Trust: The critical factor in theory and practice, from banks to cakes

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Abstract

This paper suggests that due to the incidence of leadership behaviours that are detrimental to many organisational stakeholders', more should be done in terms of corporate governance and auditing to address this. For stakeholders (such as pensioners, employees, and creditors) their relationship with organisational leaders is built on implicit trust. Any damage to that trust can have catastrophic repercussions for many stakeholders, be it emotional through stress or financial. Agency Theory provides a rationale for a basis on which trust can be broken. Rebuilding trust can be a herculean task, so it is important to seek ways in which any potential risk to trust can be avoided. Good governance practice is essential in the quest to maintain trust and protect stakeholders. Tighter guidelines for the content of Annual Reports, more insightful information on the skills, background, and behaviours of organisation leaders, and the use of forensic accounting techniques in the preparation of Audit reports will all facilitate maintaining trust and avoiding risks.

Introduction

'Trust in business has not improved over the past year either amongst the informed public or amongst the general public. Accordingly, there is much still to be done.'[1] This is an opening statement in the Executive Summary from the recent FRC Annual Review of Corporate Governance and Reporting, and outlines the problem which this research paper is seeking to address, namely diminishing trust in business leadership. In 2017/2018 several high profile business collapses occurred including Palmer and Harvey (Garrow & Awolowo, 2018), Patisserie Valerie, and Carillion, which came as surprises to many stakeholders; more recently weakening UK based businesses include Arcadia and Kier.

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[1] Financial Reporting Council, Annual Review of Corporate Governance and Reporting 2017/2018, pg 1.

The Patisserie Valerie collapse was discussed by its Chairman (Luke Johnson) in a recent newspaper article[2] in which he reflected that for 'many corporate failures - the demise of Debenhams or the decline of Thomas Cook - you could see them coming'. In the case of his own business he stated that 'the downfall was horribly rapid and unexpected'. Some of the blame for this failure was assigned by Johnson to his auditors, Grant Thornton, for not spotting what was occurring. It would seem from his article that he could spot the likely demise of other businesses, but not his own, and that the demise was the fault of third parties, such as the auditors, with him taking little or no responsibility for what occurred.

The Johnson article on Patisserie Valerie is quite revealing, indicating as it does the potential impact of poor leadership, the emphasis on 'self' by the business leader, and an apparent lack of ownership of what is occurring in the business and failure to address issues of trust between stakeholders.

The problem to address, therefore, is how to rebuild stakeholder trust in business, to understand why trust is deteriorating (and what are the drivers of deteriorating trust), and how trust might be regained.

Leadership Behaviours

This paper suggests that due to the incidence of leadership behaviours that are detrimental to many organisational stakeholders', more should be done in terms of corporate governance and auditing to address this. For stakeholders (such as pensioners, staff, and creditors) their relationship with organisational leaders is built on implicit trust. Any damage to that trust can have catastrophic repercussions for many stakeholders, be it emotional through stress[3] or financial. Agency Theory (Jensen & Meckling, 1976; Eisenhardt, 1989) provides a rationale for a basis on which trust can be broken. Rebuilding trust can be a herculean task, so it is important to seek ways in which any potential risk to trust can be avoided. Good governance practice is essential in the quest to maintain trust and protect stakeholders as indicated in the Financial Reporting Council report (Council October 2018).

Tighter guidelines for the content of Annual Reports, more insightful information on the skills, background, and behaviours of organisation leaders, and the use of forensic accounting techniques in the preparation of Audit reports will all facilitate maintaining trust and avoiding risks.

Research Project

This paper is proposing a three stage research program. The first is a study on trust and relationships in banking. The second involves an analysis of forensic accounting as an approach to enhance auditing. The third develops a series of case studies of firms who have been in financial distress.

In a recently completed study (soon to be published) looking at what effectiveness in a relationship entails and how changes in trust affect relationships involving retail banks and their primary regulators (at the time of the Global Financial Crisis, GFC) a line of enquiry focused on understanding how changes in bank circumstances impacted on regulatory

[2] The Sunday Times Business and Money section, June 9, 2019, pg5.
[3] The Sunday Times Business and Money section, June 9, 2019, pg5.

relationships. Trust between the parties evaporated as issue after issue emerged, and the regulatory relationship deteriorated and fell into disarray as a result. The impact of shifts in the regulatory relationship, were swift and significant. The interactions became request and comply in nature, trust became distrust resulting in inquisition rather than enquiry and rules were enforced with timelines for achievement imposed.

That research surfaced the implications of failing to consider that essentially a relationship is fundamentally driven by human decision making, interactions, emotions, feelings, instinct and bias to capture a few. These are malleable characteristics, which if not paid due attention can and have presented significant implications for organisations. The suggestion being that relationships need to actively recognise, understand and manage this dynamic during their interactions. In addition, that research considers how dramatic recent events from the GFC have demonstrated the importance of ensuring that the most powerful and influential leaders in organisations can build positive regulatory relationships. The dramatic effect leaders can have on the views emerging in the regulatory process demonstrates a suggested need for greater on-going assessment by Boards and Shareholders in the selection and governance of their top personnel and their leadership styles.

Beyond the scale issues of the banking organisations and their approach to the regulatory relationships, the senior actors that emerged as a result of the crisis also stood accused of alleged traits which attracted the distain of politicians and the general public. Who can forget names such as Fred Goodwin (Martin, 2014) and Andy Hornby (Perman, 2013), who hit the headlines for a variety of reasons but had one alleged common trait? Their management of their respective organisations had been deficient in the assessment of the stakeholder groups, leaving the organisations vulnerable to the changing economic environment (e.g., each suffering daily headlines of claims of mismanagement).

Fred Goodwin had his approach to the rapid growth of the Royal Bank of Scotland (RBS) questioned, getting much of the blame for the collapse of the bank, in particular its share price. 'He was even named as 'the world's worst banker' by Newsweek magazine. 'He aced every requirement for a hubristic CEO" (Martin, 2014, p. 284). Andy Hornby saw his leadership of the Halifax Bank of Scotland group (HBOS) challenged as its funding model came under pressure as the crisis unfolded; a situation which resulted in the takeover of HBOS by Lloyds TSB, following which the Lloyds Banking Group reported HBOS had sustained a £10.8bn loss in 2008, which 'was a final nail in the coffins of the reputations of Hornby' and a number of his colleagues (Perman, 2013, p. 173).

In Making It Happen (Martin, 2014), a member of the management throughout the RBS crisis period was quoted as saying: 'When you write this book you must tell everything you can about Fred because he has so much to answer for…..But there is a lot more to it than that. We on the management team should have stopped him. We failed. I failed. Where was the Board of Directors? Where were the big shareholders? Where were the regulators? Where were the auditors? Where were the government?'.

Leadership Behaviours Affecting Trust

The presence of dominant leaders in business is not new (and not always connected with deleterious behaviours and performance); but a failure to challenge, monitor, and manage these individuals is something that has not seen much progress such that the avoidance of disastrous consequences for stakeholders, particularly the most vulnerable, can be avoided. Explanations of leadership behaviours can take many forms including Hubris Syndrome (disorder of the possession of power…held for a period of years and with minimal constraint on the leader) and Hubris (impetuosity, a refusal to listen to or accept advice and a particular form of incompetence when impulsivity, recklessness and frequent in-attention to detail predominate. This can result in disastrous leadership and cause damage on a large scale) (Owen & Davidson, 2009).

Garrow (2012, p.57) notes Keynes' observations on the influence of 'animal spirits' in The General Theory (Keynes, 1936). We cannot expect that all decisions will be based on a rational and formulaic calculation of possible outcomes, but as the GFC crisis demonstrated, the extent to which powerful individuals make decisions that prove terminal for their organisations attracts significant investigation, to use the words of Keynes, *"drawn out over many days to come"*.

The food sector has seen its share of poor performances which may be associated with leadership behaviours such as Palmer & Harvey (Garrow & Awolowo, 2018) and more recently Patisserie Valerie. Shortcomings of governance were highlighted in the case of Palmer & Harvey by Frank Field, Chairman of the House of Commons work and pensions committee, who wrote to P&H Pension Trustees Ltd. seeking clarification on the current surplus/deficit of the P&H pension scheme, and what is the evidence of the Trustees challenging the company over its dividend policy, and how have the trustees communicated with scheme members to keep them informed? (Garrow, et al., 2019)

FRC Report

The Financial Reporting Council (FRC) published in December 2017 "Proposed Revisions to the UK Corporate Governance Code"[4]. In their Executive Summary, the FRC stated that "In some high-profile cases the quality of governance has been poor" and they also stated that "Now is the right time to undertake a comprehensive review to ensure that the Code remains fit for purpose and continue to promote improvement in the quality of governance" (Garrow & Awolowo, 2018). As if to highlight shortcomings in governance practice, Frank Field's question to Palmer & Harvey trustees referred to earlier could be broadened as follows: what is the evidence of the Board challenging the management over its policies and strategies? What protection did employees, pensioners, creditors have, and what should they have had, and should rightfully expect to have? (Garrow, et al., 2019).

Weaknesses in the quality of reporting are frequently mentioned in the FRC report. In Provision One of the Code they ask Boards 'to describe how opportunities and risks to the future success of the business have been considered and addressed, the sustainability of the company's business model and how its governance contributes to the delivery of its strategy' (Council October 2018 pg 4).

Forensic Accounting: Part of the Solution?

Awolowo et al (2018) positioned forensic accounting as a viable option for reducing accounting scandals in this age of an information revolution and globalization. They argued that this can complement corporate governance mechanisms by enhancing audit quality. They utilized agency theory and the fraud triangle theory as their point of departure in building their argument for forensic accounting. 'The line of reasoning of agency theory follows from the

[4] UK Corporate Governance Code, 2016

economic models that argue people are only motivated by self-interest and self-preservation. In other words, the underlying agency theory is a set of behavioural assumptions about the agent. The assumptions hold that all agents are unconstrained self-interest maximisers who do not act in the best interest of their principal' (Awolowo, et al., 2018).

As well as adopting more of a forensic accounting approach to business reporting and analysis, this paper proposes that Annual Reports should comprise meaningful information on the senior management team (including Board of Directors) which enables stakeholders to gain insights on the managerial traits of those leaders. Senior management staff profile information could be provided, and employee and supplier satisfaction surveys could be conducted with the intention of red flagging any potential behaviours or practices which could be deleterious to the organisation.

Concluding Remarks

Greater transparency and the building of trust between stakeholder groups are at the heart of this paper in the context of a considerable number of organisation failures which have not only been a complete surprise to stakeholders, but also bring very significant financial pain to those stakeholders.

In the world of financial services where the business model is one of inherent risk, stability and consistency of organisational performance is a crucial ingredient as evidenced by the recent crisis.

Trust, built on a foundation of openness and transparency, is suggested as a central pillar in any relationship, from selling financial services to selling cakes. Detrimental dominant leadership styles need to be avoided or subject to rigorous governance practice, with new reporting requirements to facilitate greater understanding by stakeholders of potentially deleterious behaviours.

This paper proposes a 3-part study to address the issues of trust in business leadership encompassing banking practice, forensic accounting approaches, and case study analysis.

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