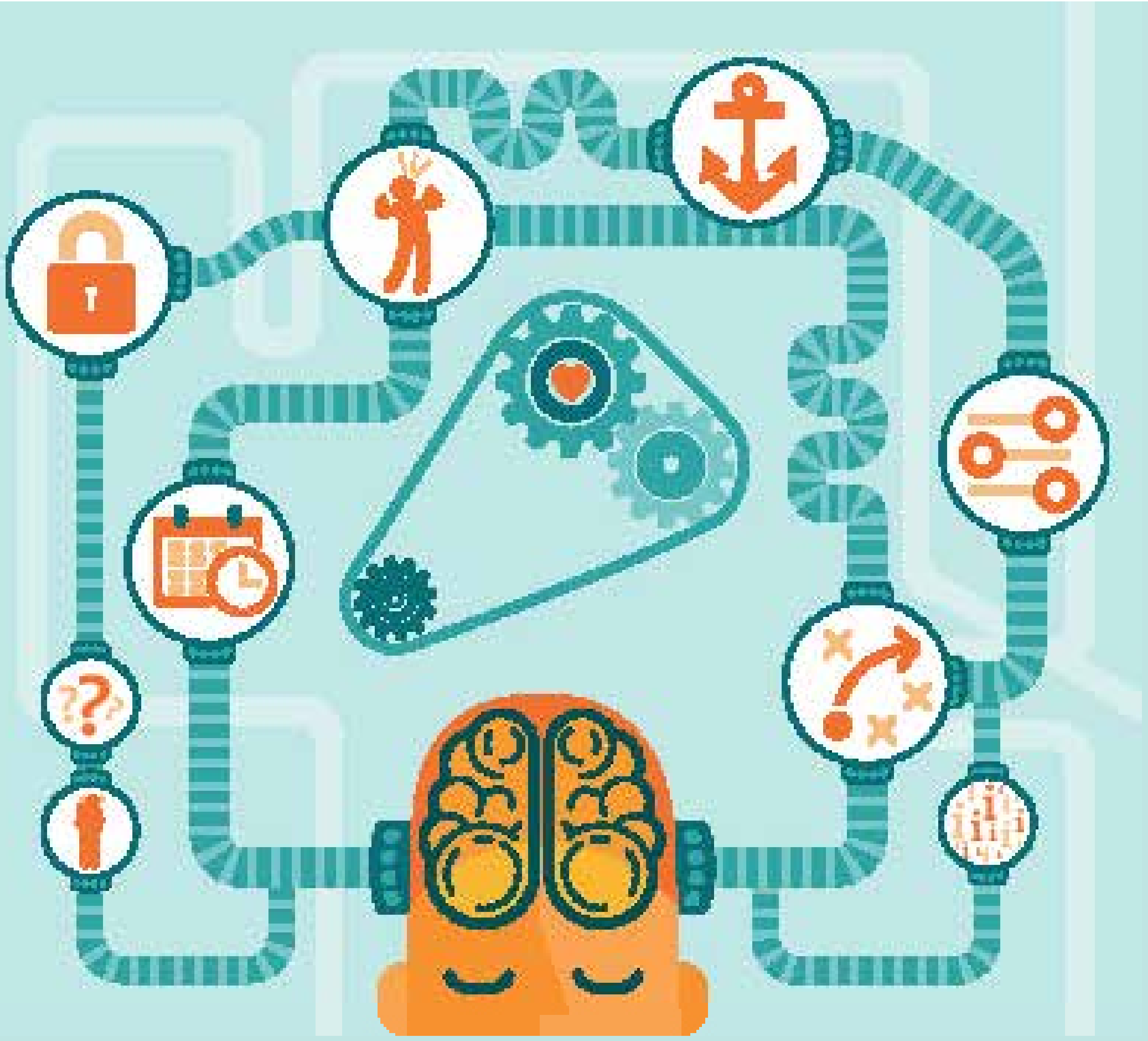

Mind your own bias

Decision-making can be adversely affected by unconscious bias, but to avoid this we need to be more aware of it, says Denis Kotov FCCA and Elena Aminova

Imagine at the end of the year you find that sales volumes have not reached their target. Your sales manager says the sales were lower than forecast because of the unexpected entrance of a new competitor. Will you be satisfied with this? What are you going to do next?

As a management accountant you might apply scepticism and start checking the feasibility of the sales manager's explanations. Maybe they were right, maybe not. Perhaps it was a failure on the part of the sales division that caused lower sales. Even if the sales manager had known the real reason, they might have blamed external factors for fear of reprisals. Perhaps sales forecasts were over-optimistic. Should the target set by the sales manager be higher than industry forecasts or the company's capabilities suggest, this could indicate overconfidence on the part of the sales manager. Whatever the reason, the shortfall will affect your future assumptions and output.

Given that there are so many variables that affect our judgment and cost so much in terms of time, effort and future expenditure, it may be a good idea to check the company's business processes against biases.

When managers make decisions under stress conditions – information overload, high degree of uncertainty, tight timeframe – their judgments can be unconsciously influenced by a number of psychological phenomena. This can arise unintentionally when we apply simple problem-solving strategies or heuristics that worked well in the past. These strategies are not negative by nature; they support us when decisions have to be taken quickly. However, if they are used automatically and without consideration, they may result in a flawed judgment.

One of the core tasks of a management accountant is to ensure the rationality of the information delivered to management. In practice, we rarely uncover behavioural bias in colleagues involved in the budgeting or investment process, partly because of our limited awareness of it. ACCA's survey *Culture and Channelling Corporate Behaviour* found that only a third of respondents thought most people were aware of cognitive biases in decision-making processes.

What's more, there are still no standard tools to track such biases, despite a clear need. A piece of research by Swiss-based consultants Detecon found that 90% of companies surveyed think the mere knowledge of 'rational deficits' can improve efficiency and are planning to introduce measures to promote awareness of biases among participants in the planning cycle. See box for some of the most common cognitive biases.

> As soon as you have become familiar with your biases it will be easier to identify mental shortcuts used by your colleagues

All in the head

Illusion of control

The tendency to overestimate one's degree of influence over external events. This might be unintentionally propagated by senior managers. For example, if a senior colleague insists on pushing requirements down to vendors to reduce costs through quality improvement, it might be uncomfortable to oppose them, even if you notice that the vendors lack the resources and abilities to deliver.

Planning fallacy

The tendency to underestimate the costs of projects and/or time to complete them. As Thomas Conine, a finance professor at Fairfield University, puts it: 'People think they can forecast better than they really can.' Faced with a thorough forecast, you may be so focused on ticking off individual steps that you miss the bigger picture of the downward trend.

Overconfidence

Overestimation of your ability to predict and control future outcomes might become costly over time. When deciding on sources of finance for investments, overconfidence might mean internal resources are favoured over cheaper, external debt.

Conservatism

The tendency to overestimate the occurrence of low probability events (the opposite of overconfidence).

Loss aversion

The tendency to avoid losses rather than acquire gains, or to neglect losses from existing customers when producing sales forecasts.

Anchoring

Excessive focus on another event, competitor, technology or product. While monitoring your competitor's actions and strategy, don't forget to revise your own plans.

Coping mechanisms

How to cope with biases? First, you need to learn to recognise your own mental hang-ups. There is no standard test for checking behavioural influences. But several research papers summarise practical tips for finance specialists – for example: *Enhancing Board Oversight: Avoiding Judgment Traps and Biases* by KPMG and two Brigham Young University professors; and *The case for behavioural strategy* by McKinsey. As soon as you have become familiar with your biases it will be easier to identify mental shortcuts used by your colleagues.

Bias training is worth considering. According to the *Culture and Channelling Corporate Behaviour* survey just over three-quarters (76%) of members suggested that teams, including boards, should be trained in better decision-making procedures to lower the effect of cognitive biases.

In the long term a company needs to set up solid control policies to mitigate the effects of biases. The factors that caused deviations can be classified into controllable or uncontrollable; related to internal business processes or external environment; perceived as low or highly uncertain at the time of planning. These procedures work well in mitigating the illusion of control, overconfidence or planning fallacy biases.

To incorporate checks and control procedures into internal policies you can add extra steps with bias-specific questions. For instance, imagine a worst-case scenario and look at the cause from an external perspective. Embracing a contrarian view may help you avoid over-optimism.

Misinterpretation of numbers and facts can cause significant errors in financial reports. Equipped with strong guidelines, finance specialists can control behavioural influences and improve decision-making. ■

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