Board Overconfidence

How Misguidance from Management can be Addressed

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HOW THE BOARD CAN BE MISGUIDED BY MANAGEMENT

Opening

The Dunning-Kruger effect

- Can be interpreted as people who are least competent tend to be most sure of themselves, while those with genuine skills frequently doubts their abilities.
- People mistakenly assess their cognitive ability as greater than it is.
- Corporate Boards may fall prey to overconfidence of management’s ethics and fail to identify red or yellow flags of compliance failures or fraud

“What’s curious is that, in many cases, incompetence does not leave people disoriented, perplexed, or cautious. Instead, the incompetent are often blessed with an inappropriate confidence, buoyed by something that feels to them like knowledge.” – David Dunning
OVERCONFIDENCE

Perfect Place Syndrome

This theory is based on the assumption that 10 percent of the people are ethical all of the time, 80 percent could behave unethically depending on the situation or the pressure(s) being applied, and 10 percent have no or a severely broken moral compass and will pounce on opportunities to commit fraud.

PREVENTING OVERCONFIDENCE IN MANAGEMENT ETHICS

The Board and Misguidance

• The Board of Directors (the “Board”) is given broad authority to exercise the powers of the corporation
• The Board is also provided the ability to delegate its authority to manage the business to officers, agents, and executive committees (“Management”)

• When can delegation of authority by the Board lead to misguidance by Management? We consider the following:
  • Management overconfidence,
  • The Dunning-Kruger Effect,
  • Application of the Dunning-Kruger Effect, and
  • Possible solutions for the Board’s consideration to avoid this Effect
OVERVIEW
Management Overconfidence

• Management overconfidence is generally characterized by feelings of superior knowledge in deal-making, decision-making, and leadership that far outstrips that of peers.

• Financial literature looks at Management’s overconfidence in the ethical realm as an extension of a natural tendency towards overconfidence in most areas, e.g. driving, intelligence, honesty and integrity.

• More specifically, studies show that approximately 92% of Americans believe they are more ethical than their peers.

• Overconfidence of skills may lead to poor decision making or a lack of ability to recognize poor decisions or poor performance.

THEORIES AND OUTCOMES
The Dunning–Kruger Effect

The Dunning-Kruger Effect posits many things:

• Individuals who are incompetent continually rate themselves as being highly competent compared to their peers;

• Individuals who are incompetent are unable to identify competence in others; and

• Individuals who are competent underrate their competence compared to their peers because they assume their peers have a similar level of competence to themselves.
FINDINGS & REMEDIES

The Dunning–Kruger Effect

For those who are incompetent

- Dunning & Kruger found that incompetence could be remedied by making the incompetent competent.

For those who are competent

- Dunning & Kruger found the false assumption that peers perform at the same level as the competent individuals can be remedied by exposing competent individuals to the output of incompetent or less competent individuals, which serves to break the false assumption of like performance.

The Dunning-Kruger Effect can pose issues for corporate governance at several levels, including the Board and Management.
LEADS TO CONFIRMATION BIAS

The Dunning-Kruger effect

• As we try to make sense of the world we work with our existing knowledge and paradigms, we formulate ideas and then systematically seek out information that confirms those ideas.

• We dismiss contrary information as exceptions. We interpret ambiguous experiences in line with our theories. We remember and then our memories tweak any experience that seems to confirm what we believe.

• In the end we are left with a powerful sense of knowledge – false knowledge. Confirmation bias leads to a high level of confidence, we feel we are right in our gut. And when confronted with someone saying we are wrong, or promoting an alternate view, some people become hostile or disinterested.

• Boards and Management want to believe their organizations are ethical and often seek information to prove this bias and may ignore information that disputes this theory.

THE BOARD

Applying The Dunning–Kruger Effect

Members of the Board may face the incompetence pitfall regarding those they have appointed as Management:

• Members of the Board may lack the ability to effectively screen the ethics and integrity of candidates considered for Management positions.

Additionally, Members of the Board may lack competence where ethical issues are concerned at a firm-wide level:

• First, members of the Board may be less aware of what ethical issues affect the corporation, since the members’ seniority and position might result in their receiving less feedback, overestimating their knowledge in areas outside their expertise, and proceeding to make ill-advised decisions.

• Second, members of the Board may be unaware of what ethical measures the corporation is expected to meet, and

• Third, the members of the Boards may be unaware of what ethical systems are available to implement and at what levels.
Causes of Board Incompetence

- Lack of Board’s interest in ethics and compliance prevents obtaining a full understanding of the environment.
- Management incompetence bias prevents communication of existence of poor control environment and instances of unethical behavior.
- Management intentionally deceives the Board by failing to present unethical behavior or other misconduct.
- Management incompetence overstates the effectiveness of the corporation’s ethics and compliance programs.
- Management lacks the skills or competency to accurately measure the effectiveness of the ethics and compliance program.
- Management’s failure to conduct root cause analysis prohibits the determination of the underlying causes of ethical failures.

Applying The Dunning–Kruger Effect

- Much like the Board, Management may display confidence regarding ethics where, in fact, Management is incompetent.
- Management may institute ethical training and programs it believes are sufficient to address ethical issues throughout the firm.
- However, Management’s belief in the programs and the programs’ ability to address ethical issues may be subject to Management’s own incompetence in identifying:
  - How ethical guidelines should be set, e.g. what laws and regulations must the firm adhere to and how are those applied;
  - What measures should be used to determine if ethical guidelines are being met;
  - What programs successfully teach ethics; and
  - How unethical behavior can best be identified.
THE PERFECT STORM

Applying The Dunning–Kruger Effect

Where there is incompetence at both the Board and Management levels, there is a perfect storm for a breakdown of corporate ethics:

- First, Management is overconfident in the ethical programs it has set out; however, Management is incompetent at identifying what strong ethical programs would actually consist of.
- Second, the Board is incompetent in two ways:
  - It is overly confident that it has selected the most ethical Management to delegate authority to, and
  - The Board is overly confident that it is able to identify ethical issues that would be missed by Management, where there to be any issues.

Once this feedback loop of incompetence and overconfidence is set in motion, the results can be disastrous, e.g. Enron.

CORPORATE CULTURE

Applying The Dunning-Kruger Effect

- Culture is a powerful driver of human thought and behavior.
- Culture provides boundaries to drive acceptable/unacceptable actions and behaviors.
- A toxic culture can add to the level of incompetence and/or drive unethical behavior.
- Signs of a toxic culture according to Annie Mckee, University of Pennsylvania, include:
  - Pressure to cover important values and believes such as respect for people or acting with integrity.
  - Hyper-competitive environment, which increases the risk of unethical behavior as employees attempt to win at all costs. Bullies and misconduct are often tolerated.
  - Pressure to overwork, which causes pressure of high performance and increases tolerance for misbehavior or failure to report concerns as employees focus inwardly and often miss signs of unethical behavior.
THE BOARD

Breaking the Chain

- The Board must be made competent regarding ethical issues the corporation faces.

- This serves two purposes:
  - Makes the Board aware of when others, like Management, are incompetent, and
  - Makes the Board more likely to address issues of incompetence before ethical issues get out of hand.

- Moreover, as the Board is more aware of its own incompetence, it may elect to retain new Board members who are competent in the area of ethics or perhaps form an ethics committee made up of individuals who are competent.

- Additionally, the Board mix may already include competent individuals, and those individuals, through training, would more readily recognize that their own role on ethical issues needs to increase to mitigate those who may be incompetent in the area of ethics.

- Encouraging the Board to challenge management and request additional information when appropriate.

MANAGEMENT

Breaking the Chain

Similarly, Management should be checked by:

- Testing for competence,
- Making those who are incompetent competent,
- Empowering those who are competent by breaking the false assumption that less competent peers are, in fact, competent, and
- Requiring use of as many measurable standards of performance as possible.

By changing the inputs received by the Board, the ethical culture of the corporation can be positively changed.
TRAINING

Breaking the Chain

- Making the incompetent individuals, at any level, competent should be a prevailing feature of any training.
- Comparing and contrasting the existing ethical paradigms and systems of the corporation against those of better performing peers, and/or a system designed to improve the corporation's existing ethical culture, could be a major step towards addressing the pitfalls described above.
- Additionally, providing case studies explaining where ethical systems have failed and comparing that to the corporation's system could benefit both the incompetent and the competent; however, this approach would best serve if coupled with other training to help those who are identified as incompetent to become competent.
- Mental pitfalls of overconfidence and incompetence are ones that can be overcome without "cleaning house.”
- Corporations that are committed to improving their ethical culture through investing in their talent can address these issues.

CAREMARK REQUIREMENTS – BLUE BELL ICE CREAM CASE

Practical Application

- A Caremark claim is premised on a "sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists.
- In 2015, three people died from eating Blue Bell ice cream contaminated with listeria. After Blue Bell recalled its products, shut down production, and laid off over a third of its employees, the company suffered a liquidity crisis that forced it to dilute existing stockholders in order to obtain a private equity investment.
- Plaintiff brought a derivative suit against Blue Bell’s CEO-chairman Paul Kruse, its vice president of operations, and its directors. The suit alleged that the executives breached their duties of care and loyalty by knowingly disregarding contamination risks and failing to oversee the safety of Blue Bell’s operations and that the directors breached their duty of loyalty under Caremark.
Practical Application

- Board must try to put in place a reasonable system of monitoring and reporting at the board level. The complaint fairly alleged that prior to the listeria outbreak, there was no board committee addressing food safety; no regular process or protocols requiring management to keep the board apprised as to food safety; and no schedule for the board to consider safety on a regular basis.

- Management knew of red or at least yellow flags preceding the customer deaths, but the board minutes revealed no evidence that these warning signs were disclosed to the board. The minutes were devoid of any suggestion that the board regularly discussed food safety.

- If Caremark means anything, it is that a corporate board must make a good faith effort to exercise its duty of care,” the court wrote. The plaintiff adequately pleaded that there was no board-level system of overseeing the “mission critical” issue of food safety.

- A high level of incompetence can result in a crisis for any organization.

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Fraud Pentagon

Fraud

- Arrogance or lack of conscience is an attitude of superiority and entitlement or greed on the part of a person who believes that corporate policies and procedures simply do not personally apply.

- Competence expands on Cressey’s element of opportunity to include an individual’s ability to override internal controls and to socially control the situation to his or her advantage, by selling it to others, coercing them, or bullying them into doing something improper, including not acting at all. Competence can also be perceived competence - meaning the individual is a position within the organization and when something goes wrong they try to conceal it because they don’t want others to believe they are incompetent and telling the truth is not an option puts the individual at risk of being challenged and exposing their true capabilities. These individuals also try to surround themselves with those who can be controlled - sometimes by overpaying them and putting the fear of losing their jobs over their heads.
A corporation’s ethical culture flows from the top:
• The Board should be competent in recognizing ethical behavior as displayed by Management.
  – The Board should be competent in parsing ethical incompetence from competence and avoid misguidance by incompetent and overconfident Management.
  – Where the Board is incompetent regarding ethics, it must be brought up to speed.

Where the Board identifies ethical incompetence, steps must be taken to remedy the incompetence because:
• The Board should consider the corporation’s ethics as being tied to the corporation’s long-term value, and
• The Board should recognize that ethical incompetence displayed from Management can spread if not addressed.