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Introduction

While the official role of the board includes setting strategy and other proactive tasks, in practice the most important role of the board is to spot when the executive team are about to make a mistake and "nudge" them into a better choice. This submission is about why capable executives make mistakes and what the board can do to reduce the number of these mistakes. We believe that this issue is insufficiently addressed in the current code.

Why do capable executives make mistakes?

The problem starts with an error of judgement in the head of an influential individual. The research we have done suggests that these errors of judgment stem from four sources – four red flag conditions:

- misleading experiences: experiences the person has had that seem similar to the current situation but differ in ways that mislead the person's judgement
- misleading pre-judgments: pre-existing judgments, theories, rules of thumb and previous decisions that seem relevant for the current situation, but differ in ways that mislead the person's judgment
- inappropriate self-interest: personal interests that conflict with the interests of the stakeholders involved in this decision and serve to distort the person's judgment
- inappropriate attachments: loyalties and attachments that the person has towards people, places or things that conflict with the interests of stakeholders and serve to distort the person's judgment

Because judgments in the brain are formed in the subconscious and influenced by feelings, these misleading influences and inappropriate feelings can distort judgments without the person realising it. If that individual has a big influence on the decision, his or her distorted judgments can lead to a bad decision, even though the individual is capable and acting in good faith. Hence one role of the board should be to spot these distorted judgments and encourage the executive team to "Think Again".

How to reduce the number of mistakes

Unfortunately, it can be hard to spot distorted judgments. Board members can identify when the judgment of the executive team differs from their own judgment. But, given the different amount of information available to the executives, it is hard for the board member to know whose judgment is most reliable. Moreover, since the information received by the board is selected by the executives, distorted judgments by the executives can lead to distorted information in the board papers. Rather than relying on spotting bad judgments by comparing the judgment in the board paper with their own private judgment, boards need an independent way of identifying which board papers are likely to be distorted by bad judgments.

The answer is for boards to use the four red flag conditions as signals that a board paper might contain bad judgments. Since it is possible to spot the existence of these conditions before a decision is made, often even before the board paper has been prepared, it is possible for boards to be warned that some proposals may contain more risk of bad judgments than others. To be forewarned is to be forearmed. Boards can then spend more time on these high risk proposals by challenging them directly, calling for additional inputs or requesting more process before the final proposal is submitted to the board.

Practical suggestions for the Combined Code

The analysis in this paper suggests that boards can improve the way they spot errors of judgment and, hence, reduce the number of bad decisions. However, the focus of the review is the Combined Code. Are changes in the Combined Code needed to encourage boards to identify red flag conditions and reduce the number of bad decisions?

We propose that between the current sections “A – Directors” and “B – Remuneration”, a new section be added – as follows:

B. DECISION MAKING

Main Principle

The board should clearly specify those decisions that need board approval and the processes of decision making that the board requires

Supporting Principles

Since strategy, appointments and other initiatives that affect the success of the company are mostly proposed to the board by executive management, the board has a vital role in deciding what proposals need board approval, and then approving or challenging the proposals made.

The main work of the board is authorising or challenging proposals made by executives. It is important, therefore, that the board has carefully designed its role in the broader decision making process. In particular, the board must anticipate situations where proposals by executive management may be flawed in ways that have been over looked by the executives. The decision making processes should be designed to help the board identify and challenge these flawed judgments without undermining the constructive spirit of a unitary board.

While it is potentially divisive to imply that the judgments of executives may be flawed, it is essential for both executive and non-executive directors to understand that even the most experienced decision makers can suffer from distorted judgments under certain conditions. One of the board’s most important roles is to help executives avoid the flawed strategies and policies that can result from these distorted judgments.

Code Provisions

B.1 The board should maintain and review annually a statement of authorities that specify those matters that require board approval.

B.2 The board should define the decision process for all important categories of decision.

B.3 The decision process should require that the information provided with each proposal is sufficient for the judgments that the board is being asked to make

B.4 The decision process should require that each proposal includes a description of the process that has been used to arrive at and challenge the proposal prior to presenting it to the board.

B.5 The decision process should include some way of identifying those proposals where the judgments of executive managers have a higher than normal risk of being distorted.

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