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# Can Bad Culture Kill a Firm?

By Stephen W. Hiemstra

## CAN BAD CULTURE KILL A FIRM?

Clearly. Weak cultures leave firms exposed to risks that had previously been assessed and mitigated. In my previous article, I illustrated this problem by showing how market and organizational changes have undermined risk management decisions. In this article, I analyze how cultural influences can impede learning and weaken risk management.

## DECISION COSTS INFLUENCE CULTURE

Nobel laureate economist Herbert Simon defined rationality as making a choice among all possible alternatives. Economists more generally hypothesize that the firm strives to maximize its net present value assuming perfect knowledge of all future cash flows. Because all decisions are rational and predictable given knowledge about technology and market prices, this theory implies that a firm has no culture.

In practice, we observe that decisions are costly, resources are limited, and decisions are frequently made based on rules of thumb and habit. For these reasons, in part, Simon extended the theory of the firm to limit rational behavior—his theory of bounded rationality (Simon 1997, 88).

**What is culture?** Culture arises because highly rational decisions are costly. Managers ration their time by applying rules of thumb based on previous decisions. These rules of thumb plus manager training and experience determine a firm's decision culture. Interestingly, the more costly rational decisions are, the stronger the cultural effect.

The existence of culture implies that history is interesting. The time sequence of decisions and their consequences predisposes the organization toward some growth paths and away from others. The personal histories of leaders are important in understanding attitudes about alternatives and the speed at which decisions are made.

**Cultural Types.** The existence of culture suggests why organizations develop classifiable personalities. Chart 1 outlines several widely observed types. Criteria describing these types include preferred decision style, key values, primary mode for training, nature of control process, and default transaction-opportunity cost trade-off.

A culture articulates key values in terms of where decisions ideally take place. A modern culture delegates authorities to line managers because good decisions require the objective information they produce. A postmodern culture shares decision authority to assure that decisions are equitable. A traditional culture centralizes many decisions to adhere to senior management preferences. Training and control processes reinforce these cultural preferences.

A dying organization is an organization in crisis. A dying organization may start with any affinity but evolves toward traditional culture. This is because crises consist of a rapid series of nonstandard problems that exceed delegations and require senior management input. Cutbacks likewise strengthen the position of senior managers.



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### NOTE:

Dr. Hiemstra is an economist and financial engineer living in Centreville, Virginia. In 2007 and 2008, he served on the program committee for the Enterprise Risk Management Symposium. For more details about the ERM Symposium, see: [www.ERMSymposium.org](http://www.ERMSymposium.org). Dr. Hiemstra contributed to research of the Enterprise Risk Management Institute International (see references). Part one of this series, *Can Bad Culture Kill a Firm?*, appeared in the December 2008 edition of *Risk Management Newsletter*.

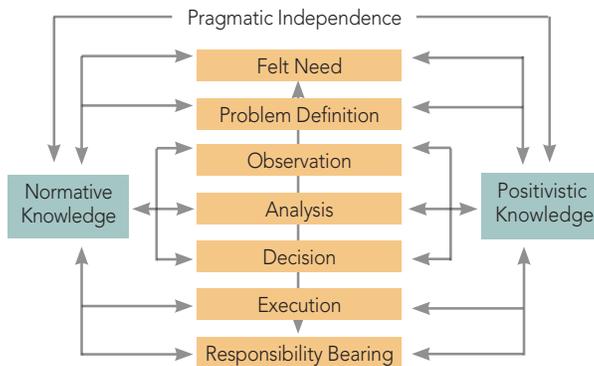
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**Chart 1: Corporate Cultural Types**

Culture	Decisions	Key Value	Primary Training	Control Processes	Transaction/Opportunity
Modern	Line Managers	Objectivity	Formal	Formal	M/L
Postmodern	Consensus	Equity	Formal and OTJ	Informal	H/M
Traditional	Senior Managers	Loyalty	OTJ	Discretion	L/H
Dying	Any of the above under pressure				

Transaction cost = overhead cost of doing business, Opportunity cost = costs of foregone opportunities, OTJ = On the job, L = Low, M = Medium, H = High

**Chart 2: Steps in Problem Solving and The Knowledge Used**



Sources: 1 Glenn L. Johnson, 1986. *Research Methodology for Economists*, MacMillan Publishing Company, New York. P. 15. 2. John Dewey. 1997. *How We Think*. Dover Publications, Inc. Mineola, NY.P.12.

The mix of transaction costs and opportunity costs also reflects cultural affinities. Transaction costs rise with the number of people participating in decisions, while opportunity costs rise as decision alternatives are excluded. The traditional culture has the lowest transaction costs because it considers the fewest options—only senior manager preferences are consulted. The postmodern culture consults the most people, but it is not particularly reflective—only options actively advocated are considered. Transaction costs in the modern culture fall between these two extremes, but the modern culture prefers a review of all options.

Williamson (1981, 1564) sees both organizational costs constrained by market prices. The implication is that cultures evolve to reflect competitive conditions in the markets that firms serve. The dominant culture type may evolve with both market pressures and leadership changes, which may over time lead to overlapping cultural attributes. An office evolving from a modern to a postmodern type, for example, may begin to exhibit more group decision making, place less emphasis on academic credentials in assignments and promotions and rely less on peer review of work products.

**BEHAVIORAL WEAKNESSES IMPEDE LEARNING**

Cultural types describe key attributes at a point in time. Changing circumstances, however, force organizations to learn and adapt. Learning behavior is therefore a key measure of risk management performance.

“Even though models epitomize rational decision making, models are cultural artifacts fixed in time and place.”

How does bad culture evolve? We observe behavior problems when incentive structures disrupt normal learning processes, create logical traps or exacerbate normal organizational inertia.

**Rational Learning.** A prominent rational decision process is the scientific method that combines learning and decision making into a process for solving nonstandard problems. Steps include: a felt need, problem definition, observation, analysis, decision, execution and responsibility bearing (Chart 2). Because this process is costly, the firm rations the number of decisions that employ this process.

**Behavioral Decision Making.** Rule-based decisions match current environmental states to prior decisions. This matching process can be formal, as in the promulgation of a law, or informal, as in the case of managerial application of experience. This decision process satisfies the conditions of behavioral learning.<sup>2</sup>

The most prominent behavioral learning process in psychology—stimulus-response theory—operates in a similar fashion. Actions (like matching to a rule with a positive result) involving a positive stimulus (+) attract further action, while actions (like matching a rule with a negative outcome) involving a negative stimulus (-) provoke avoidance (Cross and Guyer 1980, 9). We learn by repeating actions following positive stimuli and avoiding actions following negative stimuli.

**Learning Surprises.** A learning surprise occurs when long strings of positive stimuli are followed by negative stimuli (+++++), or if long strings of negative stimuli are followed by positive stimuli (-----+). Cross and Guyer (1980, 4) refer to this problem as a social trap—a situation defined as having *multiple but conflicting rewards*. Such patterns disrupt behavioral learning and suggest why habits may be a poor guide in making important decisions. Smoking, gambling behavior, drug addiction and marital cheating have an incentive structure with long strings of

positive stimuli followed by negative stimuli (short-term pleasure leads to long-term pain). Higher education, research and investment decisions have the opposite pattern: a long string of negative stimuli (cash outlays, lost income and hard work) followed by positive stimuli (increased status, power and income).

**Organizational Inertia.** Inertia is the physical property expressed in Sir Isaac Newton’s first law of motion: a body at rest tends to stay at rest, and a body in motion tends to stay in motion.<sup>3</sup> Inertia leads organizations to resist change and discount low-probability events.

An organizational culture mirrors its environment because decisions and rules evolve over time to deal with environmental challenges. Rewards of money, power and status within an organization accrue to leaders that facilitate this evolution. When prior decisions and rules need to change, a conflict arises because those changes may threaten the social position of those leaders.

Consider the case of a firm in a growing business. Suppose the firm starts out as a specialized firm in a competitive market. As it grows and acquires competitors, it takes market prices as given. As market share grows, however, it eventually becomes the market and can set price. Further growth requires that it diversify into new markets. At each stage in the firm’s growth, the rules for success and risks change (Porter 1980, 191-295). If the organizational culture adapts with a lag and a threat grows quickly enough, firm solvency could be threatened before adaptation is complete.

**Example of a Learning Trap.** Cultural factors dominate behavior even in a financial modeling shop because a model summarizes firm practices and market processes captured in the data history. Even though models epitomize rational decision making, models are cultural artifacts fixed in time and place.

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#### FOOTNOTES:

<sup>2</sup> The logic implied here is metaphorical. The syllogism is: the world is like X. Therefore, the last time X happened, we did Y and things worked out fine. The key to model use is making sure that a close match exists between the previous world condition and X. This is the basic logic behind most economic modeling. [http://en.wikipedia.org/wiki/Newton's\\_laws\\_of\\_motion](http://en.wikipedia.org/wiki/Newton's_laws_of_motion).

<sup>3</sup> [http://en.wikipedia.org/wiki/Newton's\\_laws\\_of\\_motion](http://en.wikipedia.org/wiki/Newton's_laws_of_motion).

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Rational choice theory presumes that the firm computes expected loss (probably of loss event times the expected loss given the event) before deciding how to respond. If managers outside the modeling team assume historical (unconditioned) relative frequencies of loss that are tiny, further analysis will always appear extravagant until a consensus develops that more recent forecasts show higher probabilities. A natural gap can accordingly arise between conditioned and unconditional views of the probability of loss. The higher the cost of acquiring new information and the more organization inertia marshaled behind the old view, the larger the gap that may arise.

## RISK MANAGEMENT PERFORMANCE

Good enterprise risk management (ERM) balances rational choices while attending to cultural challenges. Attributes of good ERM include:

- The whole firm is considered (holistic characteristic).
- Share profits and losses equitably across stakeholders (equitable ethics characteristic).
- Peers are encouraged to provide positive leadership (intensive management characteristic).
- Risk taking is separated from risk management (objective assessment characteristic).
- Risk management is a key corporate value, second only to profit maximization (postmodern characteristic).

If ERM is incorporated into decisions at all levels of the organization, the effect of focusing on ERM is to narrow the gap between new and historical risk perceptions. What is your firm's appetite? The assumption here is that a firm accustomed to assessing risks against an internal risk target adapts more readily to a changing risk environment than a firm whose default response is to focus on other things. ♦

## REFERENCES:

- <sup>1</sup> Cross, John G. and Melvin J. Guyer. 1980. *Social Traps*. Ann Arbor, Mich.: University of Michigan Press.
- <sup>2</sup> Hiemstra, Stephen W. 2007. *An Enterprise Risk Management View of Financial Supervision*. [www.ermii.org/Research/Research\\_ndx.html](http://www.ermii.org/Research/Research_ndx.html).
- <sup>3</sup> Porter, Michael E. 1980. *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. New York: Free Press.
- <sup>4</sup> Simon, Herbert A. 1997. *Administrative Behavior: A Study of Decision-Making Processes in Administrative Organizations*. Fourth Edition. New York: Free Press. (Orig. pub. 1945.)
- <sup>5</sup> Williamson, Oliver. 1981. *The Modern Corporation: Origin, Evolution, Attributes*. *Journal of Economic Literature*. December, pp. 1537-68.

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