Bias in the boardroom: a field study of failures in governance of a not-for-profit organization.¹

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Abstract (Extended version)

This paper is a case study based investigation on limits to the monitoring and control function of boards of directors. The paper describes a 2-year study of a housing association in the United Kingdom which came to the brink of collapse as the result of poor governance and weak internal controls. This study offers distinctive insights through the employment of a participant observer methodology and is concerned with the accountability of and by this organization's Board and how it lost control over governance. The study explores the ambiguity and contestability of the concept of accountability within the behavioural constraints and socialisation effects of the boardroom.

¹ This article has benefited from inputs by commentators and participants in its presentations at the 2nd European Risk Conference, Bocconi University, September 2008; the 6th International Critical Management Studies Conference, Warwick Business School, July 2009; and the Behavioural Finance Working Group Conference, Cass Business School, July 2010. The author acknowledges the valuable comments made by two anonymous referees but the responsibility for the paper remains that of the author.
atmosphere. The paper builds on the contrast made by Roberts (1991) and Collier (2005) between formal systems of accountability based on calculative accounting and the informal sense-making narrative form of accountability typical of Board room interaction. The identification of limits of the formal and inadequacies of the narrative, reveals spaces (Collier, 2005) where governance can be lost and accounterability forsaken (Kamuf, 2007). It is in these spaces where behavioural issues are particularly active in preventing a critical perspective by the monitors and gatekeepers. Social and psychological dependence upon executive management, biases of individual members of the board, and group decision-making effects are contributing forces at the centre of the described failure of governance. A crucial insight of the study is the need for a Board to constantly ask critical questions, to actively investigate, question the status quo, and explore areas of presumed knowledge and certainty [or as Kamuf suggests to take “…a little time to think, to stop calculating and listen at another rhythm for something else, for an incalculability and unforeseeability that cause the accountability programme to stammer or stutter: account, er, ability.” (Kamuf, 2007, p. 253), to circumvent the complacency that may prevent an early recognition of problems within an organization].
Introduction

The research study described in this paper is a two-year field study at Board level of the effects of bias on the quality of governance of a UK housing association that experienced significant adverse performance resulting in its near collapse. This provides a window into board culture, the prevailing set of values, beliefs and unstated assumptions that shape the way directors relate to one another, and the framework in which directors conduct their assigned duties. The paper explores the effects of socialisation and individual bias on the quality of decision making in the boardroom. What makes this paper unique is that it is the result of a direct participant observer study of the actual workings of a board which underwent a crisis of confidence after it lost control over the governance of the organization.

The paper is concerned with the form and nature of governance in the boardroom, exploring the limitations of formal, accounting based systems of accountability and the inadequacies of informal, socializing forms of accountability based on a sense-making narrative (Roberts, 1991; Collier, 2005). The sense-making narrative terminology builds on the contrast made by Roberts (1991) between a formal, hierarchical system of accountability based on calculative accounting, and an informal, socializing form of accountability, which typically replaces the focus on the technical and rule based. Hidden between the two systems are spaces where governance remains problematic (Collier, 2005). The research provides behavioural explanations for the failure of the informal form of accountability, the

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2 Subsequently, the housing association under study is referred to as ‘the Association’.
boardroom discussion, to dig deeper into these spaces. The reluctance of the Board to explore and decisively act upon performance shortcomings when members became aware of these, prevented a meaningful discussion of problems before these developed into critical proportions.

Collier (2005) notes the increasingly important role of corporate governance in balancing the competing stakeholders of quasi-public sector organizations. Boards of housing associations have responsibilities to a heterogeneous group of stakeholders, including a regulator, lenders and tenants. Responsibilities to stakeholders are insufficiently met when questions and concerns about wider issues of accountability remain unarticulated during boardroom discussions, as was the case at the Association. The study further adds to an existing literature which questions well established assumptions on the effectiveness of traditional elements of good governance (Larcker et al., 2005; Brennan, 2006; Marnet, 2007), and reflects on the detrimental effects of Board socialization on the willingness to explore critical issues of governance.

The study focuses on the role of Board monitoring and asks one key question: How did the Board lose control? In exploring the reasons behind the failures of governance at the Association the focus of the investigation is on behavioural factors that lead to poor decision making at the boardroom. Potential shortcomings of group decision making are of particular interest and

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3 Collier (2005) defines the quasi-public sector as a public sector organization in private sector clothing. This emphasizes the position of housing associations between the public and the private sector. Housing associations have taken over direct service provision of social housing after government largely withdrew from this function, but they remain dependent on a mix of public and private sources of funding. This results in a high level of government regulation and supervision, and responsibilities to a diverse set of stakeholders.
will be discussed in relation to the independence of directors as one of the key components of the established governance paradigm. The article is structured as follows. The first section outlines the context of the study. The second section describes the field study. The overall findings are discussed in the third section, which builds on the notions of calculative and narrative accounting (Roberts, 1991; Collier, 2005), and describes behavioural factors that prevented a meaningful exploration of the problems at the organization under study. The final section presents the conclusions.

**Governance and the independent director**

Corporate governance has been defined as “the system by which organizations are directed and controlled” (Cadbury, 1992), and as being “concerned with structures and processes for decision-making, accountability, control and behavior at the top of organizations” (International Federation of Accountants, 2001, p.1). Corporate governance has also been more broadly defined to include "the social organization of firms and their relation to their environments including their relations to states" (Fligstein & Freeland, 1995, p.22) combining an economic concern with efficiency and a broader sociological concern with social, political and cultural factors.

From the late 1980s onwards there has developed a paradigmatic approach to ‘good’ corporate governance for companies in terms of an overall focus on appropriate internal control and risk management procedures within the relevant entity. Responsibilities for such procedures lie with board members (both executive and non-executive) supported by a formal structure of board
committees; audit committee, nomination committee, remuneration committee and also by increased emphasis given to the role of audit, both internal and external, as a mechanism for ensuring appropriate governance procedures. The development of this paradigm was given significant impetus by the influential COSO report, (COSO, 1992) in the US and in the UK the work of the Cadbury Committee (see Collier, 1997), as subsequently revised and taken forward by the Greenbury and Hampel Committees, led to the development of the Combined Code covering various aspects of corporate governance. The Code is not statutory and adherence to the Code is not mandatory - but the UK Stock Exchange listing rules require disclosure of non-adherence. Although primarily focused on the private sector, the governance paradigm developed in the UK over the past two decades (Gwilliam and Marnet, 2010) applies to housing associations with the adoption of key principles of the Cadbury Code of Best Practice by the sector.

The independent director is seen as an important gatekeeper in governance. A director's independence is presumed if neither they nor their close family members are employees of the organization or have significant financial relationships with same. The notion that independent directors are more likely to have an objective view and unbiased judgement underlies the importance ascribed by the governance paradigm to these agents in reducing the agency problem arising from the separation of ownership and control (Berle and Means, 1932). This approach has the flaw of being based on a poor model of

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6 The most recent version of the Combined Code, issued by the Financial Reporting Council in June 2006, can be found at http://www.frc.org.uk/corporate/combinedcode.cfm
human choice behaviour, a model which can be extended to provide for better descriptions of actual agent behaviour. Potential sources of bias, including group loyalties, friendships, trust, and emotions, are frequently held insufficient to negate a director’s independence. Most analyses of director’s independence may not have adequately taken into account the potential impact of unconscious bias. In turn, the development of corporate governance codes, regulation, and relevant legal decisions, likewise seem to underestimate the effects of bias. In determining a director’s independence, courts typically focus on the traditional criteria set for independence (ref), but do not take into account the potential impact of unconscious bias.

Peasnell et al. (2001) support earlier conclusions (Fama and Jensen, 1983a,b; Mayers et al., 1997) that outside directors, in helping to separate decision management and decision control, are a potentially significant governance mechanism when external constraints on executive behaviour are weak. Independence of the board, conventionally associated with ‘outside’ or ‘independent’ directors, i.e., individuals not otherwise affiliated with the firm, can reduce insider pressure, and thus impact positively on measures of company performance (Fama and Jensen, 1983a,b). The inclusion of independent directors on the board can also enhance the viability of the board as a control mechanism (Fama, 1980; Fama and Jensen, 1983a,b). Finally, independent directors may lower the probability of collusion of management to expropriate security holders, and their role has been interpreted as that of a professional referee (Fama, 1980; Fama and Jensen, 1983a,b) who oversees top management, and, if necessary, replaces it with more effective individuals.
Despite empirical findings which suggest a positive effect of independent directors on governance measures, Hermalin and Weisbach (2003) suspect that the causality might run from the functional form of independence to the observable characteristics of independence (the formal form). This caveat is of importance, as there is a discomforting lack of empirical evidence supporting a clear statistical correlation between measures of board independence as a governance indicator and actual corporate economic performance (Mehran, 1995; Klein, 1998; Bhagat and Black, 1999, 2000, 2002).\(^7\) Functional independence, in the sense of directors being professional referees (Fama, 1980), or board monitors (Fama and Jensen, 1983b), is difficult to measure. Testing for the presence of directors defined as independent in the traditional definition, is relatively straightforward, but this should not be equated with independence in an objective and functional sense, since “...outsider domination may simply create a carefully calculated illusion of board independence”, (Langevoort, 2001b, p.801).

The lack of family relationships and pecuniary ties of directors with respect to senior management are frequently used as proxies for independence in empirical testing and in legal interpretation.\(^8\) The relationship between monitoring quality and board, or committee, composition would appear, however, to be more complex. Of primary concern to the present discussion, is the difficulty of effectively achieving a high degree of sceptical objectivity

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\(^7\) These papers report an insignificant relationship between various accounting measures of firm performance and the proportion of formally independent directors on the board. The use of Tobin’s Q as the performance measure also does not appear to yield a significant correlation in this respect (Bhagat and Black, 2000).

\(^8\) This definition would cover the vast majority directors of the boards of management at housing association as these are traditionally discharge their duties as unpaid volunteers. Where payments to directors are allowed by the regulator, the sums involved are minor.
and constructive criticism to board monitoring implied in the concept of independence. Independence, to be effective in the sense of directors being professional referees (Fama, 1980), monitors (Fama and Jensen, 1983b) and gatekeepers (Coffee, 2001), needs to be in the mind. Subsequently, this then needs to be translated into independent action. There is a distinct difference between independent position and independent behaviour (see, for e.g. Clarke et al., 2003). Formal independence, as demanded by many statutes on corporate governance, is simply not the same as functional independence. Functional independence is not easily implemented, and greater outsider (i.e., independent directors) presence on the board (which can empirically be tested for quite easily) cannot be equated with greater independence in an objective sense.

As a result, the independent director may mostly be an illusion, and various heuristics, group and social pressures interfere with the ideal role of the board as a professional referee (Fama, 1980), even where functional independence is an active goal. The inconclusive relationship found in research between corporate performance and the proportion of independent directors on the board or the various committees would indicate that the benefits of independent directors, as traditionally defined, are limited (ref). The limits to board effectiveness with regard to executive compensation, points to the limits of board monitoring in general (Bebchuk et al., 2002b). This includes one of the essential monitoring functions of the board, namely, controlling for managerial conflicts of interest (Langevoort, 2001a). A board is subject to potential problems of dependence, and, in the extreme, senior management
may capture the board and thus void much of the latter’s monitoring functions. The typical selection for membership on boards of directors is heavily based on compatibility, fit, consensus, and cooperation (Langevoort, 2001b). Jensen (1993, p. 863) reflects on board culture as an important component of failure of board function when he describes an atmosphere of,

“... courtesy, politeness and deference at the expense of truth and frankness during board meetings, reflecting a general reluctance of confronting a CEO regarding management decisions, which is seen as both a symptom and cause of failure in the control system.”


An overly strong emphasis on teamwork and conflict-avoidance by boards may be evidence of capture by the CEO. This is contrasted by the independence, scepticism, and loyalty to the shareholders and other stakeholders of a monitoring board (Fama and Jensen, 1983a). The problem is, that a director generally wishes to be re-elected, and also might wish to be elected to the board of other firms. A reputation as a troublemaker would severely undermine such chances. The typical CEO is closely involved in selecting the board (Shivdasani and Yermack, 1999), and in granting directors’ remuneration and perks in listed companies.⁹ This is consistent with the view that control by the CEO over board selection decreases the board’s independence (Bebchuk et al., 2002a,b). Executive managerial influence

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⁹ What Krugman (2002b) calls the ‘invisible handshake’ in the boardroom.
over own compensation packages (i.e., rent extraction), further questions the validity of the optimal contracting approach.

Board capture provides the CEO with significant powers to engage in activities which may be to the detriment of stakeholders (Bebchuk et al., 2002a,b). This interpretation of managerial power would seriously undermine the arm’s length model of boards and their crucial watchdog function, and is in stark contrast to the optimal-contracting view where directors take an adversarial position against management (Bebchuk et al., 2002a,b). The very psychology of a board is tilted toward supporting the chief executive. Short of firing the CEO, open dissent is rarely found in board meetings. The role of the board of directors in monitoring agent behaviour may be further devalued where the position of CEO and Chairman are combined.

Board capture is not the only influence bearing against independence. Groups such as boards of directors, are highly subject to groupthink (Janis, 1972) and polarization (McHoskey, 1995), with potentially negative effects on the quality of decisions. The pressures on a board of directors towards consensus opinions, makes it subject to the (negative) consequences of groupthink (Janis, 1972, 1982). An ideal board would act to counter the groupthink tendencies of an in-group (Janis, 1982), while group social effects are a potent influence against critical opinion. The social dynamics that exist in any group move members towards placating other group members, and to come to a consensus view. This acts as a strong counter-weight to the potential for group decision making to moderate an extreme position, and
instead can lead to further polarization (Janis, 1972; Myers, 1982; McHoskey, 1995).

Psychological research demonstrates that people, including professionals and agents in corporate governance, are subject to biases, and typically unaware of their own biases and how these might affect their judgement and decision making (ref). It would seem that there is no shortage of evidence regarding deficiencies in corporate governance public policy and law based on the dominant, but flawed, model of human judgement and behaviour on which much of the rules are based.

Challenges to the dominant governance paradigm have come from those who question the ability of non-executive directors to satisfactorily perform the variety of roles expected from them,10 and from those who argue that the ‘approved’ governance mechanisms put in place have been demonstrably ineffective in checking corporate irregularity to date and are unlikely to be any more effective in the future (Clarke et al, 2003). An example of related research is given in Marnet (2007) who cautions against the exclusive use of the rational choice model of decision making in explaining agent behaviour in corporate governance and proposes the use of psychologically more realistic assumptions. Prentice (2003) earlier examined Enron’s collapse using a behavioural perspective reflecting on the need to apply behavioural decision theory to issues of law and governance to arrive at more realistic policy prescriptions than those that can be derived from a strict reliance on the

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10 See for example Ezzamel and Watson (1997), see also Spira (2003) and Spira and Bender (2004) for further discussion of this issue.
rational actor model interpretation of human behaviour. Both authors argue that conventional law and economics theory suffer from major shortcomings by ignoring behavioural insights which forcefully demonstrate how law and economics (and much of the resultant governance regulation) is built on a raft of inaccurate assumptions that can lead to faulty policy prescriptions. By applying behavioural decision theory into legal analysis and accounting, the foundational assumption of law and economics that people typically and consistently behave rationally is quite misleading, and grossly inadequate in explaining the frequent occurrence of corporate scandals.\textsuperscript{11}

A behavioural perspective notes the human vulnerability to drift from accepted or prescribed behavioural norms (Maccoby, 2000), the tendency of monitors to acquiesce to corporate misdeeds (Langevoort, 2001a; Coffee, 2001), the effect of unconscious bias during the corporate auditing process (Bazerman et al., 2002a,b), and socio-psychological effects of group decision making on judgement and decision quality (Janis, 1989). These, and many more, factors may frequently combine to hide an impending corporate disaster from the eyes of the actors nearest to the events, as well as from the eyes of interested parties. Fraudulent behaviour or a lack of ethics may also not necessarily be at the heart of the problem in corporate scandals, though both can and probably do contribute to these.\textsuperscript{12} Instead, poor corporate behaviour may frequently be due to poor decision making as the result of persistent

\textsuperscript{11} Also see Prentice (2000) for a detailed application of behavioural insights to auditing and accounting; and Marnet (2008) for a comprehensive application of the behavioural perspective to the role of audits and Boards of Directors in corporate governance.

\textsuperscript{12} It may well be, however, that the boundaries of what is considered proper behaviour are pushed outward when stock markets are booming. A similar argument can be made with regards to a decrease in due diligence and proper objectiveness. Auditing might, for example, be considered more of a nuisance rather than a necessity during periods when earnings growth seems limitless.
psychological and cognitive factors. Thus, bias in judgement and decision making processes are suggested to be a major contributing factor to what ultimately is seen as fraudulent, imprudent and destructive behaviour of executive management, as well as the acquiescence (or mental blindness) to such activities by their gatekeepers.

Examples of non-rational behaviour include commitment to lost causes, belief perseverance, and the underestimation of risk. Cognitive dissonance (the clash between conduct and principles), frequently leads to beliefs being adapted to conform with own conduct, which further distorts perception and judgement.\textsuperscript{13} Even when individuals realize own bias in a particular judgement (and are explicitly asked to watch out for this), they are frequently unable to sufficiently adjust for this. A large body of literature describes the mental rules of thumb used by the human mind to arrive at judgements under uncertainty (ref). In general, heuristics allow for quick and efficient decision making, but these cognitive mechanisms can also lead to systematically flawed judgements. It would be difficult to understand how individuals were able to learn at all, if biases dominated decision tasks at all times. Obviously, learning can take place, however haphazardly. Individuals can learn from past mistakes, and are capable of applying analysis along the lines suggested by rational choice models. Nonetheless, more than four decades of research into decision making demonstrate, that human inference is subject to a set of cognitive and motivational filters which persistently interfere with an objective interpretation of information. The biases that do occur are not evenly

\textsuperscript{13} One implication is that preferences and beliefs may frequently not be formed prior to observations of own behaviour. Hence the causation may, at times, run from behaviour to beliefs.
distributed, but lead to systematic diversions from the outcomes predicted by rational choice models. While there might be some room for discussion of what is meant by ‘objective’, the results from behavioural research and social psychology warrant the view that the rational model is an inadequate description of the spectrum of human decision making.¹⁴

Field study
The Association was established by the merger of two housing associations nearly two decades prior to the described events, and is governed by a Board of Management of 15 members at the time of writing. The Association is not a no-profit organization, but rather a non-profit-distributing business, with any surplus being reinvested in the maintenance of existing homes and the expansion of social housing stock. Regulation takes place through publication of best practice guidelines, reinforced by regular financial reporting, performance measurement comparisons and periodic inspections on behalf of the regulator.

The Association's financial situation started to deteriorate from 2003 onward as a result of substantially increasing operating costs against a comparatively static revenue base. The increase in costs were mainly due to a significant increase in staff numbers and above sector pay increases, contrasted by a relatively stagnant revenue base. It should be noted that from 2002 onward, rent increases for housing associations in England were limited to the retail

¹⁴ Camerer et al. (2004) suggest that agents differ in their degree of rationality and that economic models should take this into consideration.
price index plus 0.5%. Similar constraints to rent increases apply in Scotland and Wales. This cap in rent increases had been introduced after a consultation process and did not come as a surprise to the sector. As all other housing associations faced this same constraint and did not suffer a subsequent significant deterioration in financial health, this cannot be interpreted as a cause of the problems at the Association. The divergence between costs and revenues continued in the subsequent four years, and by 2007 the Association had been transformed from an organization with a positive cash flow and substantial cash reserves (prior to 2003) to one which operated at a substantial annual loss and no substantial reserves. Crucially, the financial deterioration had not been revealed to, or known by, the Board until data on the Association’s financial situation was obtained by individual Board members from third parties.

With hindsight, it was established that financial presentations at board level for the years where the deterioration in the Association’s finances had taken place lacked crucial details to allow proper monitoring by the Board. Even when initial apprehensions about the reliability, comprehensibility or timeliness of financial information presented to the Board emerged, these were not forcefully voiced at Board meetings until an external audit inspection in 2007 indicated serious shortcomings on the quality of the Association’s service provision. By implication, although not by remit, the negative verdict of this audit report quickly raised questions about the financial viability of the Association.
This sharply focused Board members’ minds and acted as a catalyst for a thorough, but at times controversial, process of introspection and restructuring. From late 2007 onward and for much of 2008 the Board put in motion a significant number of steps to change the direction and functioning of the Association with view to ensuring its long term future as an independent organization, and permanently enhancing the quality of governance. During this restructuring process, the incumbent Chief Executive Officer and Finance Director left the Association and an interim Chief Executive was tasked to re-organize the Association, implement a sound system of internal control and accounting, provide reliable, timely and adequate information to the Board, put the Association on a stable financial base, address the service issues raised in the audit, and mend the strained relationships with the regulator, principal lenders, and other stakeholders.

The impetus for organizational change initially came from a small, but determined, minority of incumbent board members, the efforts of the interim CEO (subsequently made permanent), and a small but determined group of core staff. Key to the restructuring effort were high-frequency Board meetings which included regular and emergency Board meetings, away-days, and brainstorming sessions between key staff, the new interim CEO, a newly created Task & Finish group, Board members, and key advisors brought in from outside.\textsuperscript{15}

\textsuperscript{15} The number of regular Board meetings increased to monthly meetings during the restructuring, from what had earlier been quarterly meetings. For a brief period, a broad spectrum of meetings, which the vast majority of Board members attended, took place on a weekly basis.
Of significant assistance to the restructuring process was the addition of new Board members with an executive level housing association background. The experience and contributions of these new members was invaluable in improving the quality of decision making of the Board and enhancing its control function. Board level discussions became significantly more informed by concerns about accountability, the role and contribution of formal accounts, and the duties and responsibilities of the Board.

As of June 2009 the Association had re-gained a sound financial footing, enhanced monitoring by the Board, implemented a reliable internal accounting system, and made significant progress in addressing key service quality issues arising from the audit report. Concerns of the regulator about the viability of the Association had been addressed and relations with key stakeholders were vastly improved. This briefly summarizes the key events surrounding the crisis of confidence at the Association and provides the framework for the subsequent discussion on the causes of the governance failures, with reflections on general inferences that can be drawn from the findings.

(TBC)

Discussion

While issues relating to confidentiality prohibit the discussion of key events at the Association in detail, a number of points can be noted to provide richer insights to the case and to identify weaknesses in the governance and control mechanisms of the organization. The executive management team, prior to
the personnel changes in late 2007, had been in place since the Association was founded, as had the majority of key members of the Board, including the long-acting Chairman. The auditing firm (a Chartered Accountant and Registered Auditor) tasked to undertake the annual external audit had likewise been under contract since inception of the Association. As far as it can be established through personal exchanges with Board members, the external auditor had at no time expressed concerns to the Board related to the financial statements, the serious deterioration in the Association’s financial health after 2003, or the breaches of loan covenants which had resulted in the repeated levying of fines by the principal lender. Direct contact between the auditor and the Board had been limited and audit report presentations to the Board were typically conducted in the presence of the CEO.

Boardroom meetings during, and immediately subsequent to, the official audit inspection on service quality made it clear that the incumbent executive management team displayed a lack of enthusiasm for recognizing the Association’s problems and the need to restructuring. This is not overly surprising, as concerns about personal liability alone would prevent most senior executives from admitting past mistakes of a material nature. Dissonance reduction (Festinger, 1957) typically acts as an additional barrier to an objective assessment by the individual responsible for decisions which lead to negative outcomes.

A more serious issue for the Association was the initial reluctance (prior to the release of the highly negative audit report) of a majority of Board members to
grasp and subsequently support the need for drastic changes. Board atmosphere had generally been characterized by a high level of familiarity, bonding, trust, and a sense of common objectives. Board meetings were dominated by the CEO and the Chairman. This was interpreted by the author of this study as a potential problem for effective governance. Initial concerns about the quality of Board monitoring were confirmed when subtle reservations about the financial health and overall direction of the Association were communicated to the author by individual Board members with an understanding that the CEO not be informed of such expressions of doubt.

Group cohesion can blind a group to flaws in executive management performance and result in poor group judgement and decision making (Janis, 1972, 1989; Marnet, 2008). The greater is group cohesion, the more prevalent are the problems related to group decision making, and the poorer tends to be the quality of decisions. This is reflected (and was observed on this particular Board) in pressure towards conformity and majority decision making, rationalization of decisions taken, deference to the group leader, and a general aversion to critically question decisions made by the CEO. Dominant senior managers have a particularly strong effect on the level of bias introduced to decision making on a Board (Lee et al., 2008). Governance of the Association was further undermined by the large size of the Board, with the negative impacts of this on communication and decision-making processes as noted in the literature, which finds a negative correlation between board size and performance of the organization (Yermack, 1996; Guest, 2009).
An inappropriate sense of security, trust and of being in control exposes the dangers of the narrative form of accountability, as questions which might be interpreted as criticising the CEO tend not to be raised. Respect for, and reliance on, the long acting Chairman had resulted in a broad sentiment of mutual trust among the Board, which contributed to the unwarranted confidence in the health and performance of the Association. Traditionally, the incumbent CEO and the Chairman had set the agenda of Board meetings and took a strong lead in directing the discussion. The vast number of majority decisions made by the Board followed the lead of the Chairman in agreement with the CEO. The locus of power was initially held by the CEO, with the Chairman as a close second. The negative outcome of the service quality audit and issues of the quality of the financial statements shifted the locus of power firmly and permanently onto the Chairman, who quickly emerged as a leader for change and enhanced governance during the crisis.

Directors are normally expected to possess a minimum level of competence, knowledge, and power to investigate matters of concern if they are to fulfil their duties appropriately. Specifically there is a perceived need for directors, particularly the independent directors, to possess an adequate knowledge base, whether pre-existing or as a result of search and evidential inquiry, to allow the formation of an independent opinion as to the quality of financial reporting and managerial performance. Further board members are expected to be sceptical and ask questions if they do not understand a transaction. Formal training for Board members at the Association was limited until after the restructuring when steps were undertaken to provide more training on key
issues relevant to the monitoring function of a Board. Most Board members had limited experience with financial and accounting data, the structure and value of financial statements, and financial risk management. In addition, there had been considerable uncertainty among members of the Board on the precise role, duties and powers of a Board. Internal audits had traditionally been performed by the finance team of the Association, under the direction of the CFO and the CEO. Board discussions ultimately found that the poor quality of financial reports from 2003 to mid-2007 contributed to the Board’s neglect of financial risk management and its general failure to identify operational and financial weaknesses of the Association. Insufficient technical knowledge and expertise do not, however, explain the observed lack of critical attitude at the Association. The level of technical knowledge required to monitor the performance at a housing association would appear to be relatively modest. What was required was a willingness to question the serious deviations from long term trends in the financial health of the organization and to demand answers for the drastic reversal in both the service quality and the financial accounts, which were noticeable if somewhat obscured by the poor quality of the financial documents and their presentation at board level.

The principal lender (unlike the Board) was aware that the Association frequently requested loans without giving the required notice – for which the Association was regularly charged penalty fees by the lender – but the lender was unaware (as was the Board) of the more serious breaches in minimum cash flow to debt service ratio covenants of existing loan agreements. Part of
the problem was the incomplete or imprecise nature of the financial statements presented to the Board and to the principal lender. After the Board regained a measure of oversight over the Association’s financial situation, the lender was informed of the poor quality of prior financial statements, with led to some interest penalties being imposed on the Association, but lender support was maintained after the organization’s status as a going concern was reaffirmed.

There lies a danger in placing too much trust in the formal accounts when discussions at board level fail to explore the spaces that exist between these two forms of control. Collier (2005) explores a contrast made earlier by Roberts (1991, 1996, 2001) between formal, hierarchical systems of accountability based on a calculative accounting, and an informal socializing form of accountability based on sense-making narrative supporting the former, threads of accountability also described by Ahrens (1996). Identified in these discussions are simultaneous limitations of calculative accounting grounded in traditional financial reporting and inadequacies of the socializing forms of accountability, and spaces in-between where governance and accountability can be problematic (Collier, 2005).

The need for an expansion to the prevailing regime dominated by calculative accountability was subsequently developed by Kamuf (2007) who calls for a re-articulation of accounts to allow a better appreciation and handling of uncertainty. It is the incalculable which may frequently be ignored and neglected in formal systems of accountability which assume the efficient
assessment of risk. While the financial reports of the Association were generally consistent with recommended practice (and without fail signed off by the external auditor), accounting reports remained silent or biased on important issues. This limited the value of the financial reports and partially obscured the true financial situation over a number of years. To the ultimate detriment of the Association, the shortcomings of financial accounts were not investigated to any extent during Board discussions.

The socializing form of accountability, by allowing information to be presented in a non-technical summary form, can add to the understanding of Board members of key organizational aspects, and is typical of boardroom interaction, including that observed at the Association. Informal boardroom dialogue can thus become an increasingly important driver of control by a Board (Parker, 2008). However, the value of the narrative as a control mechanism in top-level corporate governance crucially relies on the competence, integrity and judgement of executive management, the Chairman of the Board and dominant Board members. Trust in key individuals, issues of familiarity, and effects of boardroom socialisation, exposes the informal form of accountability to biases in perception and judgement. This is a particular problem where confidence in the integrity and experience of central Board figures is unwarranted. As such, bias may limit the potential of the sense-making narrative to identify the problems with the effectiveness of formal accounts.
This study’s findings support Peck’s (1995) observations of boards as passive recipients of information, who rarely challenge such material. Contrasting observations were made by Parker (2008) who found that directors took time for critical discussions. The present study reveals a mixed picture and provides evidence of a Board’s struggles with and towards accountability. The Association’s Board certainly went through a steep learning process as it changed from a mostly passive body, which relied on the integrity and adequacy of formal accounts, to one which took a much more active and probing role in monitoring and control issues. During these changes, the Board realized that the informal dialogue prior to the near collapse of the Association had been insufficient and flawed. The sense-making narrative had, in the main, provided the Board with misguided assurances of accountability, and thus contributed to a neglect of its responsibilities to stakeholders. By constantly relegating a serious discussion about accountability, responsibility and effective governance to the future, the Board had neglected to question its ability to account, to ask whether it was actually in a position to meet its control functions. The control function was only regained after the Board realized the need to dig into these spaces, to explore what it meant to be accountable and how this could be achieved, and by challenging the meaning and value of formal accounts.

Finally, Parker (2008) notes the importance of directors’ strategic orientation over information systems and formal reports (“Reporting systems to the board are therefore employed as adjuncts to rather than drivers of the board’s control processes,...” p. 85), which manifests itself in a dominance of the
boardroom debate in identifying corporate governance issues and asserting control. This emphasizes the key importance of board debate as a form of accountability. Highlighted in turn is the need to test for the validity of our beliefs on accountability and its correlations, if any, to responsibility. These two concepts are not interchangeable, and simple adherence to the formal requirements of accountability does not guarantee that responsibilities to stakeholders are being sufficiently met.

(TBC)

**Conclusion**

The described weaknesses of Board oversight are not unique to this organization and can be observed elsewhere in the not-for-profit and private sector (Gwilliam and Marnet, 2010). A particularly problematic issue was the uncritical attitude of Board members to presentations by the executive management which (with the benefit of hindsight) were deemed inadequate to allow proper monitoring, and to the cursory managerial explanations for such inadequacies on the few occasions when non-routine questions were asked by members of the Board either in regular meetings or during face-to-face encounters. The collegial, consensus-seeking atmosphere of Board meetings, trust in, and familiarity with the leadership, limited critical discussion and led to an over-reliance on the calculative form of accountability, which contributed to the failure of the Board to act as a gatekeeper (Coffee, 2003).

Misplaced confidence in the Association’s CEO and its Chairman had resulted in a situation where calculative accounting had most evidently fallen short to
satisfy the accountability needs of the Association. At the same time, the socializing sense-making narrative had failed to investigate ambiguities or shortcomings in the formal accounts. Trust in the competence and integrity of senior management and key members of the Board, and over-confidence in the adequacy of established control practices combined to give the Board a false sense of security over purpose, direction and health of the Association. Questions that may have allowed identification of problems at an earlier time remained unasked until the dire state of affairs of the Association became a matter of public record.

(TBC)

References

(TBC)


