Noble objective

Measuring executive integrity could improve investment choices

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Integrity is one of the most highly cherished business characteristics, but one rarely discussed in polite company – let alone measured by analysts. A paper presented at last month's annual meeting of the American Economic Association in Philadelphia stakes out new ground by offering a way to quantify its presence.

A majority of over 1,500 executives in 60 countries and 33 industries rated integrity an important quality to be found in a company leader, according to a survey published by IBM in 2010 (Capitalising on Complexity).

Despite the widely accepted importance of integrity for the success of a business, there is a marked reluctance to discuss it openly. Analysts' reports treat it tangentially. Track record and governance are sometimes used as metaphors. 'Colourful' is sometimes employed as a descriptor for the mining industry executive whose implementation of past promises has proven unreliable.

Past judgements

Until now, investors in the mining sector have been inclined to make personal judgements about integrity and eschew solicitations for capital from chief executives (CEOs) with whom they may have had prior bad experiences without explanation. They will be guided in their views by others who are prepared to express opinions about past conduct privately.

Increasingly, though, reputations are enhanced or trashed in anonymised chat rooms, leaving the innocent at risk of sometimes unfair treatment.

Judgements are being made continually in the most subjective manner on a measure of executive performance frequently critical to an investment outcome.

The reluctance to openly address integrity comes from its personal links to honesty and truthfulness. However, integrity can be viewed in a more neutral and less personalised way, according to researchers from the Harvard Business School (Erhard, W, and M Jensen, 2012, "Putting integrity into finance: a purely positive approach," working paper, Harvard Business School).

Erhard and Jensen have proposed two dimensions to integrity in a corporate finance setting. First, integrity requires an executive

to have done what he says he will do by the time he says he will do it.

Second, if he is unable to complete the task by the designated time, all affected parties are informed immediately and steps are taken to "clean up any mess" that was caused.

This notion of CEO integrity is applicable in any business, but none more so than one in the mining industry. The vast majority of resource-sector listed companies rely for their capital on promises to do something in the future. Investment outcomes are almost wholly reliant on the company completing what it has set out to do on a specified timeline.

A paper presented at the annual meeting of the American Economic Association last month (Shane S Dikolli, William J Mayew and Thomas D Steffen, "Honoring one's word: CEO integrity and accruals quality") proposes analysing the content of CEO statements to measure the extent of their integrity.

On the Erhard and Jensen test, a person with low integrity would be someone who supplies explanations, rationalisations, justifications and excuses that masquerade as causes of the messes actually created.

Dikolli et al propose measuring the percentage of causation words in CEOs prose, such as the messages to shareholders in annual reports or in the transcripts of investor briefings. They argue that causation words are used to provide excuses that are more necessary when one's actions have fallen short of what one said was going to happen.

Textual analysis is a tool finding increasing applicability in measuring aspects of previously only whispered executive behaviours. Psychology deception detection research, for example, finds that the words used in true narratives differ from the words used in false narratives.

A 2010 paper by researchers at Stanford University (David F Larcker and Anastasia A Zakolyukina, "Detecting deceptive discussions in conference calls") used the transcripts of CEO question and answer sessions to look for clues in the use of words that could be used to identify lying or deceitful behaviour. They concluded that linguistic features of CEOs and CFOs in conference call narratives can be used to identify deceptive financial reporting.

Today's software permits a very rapid analysis of texts and the categorisation of words across multiple dimensions based on the considerable work that has been done in classifying how words are used. For example, the psychosocial dictionary used in the Dikolli et al paper utilised 108 words and their derivatives intimating 'cause'.

Although in its infancy, this tool has some obvious applications for investors in the mining industry. In rating a company, capacity to meet targets and how individuals react when those targets are not met represent key investment attributes. The approach offers an innovative means of quantifying within a standard framework a hitherto elusive characteristic with an impact on investment performance.

The approach would have value if it helped investors to foresee future differences in share price performance due to investment disenchantment arising from what would have otherwise been privately held views about executive integrity.

The development of appropriate dictionaries that extend psychosocial research into word usage patterns in the broader business context is likely to enhance the technique.

One flaw in applying this approach to the resources industry in the way proposed by Dikolli et al arises when a company completely ignores a failure to meet a prior commitment.

A most egregious example of this arose in the case of Pluton Resources Ltd. In December 2012, the company announced it had raised A$17 million (US$15 million) from Hyundai Steel. Subsequently, the managing director and the former chairman of the company confirmed in response to questions that the funding never occurred. No excuses were ever proffered publicly.

Quantifying integrity using textual analysis will only contribute something if executives feel guilty enough to explain what went wrong.

Word usage analysis will fail to catch the most egregious integrity failures in which the company itself is oblivious to its failings or sufficiently contemptuous of shareholders not to recognise them publicly. ▼

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