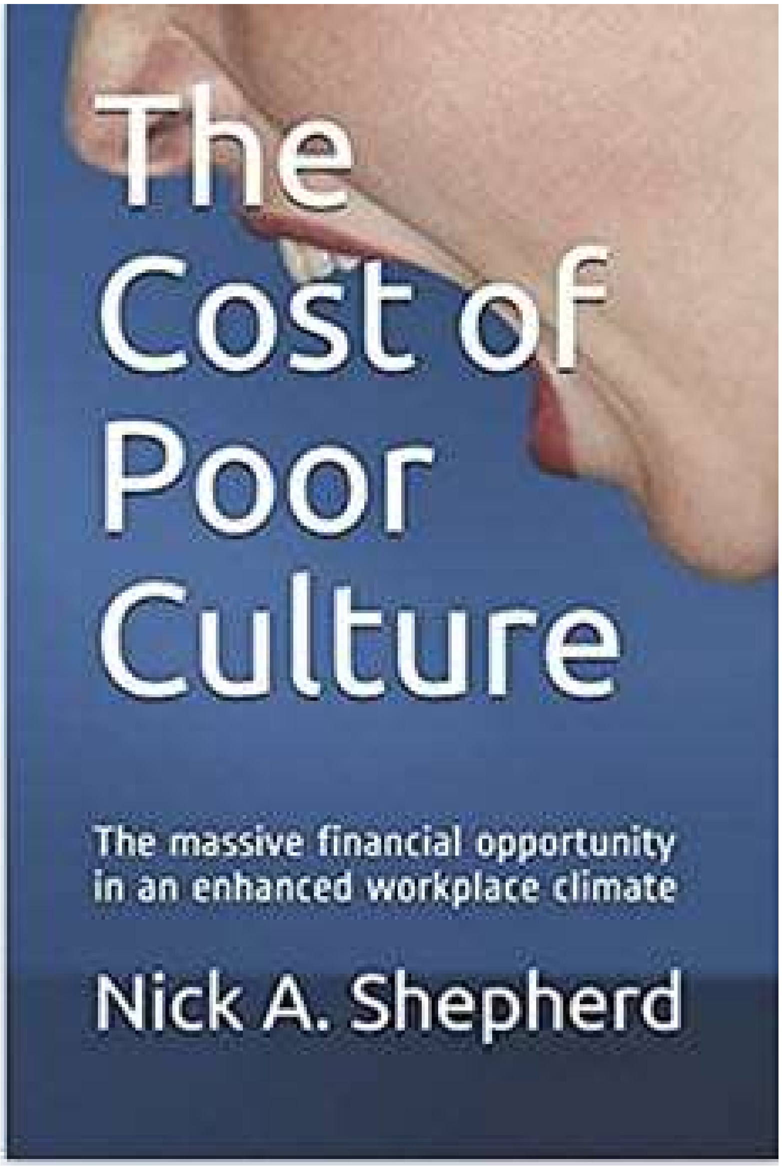
The Cost of Poor Culture
The massive financial opportunity in an enhanced workplace climate
Nick A. Shepherd

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Notice to reader.

This document contains extracts from the original book “The Cost of Poor Culture.” The two chapters included here are:

Original Chapter 1 Executive overview
This provides the reader with a short summary of the purpose and contents of the book.

Original Chapter 3 Where are the costs of poor culture hiding?
This chapter shows the three categories of waste - financial surprises, buried costs and lost opportunities. Traditional accounting and financial reporting provide very little insight into this consumption of financial resources that reduces performance and depletes value

Nick A. Shepherd, Author.

1 Executive summary

Many years ago, Dr. Joseph Juran, a pioneer in quality management, referred to the “cost of quality” as the “hidden gold in the mine.” Organizations that heeded his advice and started to investigate the costs of poor quality, soon realized that there was much more to effective quality management than meeting specifications and keeping customers happy. It was about saving money and improving profits.

Today the focus has shifted to the critical importance of human resources as a competitive advantage. Yet, for many organizations, their HR focus is failing to deliver the opportunities that exist. There is, once again, “gold in the mine” – but now, it is the hidden costs of poor culture. While leaders focus on developing human resource (HR) metrics, few organizations link this focus on people and relationships, with the financial impacts and benefits that would result.

The costs of poor culture exist in three aspects of organizational performance, most of which are invisible. First, there are the financial surprises. These can be fines, penalties and losses that occur when unplanned or unexpected behavior creates an unexpected financial impact. Financial surprises are the unseen risk of poor culture.

Next are the hidden costs. Buried within existing financial expenses can be major costs reflecting disengaged employees and dysfunctional relationships: the impact of poor leadership and relationships internally; a lack of understanding of corporate purpose; a failure to understand behavioral expectations around collaboration, and cooperation; poor communications; external relationships built on win / lose rather than mutually sought benefits and improvements; and actions by employees that harm the brand, reputation, and loyalty. Many of these are buried in annual operating costs. What do these amount to? How much benefit could an improved culture deliver to bottom line performance?

Then there are the lost opportunities: suggested improvements by employees that have been ignored, or the failure to base customer or supplier relationships on mutual long-term benefit. There is no magic in continuous improvement, which can only come from an engaged, interested, and committed workforce.

Yet the benefits go way beyond surprises, hidden costs, and lost opportunities. Many organizations are spending massive amounts of money, investing in intangibles, including the workforce. These costs are seen as an investment in the future. Yet traditional financial reporting not only fails to identify these investments, but it also fails to recognize them as assets that are contributing to the value of the business. While the human resources sector is developing metrics for integrated reporting, the financial impact of effective HR management – underpinned by a positive culture – remains hidden.

This book is based on the author's knowledge and involvement in the cost of poor quality, both from spending some time as Chair of the Quality Costs Committee of the American Society of Quality, and as a workshop facilitator and consultant. This experience has been used to develop a similar framework for understanding the costs of poor culture (COPC); while the approach is not an exact science, it defines a framework and thinking process for identifying the hidden costs and follows this with a suggested implementation plan. The book also provides links to the developing ISO standards on human resource management, in particular the guidelines and technical specifications on HR metrics. It also links with the concept of integrated reporting.

To provide a context for the importance of organizational culture, the early chapters describe the evolution from a tangibles-based business model to one where intangibles are the prime drivers of value creation. This information can also provide a bridge to the author's book *Corporate Culture – Combining Purpose and Values*.

As we enter a new world, in which organizations must transition to become increasingly people-centric, this book illustrates that corporate culture is a critical success factor for corporate strategy, which must start at the highest levels and permeate every aspect of an organization's behavior. The benefits are not just to be a better corporate citizen, but to build an enhanced, higher performing, and sustainable enterprise.

2 What is the problem?

3 Where are the costs of poor culture hiding?

The evolution in business and the changing importance of human behaviors might – or probably should – raise fear in the hearts of accountants, investors, and boards of directors: There are all sorts of different and possibly irrational people out there, who all think differently and are making day-to-day decisions in their organizations – especially since these behavioral aspects apply equally to senior managers and "C-suite" executives! No wonder that culture is becoming recognized as something that is important in organizational performance. The important question though is: Does it really matter?

There are three key risks that impact financial performance related to poor culture (or lower level of maturity) – the problem is that in almost all situations, current financial reporting does a poor job of highlighting such risks, and when they are reflected, it often occurs after the event. These risks are:

- **Financial surprises** Unanticipated impacts on financial performance that occur due to control failures and unanticipated behavior (examples would be legal and regulatory fines and penalties, as well as negative impacts in areas such as brand and reputation).
- **Buried costs** The impacts of lower or poor financial performance that come from restraints on value creation, that result in lower output, higher costs, lower revenues and lower quality of products and services.

- **Lost opportunities** to enhance value, which come from opportunities to increase output, lower costs, increase revenues and enhance quality.

Financial surprises are typically unanticipated, have a negative impact on earnings, and will usually reduce organizational value. In the second situation, buried impacts caused by “sub-optimization” are often not visible, as the higher operating costs are buried within the existing expenses. While performance benchmarking might indicate an opportunity for improvement, the excess costs are not clearly reported or understood – it’s just “what it is.” Often, as a result of these perceived excess costs, organizations resort to short-term cost-cutting measures like layoffs, which might have short-term benefits but, in the longer term, do little to enhance cultural maturity; such measures deplete intangible value, often causing deterioration in employee morale and other areas such as client and supplier relationships. These then further reduce morale and motivation to create a “vicious circle.”

The third area of lost opportunity is the most strategically critical. Most organizations develop performance improvement budgets but rarely is the question asked, - how much better could performance be if everything and everyone was operating as a fully effective, aligned, and holistic system?

It is interesting that when the **Cost of Poor Quality (COPQ)** was developed as an approach to understanding the impact of poor quality on financial performance, a definition was developed[1] and is still used today. This provides the basis for understanding the question above as it applied at the time to the goal of increased quality and reads as follows:

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[1] From: *Principles of Quality Costs* (1999), *3rd* edition. Jack Campanella and ASQ Quality Costs Committee, Quality Press.

Definition

Total quality costs represent the difference between the actual cost of a product or service and what the reduced cost would be if there were no possibility of sub-standard service, failure of products, or defects in their manufacture.

Whole-system proponents have been exploring optimum performance for years; the **Theory of Constraints (TOC)** was one such approach that demonstrated the potential improvements available from those who had moved to a more "systems thinking" framework[2]:

On time delivery	↑	**60%**
Revenues increases	↑	68%
Profit increases	↑	82%
Inventory reduction	↓	50%
Cycle time reduction	↓	66%

This holistic or whole-system thinking is core to corporate culture and organizational maturity and, as will be demonstrated, can significantly reduce **organizational risk**, and enhance **operating performance**. These two factors combined enhance organizational competitiveness, increase competitive advantage, and reduce risk (thus enhancing sustainability).

3.1 Financial surprises

This category involves actions that take place that were unexpected and will typically have a negative financial impact on the organization. First some boundaries: this segment will not discuss private, owner-operated

[2] Quick guide to Theory of Constraints http://www.tocinstitute.org/theory-of-constraints.html

organizations, or those that may have a large portion of private ownership even if they are publicly listed. In such cases, the behavior will typically be the result of the values of the person running the organization. If that person is prepared to act illegally or unethically, then they will make that decision and there will only be the regulatory or legal system to stop them.

Examples might include scandals such as that concerning Bernie Madoff (2008), The Satyam Scandal, involving founder Ramalinga Raju (2009), Waste Management, involving founder Dean L. Buntrock (1998), and the Livent founder, Garth Drabinsky (between about 2001 and 2013). The poor, unsuspecting external investors might have had difficulty influencing the actions, penalties, and collapses in these cases.

The broader issue is where these events and surprises occur in widely held, publicly traded organizations, in which the system of governance should protect against illegal or unethical actions. One might assume, in these cases, that the events came as a surprise to those responsible. They may have occurred with board knowledge of the risk, or by management acting on its own authority or by individuals or small groups acting alone.

Financial surprises can be looked at in two groups – those caused by individual action, and those caused by the organization as a whole. Individual actions leading to surprises would include those of Nick Leeson at Barings Bank in 1995, which resulted in the bank's collapse.

This was a classic case where inattention to culture increased the risk of financial problems; if people are left to their own "devices" with little or no guidance (and poor oversight / governance) then results will be unpredictable! There is a great quote on the University of Essex website that provides a history of scandals and frauds[3] :

[3] https://projects.exeter.ac.uk/RDavies/arian/scandals/classic.html

> "Bankers who hire money hungry geniuses should not always express surprise and amazement when some of them turn around with brilliant, creative, and illegal means of making money."
>
> *The quotation is from a speech by the financial thriller writer Linda Davies, on "The Psychology of Risk, Speculation and Fraud", at a conference on EMU in Amsterdam.*

It appears that, even before he arrived in Singapore, the risk existed; Nick Leeson was "less than honest[4]" when applying for his broker's license. There have been several other cases of rogue traders acting alone in the financial services industry. These might be considered "control" surprises, but what about the larger corporate surprises?

Publicly available data reveal that, in the USA, penalties and fines imposed on organizations over the last 20 years have exceeded $490 billion; that is $490 billion charged for anything from safety violations to illegal acts, lack of protection of privacy, fraud, and many others.

It would be unfair to generalize about these unplanned charges – in fact, some may be the result of management decisions to accept certain levels of risk, so that when an unplanned incident occurs, paying the fine is part of the cost of doing business. The table below lists the top six in total penalties imposed:

[4] Scott, Hal S., 2006. *International Finance: Transactions, Policy, and Regulation*. Foundation Press.

Parent organization	Cumulative cost in $ billions
Bank of America	$82.764
JPMorgan Chase	$35.819
BP	$29.197
Citigroup	$25.454
Volkswagen	$23.780
Wells Fargo	$21.359

Probably one of the most obvious costs relative to poor culture is demonstrated by the financial meltdown between 2008 and 2010, which caused the near collapse of the financial services industry; it can be seen from the table above that banks and other financial services organizations suffered heavily from fines imposed in the years following these problems. But this was not the only problem.

Wells Fargo arrived at a $3 billion settlement in 2020[5] for offences that apparently occurred between 2002 and 2016 related to the opening of fraudulent accounts. This was a widely publicized event and had a significant impact on both the firm's reputation, value and, of course, finances!

This last example may well have been a situation caused by people doing what they thought to be acceptable. They were, after all opening these accounts based on "direction" imposed by quotas and managed by those in leadership positions. Was such illegal and unethical conduct acceptable to meet quotas?

Another example on the list is Volkswagen; many will remember this scandal, often referred to as Dieselgate, in which fuel consumption / mileage claims were generated incorrectly. Could it be that, in this situation, the engineers working in the company thought they were doing

[5] See NY Times and other reports

the right thing and finding a way to meet the fuel consumption requirements? Did senior leadership even know about it? Why didn't anybody blow the whistle? What type of culture allowed this to be done?

While one can concentrate on the large number that hits the headlines, this does not tell the whole story. The top six organizations in the list account for almost 40% of the total $490 billion, yet using the data available from Violation Tracker[6], it can also be seen that there were over 480,000 individual fines and violations.

Parent organization	Cumulative cost in $ billions	# of items	Average fine or penalty
Bank of America	$82.764	219	$377.9M
Volkswagen	$23.780	57	$424.6M
Wells Fargo	$21.359	182	$117.4M
Canadian National Railways (CNR)	$0.014	559	$25,856
Union Pacific	$0.183	3,298	$55,486

For Volkswagen, three of the offences (related to Dieselgate) account for over 90% of their total fines and penalties; could this suggest that the overall governance is good but that the fuel economy lapse was more of a one-off problem? In the cases of Wells Fargo and Bank of America, the average fines are extremely high, and the number of offences is almost the same, but the average cost is lower. Does this suggest that Wells Fargo is relatively better than Bank of America?

Looking at a totally different industry, we can see that the railroads seem to have much lower average fines, although, upon investigation, it seems that almost all the events are safety-related, and the fines are much smaller. Does this tell us anything about either CNR or Union Pacific? Are these maybe the acceptable costs of doing business? However, might this contravene a safety-based culture, which is what both railroad companies

[6] See https://violationtracker.goodjobsfirst.org/parent-totals

are very conscious of? The fact is that ALL these events were unplanned, or if planned then clearly illegal and/or unethical. Were they sanctioned?

To these costs, particularly in financial services, can be added the prior societal impact of bailouts from various national governments; in the USA alone, the official number was about $700 billion, but broader-based assessments[7] put the numbers much higher, with $4.6 trillion paid out and a total commitment that can be up to $16.8 trillion. There would also be societal costs associated with areas such as health and safety impacts.

While it is a smaller amount, GM was fined $1 million by the Securities and Exchange Commission (SEC) over ignition switch problems that apparently killed at least 124 people (small price to pay!) on top of at least $595 million that the company paid out to victims[8]. The CEOs' responses to these fines are interesting: GM's CEO, Mary Barra, told the House Energy and Commerce Subcommittees she was aiming "*…to correct a culture that has displayed a pattern of incompetence and neglect*." This links the problem right back to behavior, but doesn't it seem to leave hanging the role of leadership? Why did people act in a way that was either unethical or illegal?

The key point in the sorts of prosecutions detailed above might be less the impact of the fines and penalties and more the damage that the conduct had on "social capital," that is, the relationships with employees and the sort of conduct they saw as acceptable. In many cases, the levels of fines amounted to a small proportion of income. (A detailed analysis was not performed because the dates of the various events, the delays and challenges of prosecution and the date the penalties were decided are almost impossible to reconcile to the income in the year or years that the events took place. Additionally, several organizations went through

[7] "The Big Bank Bailout," *Forbes Magazine*, July 2014 (Mike Collins). https://www.forbes.com/sites/mikecollins/2015/07/14/the-big-bank-bailout/#31bda9aa2d83

[8] *USA Today* http://www.usatoday.com/story/money/cars/2017/01/18/general-motors-securities-and-exchange-commission-sec-ignition-switch/96717570/

mergers and acquisitions during the period, especially in the financial services.)

As can be seen from the above examples, the costs associated with surprises can be significant, and have both financial and reputational impacts; at worst, they can lead to the collapse of a whole sector, such as the financial meltdown in 2008–2010. Financial reporting informed investors about these issues after the fact. Could investors have been better prepared for these risks? If one looks at the financial services industry, not every bank participated in the actions that led to the collapse. What was the difference? Were the other banks more prudent? Was their culture more risk averse? Did every employee understand where the line was drawn, beyond which they could not go in decision making?

If we drill down further, is it possible to say that the less risky banks' approach to hiring and compensation was more driven by hiring people with the "right values" and compensating employees and executives in a way that did not encourage undesired behavior? Was there an orientation program and was it effective? Was the whistle-blower program more effective? Was there a greater level of trust, communication, collaboration, and cooperation within the bank? How are leaders selected, developed, managed, and compensated? These are all features of the maturity and culture with which the organization is managed. If investors don't have visibility into their organization's maturity, they have little protection against surprises that reduce earnings and deplete value and, at worst, void their investment completely.

A growing category of surprises is the increase in Impairment losses that are being incurred by corporations; these happen after a merger or acquisition where the buyer pays more for the acquired organization than its book (accounting) value. In effect, the cost of buying the business as a system capable of earning an income stream is justified at this higher market price, and this "premium over book price" appears as an (intangible) asset on the buyer's financial records, recorded as "goodwill." This is obviously a cost incurred by the shareholders of the buying organization that is funded from either diluting the value of their own shares or taking on more debt. When management and/or the auditors determine that this asset (goodwill) is worth less than is shown in the records, it is considered to have been "impaired" and the amount must be taken as a financial loss. Why?

"Over the last five years, there have been a total of 1,556 events in which goodwill has been considered impaired and written off (or written down) by publicly-traded companies incorporated in the United States." The total cost of this has been $270.4 billion[9]. While there are many issues and challenges behind these numbers, a key issue is that part of what the buyer was willing to pay for was "the system" that included the culture which gave the acquisition some of its market value. Could one believe that this was a surprise?

3.2 Buried and invisible costs

Financial reporting provides limited insight into details of existing costs; for external users, costs are aggregated at an extremely high level, such as operating expenses, which might then be analyzed by cost of product and services, sales, general and administrative (SG&A), and depreciation and amortization; even internally, costs tend to be reported "by department, by type of expense." This approach often leads to reinforcing the belief that the workforce is the largest cost and, therefore, if performance is to be enhanced costs must be reduced. Interestingly, in many public financial reports, the total cost of the workforce is not published. The questions should always be: Why are the costs as high as they are? What is driving the demand for resources?

Financial reporting has been a barrier for understanding opportunities for change in the past. When quality management was being recognized as a

[9] https://www.duffandphelps.com/insights/publications/goodwill-impairment/2020-us-goodwill-impairment-study

key issue for business, particularly in the 1970s in North America, many CEOs couldn't see the value or benefits from investing in quality management systems. Very often the rationale was given that better quality would improve customer satisfaction; however, rarely were quality practitioners able to convince CEOs that not only would better quality save money, but the absence of it was also already costing the organization significantly higher expenses (to coin a phrase, "hidden gold in the mine.")

It was only when someone like the late Phil Crosby, in his book *Quality is Free*[10] (1979), demonstrated the benefits by dispelling the myth that improving quality would cost money and focused on the unseen opportunity, that CEOs started to come around. Crosby's "stages of maturity" in management approaches to quality demonstrate the problem, especially when metrics don't show the existing costs being incurred:

Crosby suggested there were five stages of understanding the relationship between quality and financial performance. While his estimates for the financial impact at each stage were the result of his own research, they were later validated by the level of savings identified by proponents of an approach to process improvement called Six Sigma.

The first stage of uncertainty reflected an unawareness of the hidden financial impact of poor quality; this often-reflected organizations that relied on "inspection" as their primary approach to ensuring quality. Once awareness started developing and management "awoke" to the hidden opportunities, efforts started to identify hidden costs; these costs were always there - but were never identified as being opportunities for improvement. Typically, the real "Ah Ha" moment came at level three when efforts started to build quality into the business as a "way of operating" rather than relying on inspection. It was at this point that opportunities really started to be understood and management re-allocated resources to fix the underlying causes of poor quality. As the following chapters

[10] Crosby, Philip, "Quality is Free," 1979, McGraw Hill

demonstrate, once resources are directed at changing the root causes of the problem, the whole "system" works more effectively and the outcomes are significantly improved.

Maturity stage	Description	Management understanding and attitude	Cost of quality as % of sales	
			Reported	Actual
1	Uncertainty	No comprehension of quality as a management tool; tend to blame quality departments for quality problems	Unknown	20.0%
2	Awakening	Recognizes that quality management may be of value but not willing to provide money or time to make it happen	3.0%	18.0%
3	Enlightenment	While going through quality improvement program learn more about quality management; becoming supportive and helpful	8.0%	12.0%
4	Wisdom	Participating; understand absolutes of quality management. Recognize their personal role in continuing emphasis	6.5%	8.0%
5	Certainty	Consider quality management an essential part of the company system.	2.5%	2.5%

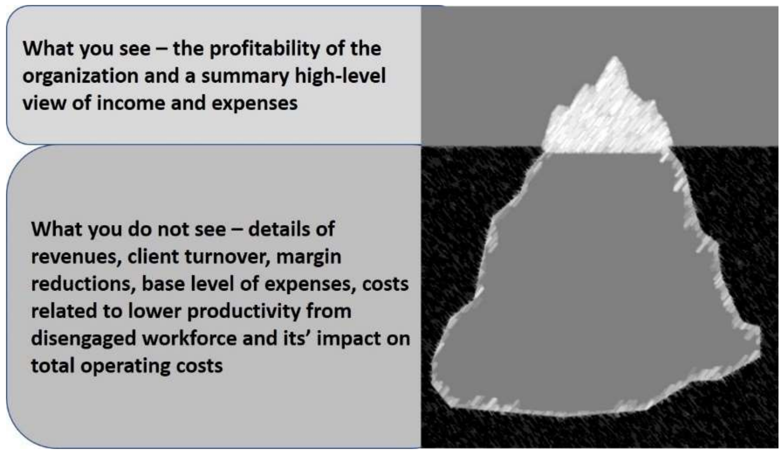
At the time, many organizations were operating at Stage 1 or 2 – not realizing that buried in their costs was a possible opportunity to enhance performance by 18–20% of revenues. Almost no financial reporting was showing this, as it was buried in the existing cost of doing business; the same is true today for the cost of poor culture. The "way things are" is an embedded cost of doing business and the concept of "how much better it could be" is hard to identify and evaluate. Maybe a similar approach could be taken with the hidden costs of poor culture?

At stage one, culture might be talked about, but it is not “managed” as a “way of doing business;” it often relies upon solutions like team building and leadership training. It is only when the hidden costs of a poor culture start to be realized that culture starts to be planned and managed effectively. This involves the strategic re-allocation of resources to treating people as an investment and making them central to organizational strategy.

Culture Maturity stage	Description	Management understanding and attitude	Cost of poor culture as % of sales	
			Reported	Actual
1	Uncertainty	Culture is unplanned; surprises occur, people are the problem.	Unknown	20.0%
2	Awakening	People’s behavior is unpredictable and a key risk, need for codes and training.	3.0%	18.0%
3	Enlightenment	Start to move toward people centric management.	8.0%	12.0%
4	Wisdom	Understanding of intangible trade off issues and focus on value.	6.5%	8.0%
5	Certainty	People at centre of human centric business model.	2.5%	2.5%

The values in the above table might be questionable; this will be developed and expanded later to illustrate that culture costs may be equivalent.

Buried costs form a significant part of the impact of poor culture, and many of these start with a lack of employee commitment. This not only decreases operational performance, but it also permeates almost everything that people are involved with – suppliers, customers, other employees. This results in a flawed business system that is unable to optimize performance, which often shows up in lower or inconsistent profitability. Management has two choices to fix profit – increase the income side or decrease the cost side. The challenge for management is to know where to focus to achieve the desired improvements. Profit is like the tip of an iceberg because most of what is happening is invisible.



A poor or toxic culture results in disengaged employees who impact ALL aspects of an income statement. There has been significant research on this whole-system impact.

- Gallup estimates[11] that actively disengaged employees cost the USA between $483 and $605 billion each year in lost productivity.
- Overall excess turnover because of toxic workplaces has cost the US economy $223 billion over five years[12] (by causing over 20% of employees to leave their jobs).

[11] "State of the American Workplace Report," 2017, Gallup.
[12] "The High Cost of a Toxic Workplace Culture," 2019, SHRM (Society of Human Resource Management).

- Poor workplaces contribute to absenteeism, and burnout costs the US economy $225.8 billion, or $1,685 per employee per year[13].
- Toxic workplaces cost the UK economy around £15.7 billion annually[14].
- *Harvard Business Review*[15] identified numerous impacts from poor culture, including 50% greater healthcare costs; 37% higher absenteeism; 18% lower productivity, and 56% lower share price over time.

An even more important observation[16] about the widespread damage that a poor culture can create is the impact of a toxic worker on the rest of the organization. The benefit from hiring a "superstar" who ranks in the top 1% of performers will generate $5,303 in savings, while *avoiding* hiring (or importantly developing) a toxic worker will generate savings of $12,489.

What are these buried costs and where are they? Some may be visible, but the majority are buried within existing operating expenses. The largest portion of such excess costs relates to employee productivity. This can cover many activities such as lower "on-the-job" productivity; spending excess time on the internet, including social media; nonproductive meetings because of poor meeting skills, including an unwillingness to cooperate and collaborate; wasted time spent looking for information that may already be available; excess absenteeism, or time off for sickness;

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[13] CDC study published in "4 Devastating Consequences of a Toxic Workplace," Tanya Prive, November 3, 2019, Inc. https://www.inc.com/tanya-prive/4-devastating-consequences-of-a-toxic-workplace-culture.html

[14] *The Culture Economy Report 2020*, Breathe. https://www.breathehr.com/en-gb/resources/culture-economy-report-2020

[15] *Harvard Business Review*, December 1, 2015. "Proof That Positive Work Cultures Are More Productive" (Emma Seppälä and Kim Cameron). https://hbr.org/2015/12/proof-that-positive-work-cultures-are-more-productive

[16] Houseman, M., and Minor, Dylan, "Toxic Workers", Harvard Business School, Working Paper 16-057.

higher staff turnover driving higher HR costs, as well as more time spent by operational managers on hiring activity.

Given that one of the single largest costs for many organizations is money paid to employees, even a 1% improvement would result in significantly improved performance. However, the cost does not end there: studies have shown that dissatisfied employees also have a negative impact on relationships with others, such as customers, suppliers and other third parties. Again, this can reduce the productivity of these relationships.

To really understand the costs of a poor culture, the hidden excess costs need to be identified and reported and then used as a base against which a re-allocation of resources can take place. This was Crosby's and Juran's main theme - improvement would not actually cost the organization more money. What was needed was a re-allocation of resources away from the hidden expenses that were already being incurred towards investing in the underlying "root causes." However, unless there was a clear ROI from these investments' management would be reluctant to make the changes. This is why identifying the hidden costs is so important - it starts to build a foundation for a return on investment.

There is significant research available that demonstrates the benefits of "fixing" a poor culture – or as it is often referred to a toxic culture. The challenge is that many of the existing metrics do not have financial values associated with them. Using some of the examples below, it would seem obvious that turnover and absenteeism are important HR metrics and that improving these would lead to potentially improved financial performance. But how much is our current level of turnover costing the organization? What level of savings could be generated if the whole approach to hiring could be changed? Does the organization really know the root cause of turnover or absenteeism? The following table provides some examples of improvement areas and where the current impact of these events is buried or hidden; applying financial numbers to these would be revealing:

#	Benefits from enhancing Culture	Where the negative impact is hidden today
1	37% lower absenteeism	Currently buried in labour costs which translate into higher costs / unit of output; higher temporary staffing costs; customer penalties from unplanned delivery delays; quality problems from using untrained staff to fill in
2	25% lower turnover	Higher hiring and training costs; larger proportion of employees lower on the "learning curve" so output lower; excessive supervisor time spent on hiring / discipline problems
3	21% productivity improvement	Current labour costs higher relative to output; problems remain unresolved; supervisors ignore employee ideas; suggestions for improvement are unaddressed; employee ideas for machine improvements ignored; maintenance downtime higher; suppliers unwilling to share improvement ideas; higher sick leave / absenteeism; employees work in silos and fail to collaborate, communicate and share ideas
4	48% lower safety accidents and issues	Higher absenteeism for sick days (higher temp staffing / union pay adjustments / overtime costs); indirect negative impact on customers (services not provided)
5	28% lower shrinkage	Currently wastage and losses written off as higher cost of sales; can also impact time spent on inventory counts and analysis
6	41% lower defect rates	May show up as excessive scrap or rework costs but in many cases buried within existing operating costs when work is repeated to correct problems
7	10% higher customer ratings	Higher sales and support costs (e.g. call centres) to service higher levels of complaints, problems, customer turnover, returns and time spent when problems are escalated

Items 1 through 3 would reflect the lower output/productivity per person; and item 4 would suggest both excessive labor costs but also impacts on other costs, as well as, potentially, relationships with others. Item 5 typically comes as a write off, either because of poor record keeping (employees do not care about accuracy) or, worse, actual shrinkage and losses. Item 6 is a classic cost of poor quality. With all the quality processes and procedures in place, employee commitment remains a key driver of delivering on "first time right." This is an especially challenging area for the service industry as service problems may only ever show up in the load factors on call centers and other support areas. Item 7 is often a composite of improvements from other areas. However, it is well-known that “happy employees mean happy clients.” The UK-based Maturity Institute[17] developed research that linked underlying operational issues to poor culture, and increased risk that can have an impact on operational effectiveness and thus costs. These might include:

Risk area	Nature of risk	Examples of operational costs impact
Systemic disconnection: reward and value outcomes	Rewards for senior executives through to management and staff do not relate to value and encourages other outcomes.	Higher absenteeism from safety issues; encourages higher turnover through poor morale which drives higher hiring costs; increase losses / theft; sales /support costs increase caused by focusing on financial returns more than client satisfaction (legal bias vs. relationship); higher overtime costs
Knowledge and learning failures	Failure to use internal knowledge; Inability to learn from mistakes	Higher process costs due to defects and repeated errors; less process improvement; problems hidden and not resolved; higher call centre costs (repeated calls / problems not solved); consultants used vs. employee driven improvements
Supply / value chain failures	Weak oversight driven by cost rather than value	Lower product costs being more than offset by higher administrative costs due to paperwork defects, rework, failures to deliver on time and others; savings not passed on by vendors
Target and goal setting	Excessive, meaningless and/or conflicting performance targets & KPIs drive adverse outcomes	Excess reporting / admin time; more meetings vs. voluntary collaboration and cooperation; workplace conflict / stress causing higher sick leave; excess management time resolving issues;
Behaviour and conduct	Individuals or small teams in one or more locations behave or act such that catastrophic organisational damage occurs	Non-compliance with regulations / fines; employee work duplicated vs. knowledge shared; privacy / confidentiality breaches cause higher legal costs; fraud / collusion between staff and with 3rd parties; need to rebuild image / brand marketing increases costs;

Systemic problems in the approach to pay are a well proven driver of perceived unfairness and can drive the wrong behavior (such as the Wells Fargo or Volkswagen examples). Knowledge and learning failures come

[17] All references to The Maturity Institute with permission

from a lack of collaboration and cooperation as well as higher turnover; one study[18] put this loss at $47 million per year per company. Failures in the supply chain, where a bias towards cost versus the relationship is predominant (an aspect of poor culture), can result in higher operating costs. Ineffective goal setting, where targets are handed down rather than being mutually agreed, also has negative impacts on employee behavior (again, the Wells Fargo situation but also many of the other underlying behavioral / ethical issues that were revealed behind the 2008 mortgages and toxic securities problems). The final example, related to behavior and conduct links back to the previous section on financial surprises.

Successful organizations used the COPQ framework developed by The American Society of Quality to extract the underlying costs and make then visible. Simplistically, the approach involves the identification of activities and events that occur in the organization that drive the consumption of resources, but which, if everything was working effectively, should not happen. A similar approach could be applied to the identification of existing operating costs that are being impacted by key risk areas in human governance and human capital management.

Traditional accounting systems lack many of the analytical approaches to reporting on these hidden costs. However, some might be developed by looking at HR reporting in areas like turnover and comparing current to “leading” practice and then applying a cost to the improvement opportunity. This might be done in several areas and will be explored more in the “Failure costs” discussion.

3.3 Missed opportunities.

The effective engagement of people in an organization not only results in lower operating costs, as just discussed, but also contributes to a higher level of innovation and creativity. This will drive both the opportunities to

[18] The Panopto Workplace Knowledge and Productivity Report, July 17, 2018.

improve current operations and, more importantly, the development of ideas to drive future growth.

Missed opportunity	Description of risk / impact
Limited continual improvement	Operational costs are not being continually reduced causing margin shrinkage; result is programs for cost reduction that often fail to remove the root cause of excess costs and lead to lowering of morale. The organization struggles to sustain a competitive advantage.
Limited innovation	Related to the above; lip service paid to new ideas from employees; feedback is slow or non-existent and managers / leaders do not actively encourage employee innovation. The result is a maturing of capability and offerings which can often only be resolved through mergers / acquisitions or the "buying in" of patents and product / service opportunities.
Limited ability to benefit from being "lean"	A lean organization is, by definition, one in which there are extremely low levels of waste; however, to "be lean" requires cooperation and collaboration across traditional functional organizational silos and a willingness of employees to take on more "caring and responsibility." Where people feel they are valued and recognized, the probability is that lean initiatives will bring greater positive results.

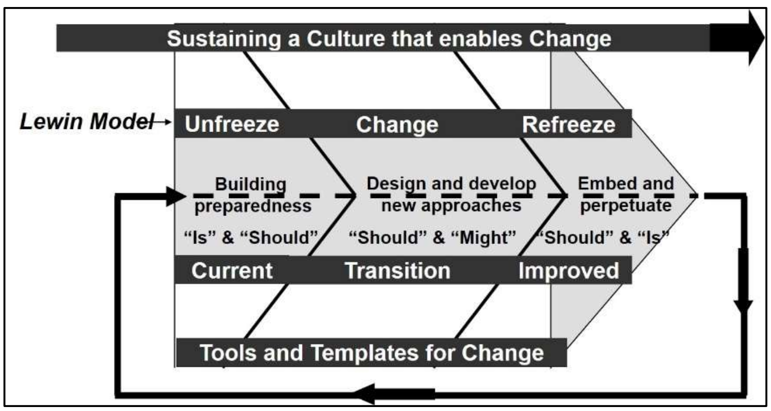
The above three items all relate to efforts around day-by-day improvements. Readers may reflect that one of the key competitive advantages of a company such as Toyota is in its ability to constantly improve everything that it does. This cannot be driven from the top by directive; it must be part of the ongoing interest; it must come from the interest, commitment, inquisitiveness, and creativity of the workforce together with their supervisors and others, who can collaborate to investigate and – where possible – implement new ideas.

Missed opportunity	Description of risk / impact
Responsiveness (market)	Organizations today seek to be agile and responsive. These qualities come from employees who care and are willing to collaborate, cooperate and communicate; in short, they are fully committed through what they do to the success of the business. A positive culture is one that creates this atmosphere; if these human qualities are not present, the organization will not attain the capability.
Responsive (change)	Organizations need to be able to respond rapidly to changing markets and deploy their changes as rapidly as possible. Effective leadership that fully embraces its human capital and creates a culture of trust and commitment will develop a foundation for rapid deployment of change rather than one where there is a lack of trust.
Responsive (regulatory)	For many organizations, the regulatory framework within which they operate holds the power to support (speed up) or frustrate (slow down) certain business initiatives and changes. An organization that has open and transparent communications with regulators and which builds trust in its commitment to behavior, compliance, and responsiveness will likely be better supported and trusted by regulators when changes are needed.

This second batch of opportunities arises from the ability to respond to change; this ability (once again driven by the behavior of people) has become a critical competitive advantage. The idea that "people do not like change," is inaccurate. What is true is that many people do not like to be told to change by others – such as management – especially when they have no understanding of the need for change, nor of the impact that it will have. A positive culture creates a higher level of confidence in management and enhances trust.

The author experienced a client example of this impact. A manufacturing plant based in Canada was part of a group of about forty plants in North America. This plant not only had one of the highest productivity levels but also seemed able to respond to schedule and product changes far faster and more effectively than any other plant. Additionally, based in Canada, it tended to have shorter production runs and more product changeovers than other, US-based operations that benefitted from greater specialization and larger volumes. An evaluation of why this difference occurred eventually revealed that the ONLY major difference was the level of trust and respect the employees held for both the General Manager and for people in supervisory roles.

It is worth mentioning as a codicil to this story that the General Manager was also one of the longest serving managers, who had been with the company almost his entire career and had therefore had the time to develop strong relationships. The practice of changing managers and appointing people who have little hands-on experience with the work being managed can, in itself, have a negative impact on culture.



Responsiveness is a critical success factor and organizations that develop a "change-ready" culture gain a strong competitive advantage. While many ideas and resources are available on the "tools and templates for change", it is harder to find those for managing the impact of change on the human dimension. Change takes place within an envelope of organizational activity and reality and, while a change initiative is an event often managed as a project, the people involved are part of an organizational continuum. Change readiness comes from this continuum, which is why good change management initiatives involve an assessment of organizational readiness as part of their preparation, and why organizations with positive cultures re often more "change ready" allowing the projects to proceed faster.

The final examples of lost opportunity are driven by human behavior – individual or collective:

Missed opportunity	Description of risk / impact
Reputation loss	While purchase decisions are heavily financially based, increasingly products are not differentiated, and the " ability to do business with the company – i.e., the interactions between staff and clients – becomes a key competitive edge. In this case, a positive reputation through staff who are knowledgeable, and care becomes an asset in retaining clients and growing sales.
Talent attraction	In many knowledge-based companies, attraction and retention of human talent is a core requirement. Creating a reputation generated by existing employees as a "great place to work" will assist in the attraction of potential talent (especially in a competitive market where people have choices), as well as reducing the costs of hiring.
Investor attraction	Investors are becoming increasingly concerned with organizational behavior as it relates to the risk of their investment (both capital and returns). Organizations that develop, sustain, and communicate positive attributes that are seen to lower risk will have less challenge attracting investors and will possibly pay less of a financial risk premium for the money that they borrow.

Reputation loss can come from an organization that collectively fails to change with the times and, as a result, becomes out of touch with the social reality of the world within which it operates. The value of an organization's brand or reputation can be significant, yet it is not part of financial reporting. This area of reputation is important, as **environmental, social and governance (ESG)** reporting is demanded by investors and is becoming more mainstream. Failure to address societal concerns about *environmental* impacts can cause surprises (some of the fines and scandals mentioned earlier occurred in this area). They can also cause people to become disenchanted with the way an organization behaves and thus seek alternative products, services, and suppliers. *Social* awareness, the issue about relationships with society as a whole, as well as between people both internally and externally, is important to reputation. Organizations are beginning to understand that, as part of their “license to operate,” they need to consider the impact of their actions on people both within and outside the organization. What is critical is that organizational culture that is founded on its responses to both environmental and social issues is a core component of its *governance* – how the organization is managed and led.

Attraction and retention of human talent is another key competitive advantage and one which is enhanced when an organization positions itself as a “preferred employer.” The pool of available people with the skills and capabilities required may have choices, and candidates are more selective than they used to be. Some will look at the culture as more important than the salary and will accept lower compensation to start work with an organization that they have greater respect for. The hiring organization MUST be socially connected to be able to respond effectively to these candidates.

Finally, culture will have an impact on the investors – mainly because of the issue of risk. Many investors are becoming more mature in their understanding of the factors underlying financial performance. Investment advisors are also expanding their analytical services to seek out information about aspects of organizations that make them more aware of issues such as ESG reporting. This has already been demonstrated by shareholder activism in areas such as executive compensation that was discussed earlier. There are many areas of hidden opportunity that can all be leveraged by building a positive culture.

3.4 SMEs, culture, and costs

Before we leave this chapter, it is important to address the significant number of organizations that are NOT large or publicly traded. The examples given so far may tend to suggest that this problem only applies to big organizations, but hidden costs exist everywhere.

- Culture in a smaller organizations is often managed by the attitudes of the owner and the degree to which they are involved with the grass roots of the business and know what is going on. They should already know where the risk and problems are and have addressed them.
- If the owner of a smaller business has a leadership style that engages and involves employees and has (almost) eliminated fear in the workplace, these employees will know where the problems are and, given the opportunity, will offer improvement suggestions.
- As a business grows in employee numbers, the problems may start to become overlooked as the owner is no longer able to be close to the action. This is where a culture needs to start being built to encourage the continuing identification of problems and opportunities.

3.5 Hidden costs – summary

Whether we consider the hidden 90% of the iceberg from the “gold in the mine” concept, or the hidden costs approach, we know that there are opportunities to improve organizational performance. The problem is that, unless you know where the waste or unappreciated opportunity is, there is little you can do about it. Successful strategies have been employed by CEOs for many years to counteract this lack of information. Management, by walking around, building a culture that allows people to raise ideas and speak their mind, or just doing what they think based on their experience, are taking the right action. In some cases, this involves constant shake-ups and reorganization of business. This can be self-defeating in that, unless people understand the purpose, they tend to watch from the sidelines.

For too many years, organizations have given lip service to the phrase "people are our most important asset," yet often actual management of human capital as a strategic resource continues to focus on people as costs rather than investments. Financial reporting often masks the impact that poor human capital management has on an organization's actual performance, as well as its potential opportunity to reduce risk and enhance value creation. Understanding of the impact of human behavior has been downplayed and often referred to as the "soft and fuzzy" side of management, yet the growing importance of organizational culture is encouraging investors and leaders to take the issue of human behavior and the optimization of human capital more seriously.

Because the impacts of poor, or less than optimum, approaches to human capital management are not clearly demonstrated through financial reporting, Investors, boards, and CEOs often fail to grasp the significance of a strategic focus around human-centric strategy and the benefits it can bring; short-term incentives add to the focus on short-term performance that often exacerbates the challenge of shifting focus.

There is a financial risk to a less-than-optimum human-centric strategy; at worst, this can expose the organization to higher operating costs, including unplanned and unanticipated financial impacts such as penalties and fines; for most organizations, even at the medium and lower risk rankings, there remains an opportunity to reduce hidden costs and enhance strategic competitive capability. As a business grapples with the need for competitive advantage, transparency, and sustainability, the adoption of additional measures that focus on whole-system performance becomes a necessary imperative.

Where are the costs of poor culture hiding? Summary
• People's behavior has a direct impact on the success and sustainability of any organization. • Without a strategically driven, clearly defined culture people's behavior will be unpredictable. • If culture is not managed, based on values and expectations, there is a risk of a poor culture developing. • If a poor culture exists, the three cost impacts will be financial surprises, hidden costs, and lost opportunities. • Corporate culture is core to systems thinking and can bring substantial performance improvements, if applied. • Surprises can be caused by misunderstanding expectations, failure of controls or illegal / unethical behavior. • Hidden costs are buried within operating costs and are largely invisible yet might be significant. • A five-stage approach of uncertainty, awakening, enlightenment, wisdom, and certainty will help the learning process. • Like an iceberg, most of the costs of poor quality are hidden. • The impact of disengaged employees can cost businesses billions annually. • Significant performance improvements can be seen when the causes of poor culture are removed.

Checklist
• Has your organizational culture evolved, or has it been defined and managed? • Does your organization have a defined set of values upon which expected individual and group behavior is based? • Are these values deployed throughout the organization? • Are the values aligned with policies, procedures, and leadership development? • Does your organization experience any financial surprises? • Is your financial performance a continuing challenge? • Are there indicators that your workforce may be disengaged? • Do you ever discover costs that are being incurred that could have been avoided through improved communication, collaboration, or cooperation? • Do you have problems at the supervisory or leadership level where employee disputes are escalated? • Are relationships with suppliers and customers on a win / win continuous improving foundation? • Do you believe you are getting the best from your workforce in terms of innovation, creativity, and commitment? • Do you have HR metrics that are being used that link directly back to financial performance (e.g., costed turnover)?