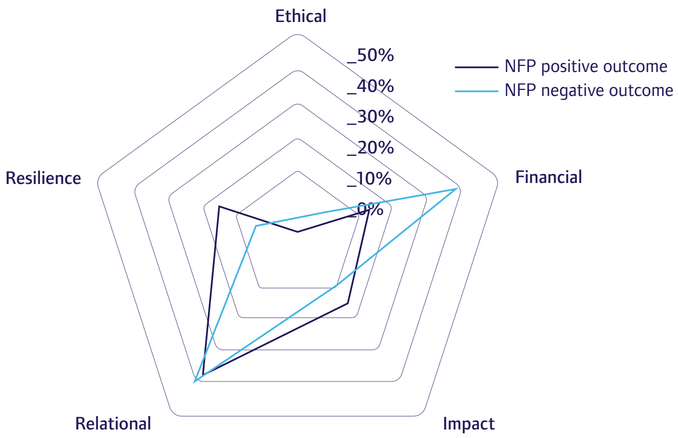


Figure 4:
Performance characteristics – Not-for-profit



The public sector presented a very different profile to the two already discussed. Interestingly, the ethical dimension received almost no mentions in relation to either the positive or negative stories. It could be that this is related to the perceived sphere of influence, as in many circumstances the challenge for the public sector was delivery of a given policy, not a decision about what the policy should be. As a consequence, the ethics of a given direction is assumed, to some degree.

This dynamic may also be an explanation for the difference in emphasis on financials between the positive and negative stories. While financial performance was seen as a strong characteristic of positive performance, it was not even discussed in the context of negative performance. Put simply, budgets come and go with changes in government and policy, and as a consequence, the focus in the negative stories was on surviving the disruption (resilience) in policy until things turned around again. Control over the financials was limited.

The key performance indicator in the public sector related to engagement with stakeholders and therefore the relational aspects of performance. This emphasis was consistently high across both the positive and negative stories, as was maintaining the reputation of the organisation.

The not-for-profit sector in many ways reflected the same broad dynamic as the listed and private sectors. Positive performance was associated with multiple performance forms at once, while the financial and relational performance was emphasised in the negative stories. That ethical performance was not really discussed is perhaps unexpected, and a factor that requires more research. Most of the chairs interviewed for the study held multiple positions, and told stories from more than one sector in responding to the questions in the interview. As a consequence it may be that this dimension is not representative due to the relatively small sample size and the nature of the stories that they told.

Interpreting the relevance of these findings in relation to the ideas introduced in the earlier sections of this paper raises a number of interesting observations. Firstly, if we are to measure the relationship between good governance and performance, then arguably we want to measure this relationship against all aspects of positive performance as described by the chairs. Based on these initial results, that measurement would not be limited to financial information, but would involve a series of other measures as well. Currently, none of these measures really exist. Secondly, the measurement regime would look different for each sector, in the sense that what good performance looks like varies from sector to sector, and as a consequence, a characterisation of 'A grade' performance would need to be sector-specific.

There also exists the question of the degree to which these different factors are co-occurring and therefore carry with them some form of causal impact on each other. For example, does a focus on relational performance support improved resilience or vice versa? Understanding these causal factors is crucial in the context of the volatility created by multi-sphere disruption. The strategic challenge created by a shift towards a 'shaping' approach to resilience is all the more difficult when considered in the context of satisfying these quite different aspects of performance. It would be quite easy to compromise one by advancing another. An example may be using processes of influence to impact policy settings and so advance financial performance, but in such a way that it compromises perceived ethical standards and, hence, relationships and reputation.

The effect of a 'shaping' strategy on each of these aspects of performance may not be uniform in time (financial improvements may accrue quickly but at the cost of long-term reputation, for example). These represent significant design and evaluation challenges. As the approach to minimising blind-spots being advocated here is argued to require continuous cycles of shaping and learning, the capacity to assess impact against these factors becomes more immediate. Quality information and experience of what is happening can address knowledge gaps and reduce potential unintended consequences associated with natural blind-spots. Many organisations may find that their current information systems are not well-tuned to provide the short-term, lead- indicator biased, insights that are needed to support this approach.

"The strategic challenge created by a shift towards a 'shaping' approach to resilience is all the more difficult when considered in the context of satisfying these quite different aspects of performance."

Conclusion

Evidence from the original 2014 chairs study suggested that traditional governance systems perform least well when we need it them the most, i.e. in periods of disruption. Given the outlook in the medium- to long-term, it is reasonable to ask whether we are looking down the barrel of a period of increased governance failure.

While it is increasingly recognised that human decision-making is flawed and that group processes are likely to make it worse in more circumstances than improve it, we need to know more about the determinants that give rise to that scenario in order to improve governance. If we believe that good governance is characterised by the 'sweet spot', as described in this paper, we find ourselves in a potentially difficult situation. Can a behavioural state that exists on a knife edge be seen as the most sustainable option?

We have argued that 'shaping', as an approach to resilience, has greater potential to deal with the increasing complexity expected in the future. It is not, however, an all-in-one solution. Enron, for example, was an effective 'shaper', but opened itself up to internal blind spots in regard to the ethics of its actions, which ultimately brought down the organisation. Perhaps it is time to question the way these challenges have been approached in the past and look deeply at the assumptions we hold regarding the relationship between governance and performance.

Addendum

At the 2017 Australian Governance Summit held in Melbourne, we held a panel session with a group of highly experienced directors to get their reactions to the research findings and their thoughts on some of the questions it raised.

The conversation covered a range of different aspects of the research findings, but in particular focused on three main outcomes from the research:

- Understanding the sweet spot
- The role of trust
- The need for 'shaping' versus 'change and adapt'

The notion of a sweet spot in governance and governance teams resonated with a number of directors in the room, and was acknowledged as something that needed to be better understood. Bill Scales AO FAICD former chancellor of Swinburne University of Technology observed: "…sure there's a sweet spot and most of us will have experienced it, but that's not the question. In my view the question is can it be sustained? Does it come about because of a crisis primarily or does it come about because things are going well and we've all combined together to make sure they continue." Nancy Fox FAICD, non-executive director at Perpetual also wondered: "…can we train for it, can we turn it on and crank it up …?" Richard England MAICD chairman of Qantm Intellectual Property opined that "… it is something you can learn." Largely because there are precedents in other forms of teams like sports teams that have been doing it for some time.

Members of the audience, who felt their board had operated in the sweet spot were asked to comment on how they felt it was achieved, but this was acknowledged as something that required further work: "…for some reason we had the right people, general skills and challenge, and in a way that is respectful but robust…you walk out knowing that whatever decision was made, we asked all of the questions and left nothing on the table".

The topic of trust emerged more than once in the discussion. Not just in terms of its role in supporting good governance, but also in relation to the challenge of how to effectively build trust within and the board and the broader governance team.

Fox added, "…we spend board meetings staring at iPads. We're losing a lot of contact… a lot of the real conversation around the table. Maybe we put the iPads away and have a real conversation…."How do we spend more time together, to know each other, to build that trust and respect?

This challenge was all the more difficult to achieve when governance was considered from the team perspective. Scales noted:

"[we need]…new ways by which we can create the relationship between the board and the executive team so that we get all the info that is required and at the same time… board meetings may not be the only or appropriate way of making decisions.

"…the more we think about culture and ethics, and that way by which that links into trust, links into the way by which we can respond to a rapidly changing environment, there is some sort of a nexus there," he said.

The ability to deal with an environment characterised by multi-sphere disruption brought these concerns into more focus. The fact a 'change and adapt' approach to the environment appeared to be the most common outlook amongst directors and CEOs, suggested a paradigm change may be needed.

Governance consultant David Shortland MAICD noted "We have to learn how to disrupt ourselves, to see through our bias and go beyond it. Disruption is no longer linear – it happens in several dimensions at once." England expanded on this, commenting that "…change and adapt is what we've been used to… it's linear for want of a better expression, and you get into a three dimensional world when talking about 'shaping'…because you're trying to find a way to eliminate surprise, to find a way to anticipate the future, to influence regulation and legislation, to find a way to innovate with existing products or new ones into new markets."

In combination, the reaction of the panel members suggests that questions raised by the research are pertinent not only to how boards operate today, but perhaps more importantly, the way they will need to operate in the future. What is also clear is that more work needs to be done to understand these issues in sufficient depth so both practice and regulation can be improved.

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