Professional Skepticism in Compliance & Ethics

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This Session includes Polling

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Session Objectives

- **CONTEXTUALIZE** professional skepticism and its significance in Compliance & Ethics
- **UNDERSTAND** the sources of unconscious bias that get in the way of exercising appropriate professional skepticism
- **ANALYZE** our mental skews and predispositions to proactively manage and sustain our professional skepticism

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The Significance of Professional Skepticism in Compliance & Ethics

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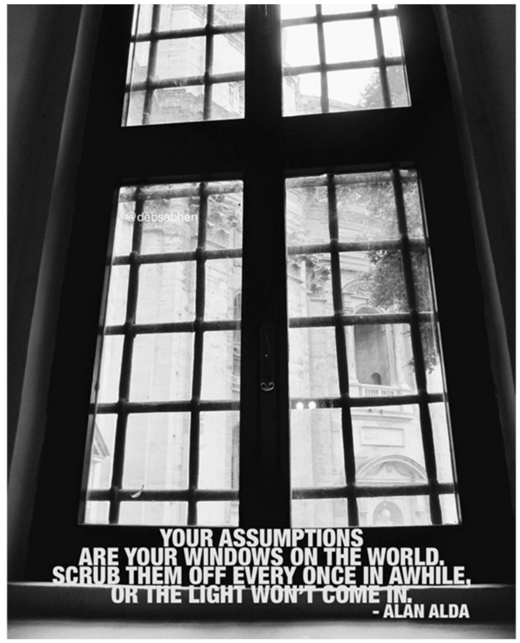
What is Professional Skepticism?

Context



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Acknowledging Our Vulnerabilities

- **Fact-based decision-making and objective reasoning**
  - Critical to our effectiveness as professionals
  - Cannot take them for granted
  - Not always as rational or objective as we think
- **Blindspots, cognitive biases and rationalizations**
  - Created by external pressures and motivations
  - We are all susceptible, regardless of our level of expertise and years of experience
- **Vulnerabilities in our perceptions and decision-making**
  - Acknowledging this is always a strength, not a weakness
  - Accepting the unconscious biases that cause these vulnerabilities is critical
  - Addressing this is part of being an effective, objective professional in our field

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"Truthiness"

- Concept made popular by Stephen Colbert
  - From his first segment of "The WØRD" in his debut of *The Colbert Report* (Oct 17, 2005)
- From Dictionary.com:
  - The quality of seeming to be true according to one's intuition, opinion, or perception without regard to logic, factual evidence, or the like: *the growing trend of truthiness as opposed to truth...*

Distinguishing "truthiness" from fact-based, objective reasoning is key to rational decision-making and professional skepticism

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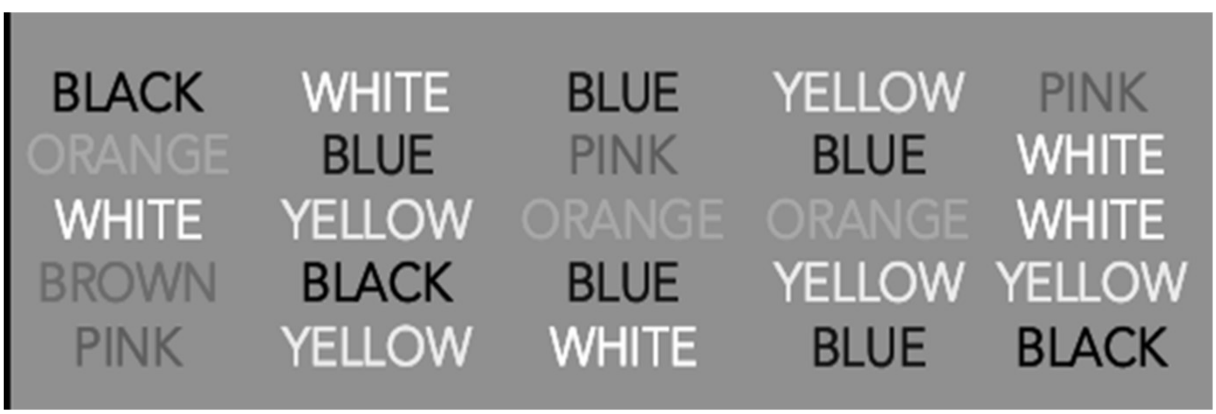
How Does Our Brain Process Information?



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Perception, Processing and Pressure*

RED	GREEN	BLUE	YELLOW	PINK
ORANGE	BLUE	GREEN	BLUE	WHITE
YELLOW	YELLOW	ORANGE	BLUE	WHITE
BROWN	RED	BLUE	YELLOW	GREEN
PINK	YELLOW	GREEN	BLUE	RED

*The "**Stroop Effect**"

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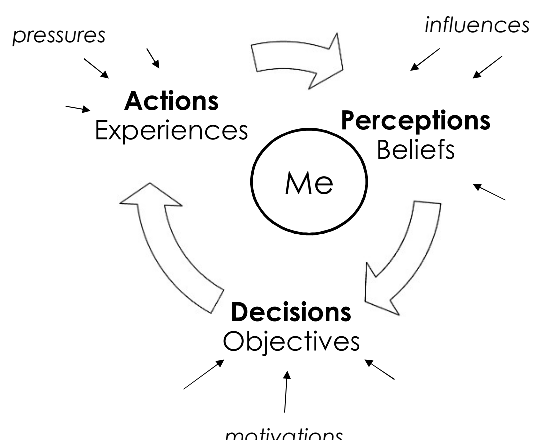
Influencing Perceptions, Decision and Actions



My **Actions** are driven by my **Decisions,** which are driven by my **Perceptions…**

- But external motivations, pressures and influences can drive changes in my perceptions; and
- Changing my perceptions changes my decisions, which change my actions…

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Some “Professional Skepticism” Context

There is a professional standard* for auditors that specifically defines professional skepticism, which has some relevance in the Compliance & Ethics context:

*An **attitude** that includes a **questioning mind**,*

***being alert to conditions** that may indicate possible misstatement due to fraud or error,*

*and a **critical assessment** of audit evidence*

*Source: AICPA, AU-C §200.03

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Professional Skepticism in Compliance & Ethics

- What does this term mean to you, as a Compliance & Ethics officer, leader, professional, attorney, auditor, investigator…?
- Are your definitions or expectations based on:
  - Professional standards?
  - Job descriptions and competencies?
  - Something else?

How important is professional skepticism to the Compliance & Ethics field, based on your experience?

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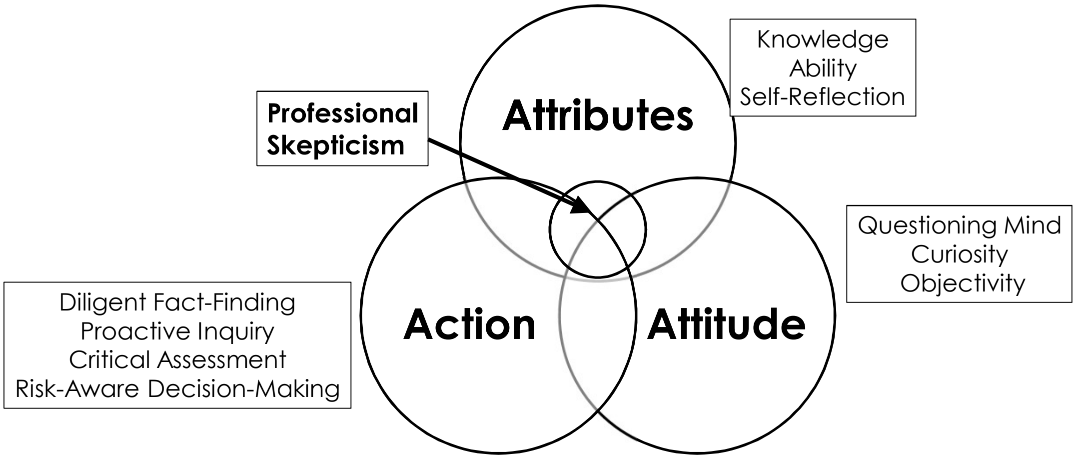
A Framework for Professional Skepticism



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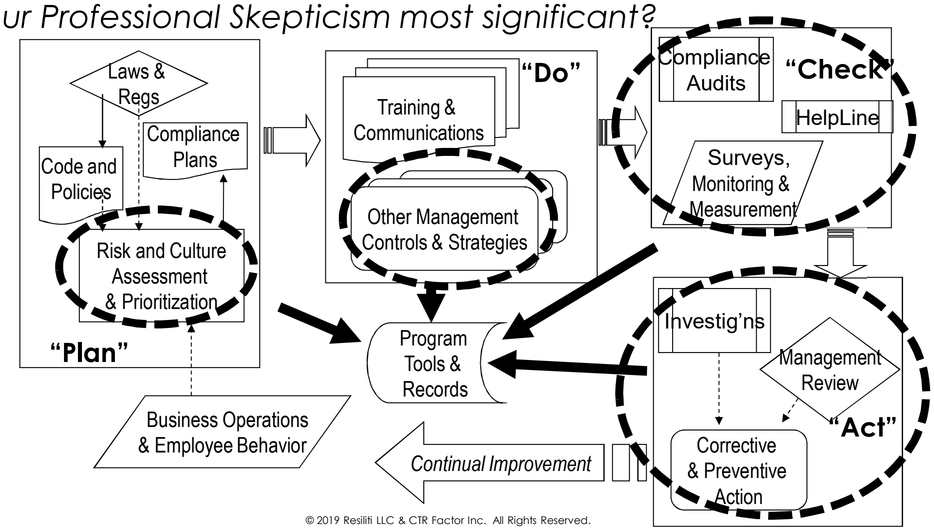
The Ethics & Compliance Management System

Where is our Professional Skepticism most significant?



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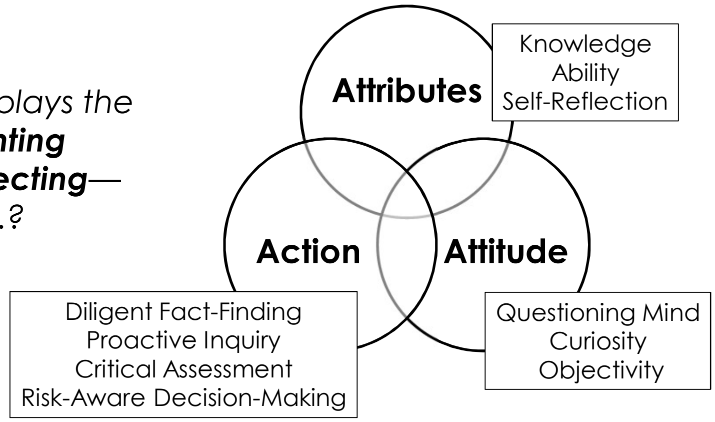
Professional Skepticism and Non-Compliance

*Which of these elements plays the biggest role in **preventing** — or **detecting and correcting**— non-compliance…?*



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Impediments to Professional Skepticism*

Influences on Attitude:

- Unconscious biases
- Scheduling pressures and workload demands
- Avoiding significant conflicts with management
- Providing an unqualified opinion by a deadline
- Achieving high performance evaluations
- Keeping costs low
- Building or maintaining confidence in long-term relationship

Impacts on Action:

- Seeking information ("evidence") that is easier to obtain, rather than more relevant and reliable;
- Obtaining less information/evidence than is necessary
- Giving undue weight to confirming evidence, without adequately considering contrary evidence
- Developing an inappropriate level of trust or confidence in colleagues or leaders

* Adapted from Public Company Accounting Oversight Board

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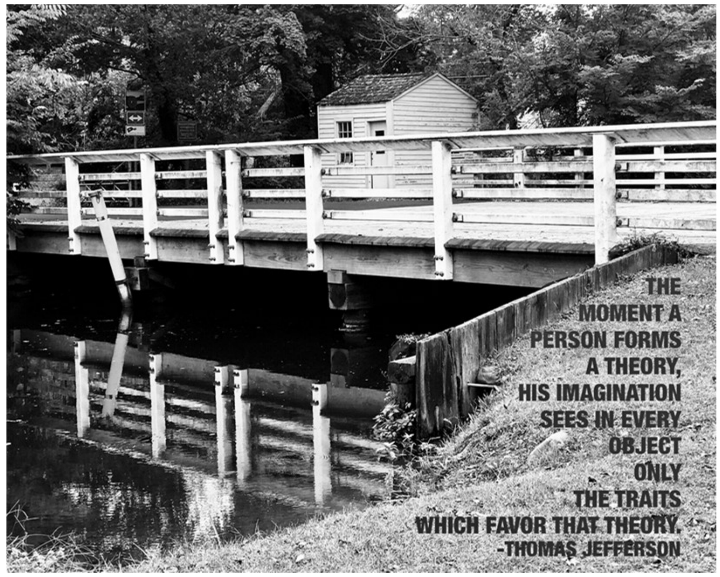
Understand and Analyze

Unconscious Bias



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Sources of Unconscious Bias

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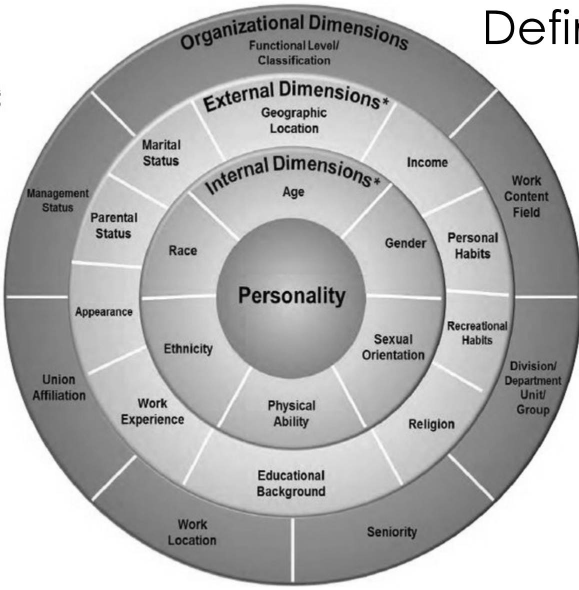
Definition of Bias



A predisposition or preference for or against something, based upon a unique combination of internal, external, and organizational variables that influence us

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Reasons for Bias

11 MILLION

Bits of information received every moment by the average human brain

40

Bits of information processed consciously every moment by the average human brain

99.999996%

Percentage of unconscious processing of data every moment by the average human brain

The ***unconscious preferences*** of the human brain**,** developed through ***pattern recognition*****,** triggered due to ***cognitive complexity*****,** and manifested via ***heuristics*** result in bias in everyone of us 99.999996% of the time

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Reasons for Bias (contd.)

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Bias-Enhancing Aspects of Audits/Investigations*

- **AMBIGUITY:** People tend to reach self-serving conclusions whenever ambiguity surrounds evidence. Many decisions require subjective interpretations of ambiguous information.
- **ATTACHMENT:** Auditors are highly motivated to remain in clients' good graces and approve their accounts. Why? Clients can fire them for delivering unfavorable audits. Also, long-term relationships enable firms to sell more lucrative consulting services.
- **APPROVAL**: Bias intensifies when people endorse others' biased judgment—provided it aligns with their own bias. Thus, auditors may accept more aggressive accounting from clients than what they themselves might suggest independently.

* From Harvard Business Review: "Why Good Accountants do Bad Audits," Bazerman, Loewenstein, Moore (Nov. 2002).

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Bias-Enhancing Aspects of Audits/Investigations* (Contd.)

- **FAMILIARITY:** People are more willing to harm strangers (such as anonymous investors) than individuals they know (long-term clients, for example). The deeper the investigator/client ties, the stronger the tendency toward approving dubious practices.
- **DISCOUNTING:** We tend to be much more responsive to immediate consequences than to delayed, uncertain ones. Investigators may hesitate to issue critical reports because of possible immediate damage to the relationship, loss of the contract, or unemployment.
- **ESCALATION:** People often explain away minor indiscretions—then conceal the growing problem. Unconscious bias can evolve into conscious corruption.

* From Harvard Business Review: "Why Good Accountants do Bad Audits," Bazerman, Loewenstein, Moore (Nov. 2002).

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Strength of Bias

- **Thought:** Something on our mind, haven't taken a side yet
- **Opinion**: Picked a side but still open to question
- **Conviction**: Opinion no longer open to be changed
- **Judgment:** Any other opinion is wrong

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Types of Bias

- More than 150 different biases have been established by researchers
- We will talk about 5 of those that specifically affect professional skepticism
- Before we tell you what they are, we want you to experience them yourself

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Overconfidence Bias

Tendency to overestimate one's own capabilities and talents, impacting the following areas:

- Ability to prepare and fair value estimates
- Assess risks in enterprise resource planning systems
- Evaluate the accuracy of our performance as well as the performance of others
- Taking on too many projects
- Overpromising on deadlines
- Considering just one possibility when problem-solving
- Truncating or skipping information searches
- Making snap judgments

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Overconfidence Bias Example

An example of a statement often used by investigators which demonstrates overconfidence bias is:

"We are up against a tight deadline. Based on my experience with similar projects in the past, we have the minimal needed information at this point to make a reasonable determination."

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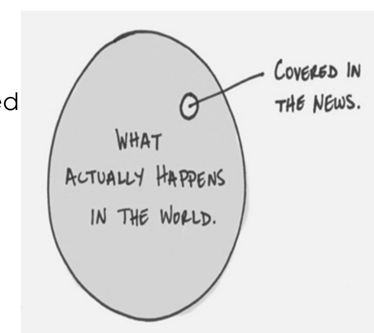
Availability Bias

Being influenced by the most easily retrieved data as we generate hypotheses, seek information, evaluate evidence, and assess risks.



- When hypothesizing the cause of fluctuations, managers may readily recall the types of events they have personally experienced but will have a harder time generating new ideas.
- Investigators may be tempted to easily consider the explanation provided by management, but it may be more challenging for them to generate additional possibilities.
- Professionals may form judgments regarding the defensibility of positions based on the ease with which they recall similar cases, without fully considering the outcome of the cases.
- This tendency may also bias analysts' forecasts and investors' predictive earnings judgments.

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Availability Bias Example

An example of a question often used by auditors which demonstrates the availability bias is:

"I know last year you capitalized your website costs, as you were developing a sales component to your website. Is that the reason you have capitalized website costs this year as well?"

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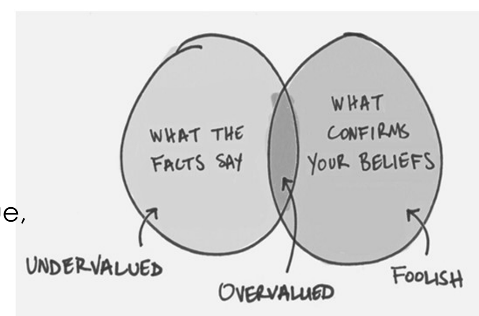
Confirmation Bias

The tendency to seek or interpret evidence in ways that support preexisting beliefs or expectations.

- Investigators may exhibit this tendency when
  - Evaluating the strength of internal controls
  - Selecting compliance standards
  - Estimating the probability of successfully defending a position in court.
- In reality, for an individual to know something is true, he or she must test to see how it may be false.
- If C&E professionals want to increase their professional skepticism, it is important for them to change their mindsets to seek or interpret evidence in ways that disconfirm prior beliefs or expectations



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Confirmation Bias Example

An example of a question which displays the confirmation bias is:
"Can you confirm that the debtor's balances have been correctly recorded?"

This question indicates that other alternatives have not been considered, such as the risk that management has overstated the debtors balance to inflate their revenue position in order to meet their profit (and bonus) targets.

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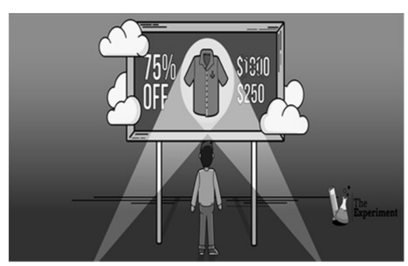
Anchoring Bias

When estimating a value, individuals often anchor on a preliminary amount and then make adjustments to arrive at their final estimate; however, they often make insufficient judgments to arrive at the true value.



- For financial decisions, this type of bias may occur
  - During the budgeting process
  - When making capital allocation decisions
  - When conducting a cost-variance analysis.
- It may also affect analytical review procedures and sample assessments.
- Investigators are particularly vulnerable to this bias since they typically begin their process with management-provided anchors (i.e., financial statements)

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Anchoring Bias Example

An example of a question often used by auditors which uses ‘anchoring’ is, *”Could you please tell me why revenue has increased from last year?”*

The starting assumption here is that the company would earn the same amount of revenue each year and that additional factors, such as external trading conditions, would not have changed the earnings pattern.

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Rush-To-Solve Bias

Forming a judgment without fully considering all available data.

- This may occur if a management team reaches an early consensus without deliberating on an issue…
- …or if investigators rely heavily on the perceived trustworthiness of a client when evaluating the likelihood of fraud.
- The rush-to-solve tendency may be exacerbated by external factors, such as time and budgetary pressures, and may inadvertently lead decision-makers to fall into other biases

Factors Affecting Judgment

External factors	Internal factors
• Time pressure • Limited resources • Client, regulatory, industry	• Limitations due to judgment “frames” • Judgment short-cuts • Bias caused by self interest • Judgment traps • Rush to “solve”

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Rush To Solve Bias Example

An example of a statement often used by auditors which might indicate rush-to-solve bias is:

"Let us make some reasonable assumptions to estimate the missing invoice amounts – approximately how much do you think they should be?"

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Sustaining Our Professional Skepticism

Conscious Mitigation

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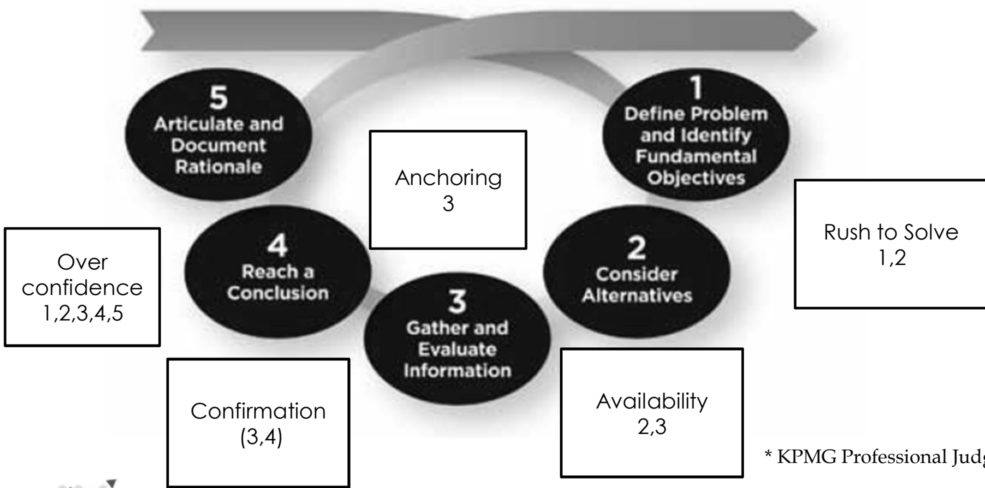
A Professional Judgment Framework* and the Impacts of Unconscious Bias



* KPMG Professional Judgment Framework

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Mitigating Unconscious Bias

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Mitigating Overconfidence Bias

Tendency to overestimate one's own capabilities and talents…

- Be self-aware of your limitations
- Remember the Dunning-Kruger effect
- Always be learning – growth mindset
- Ask yourself: What if I am wrong?
- Ask others to play Devil's Advocate

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Mitigating Availability Bias

Being influenced by the most easily retrieved data as we generate hypotheses, seek information, evaluate evidence, and assess risks.

- Increase availability through diversity
- Focus on facts, not feeling
- Push for less available data
- Don't confuse probability with impact
- Don't confuse correlation with causation

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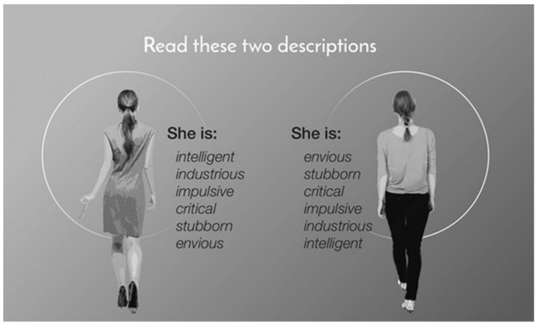
Mitigating Confirmation Bias

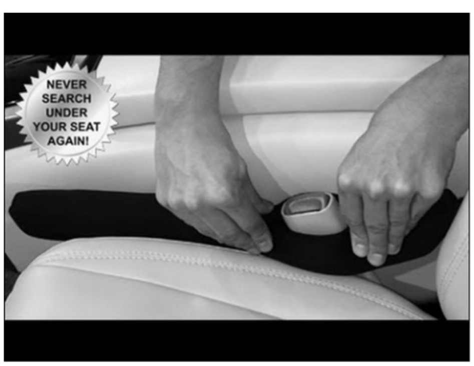
The tendency to seek or interpret evidence in ways that support preexisting beliefs or expectations.



- Postpone, postpone, postpone
- Remember the "rule of three"
- Share the data, not the conclusion
- Seek disconfirming evidence
- Believe in circles not straight lines

Mitigating Anchoring Bias

When estimating a value, individuals often anchor on a preliminary amount and then make adjustments to arrive at their final estimate; however, they often make insufficient judgments to arrive at the true value.



- Change the sequence of the process
- Change your benchmarks
- Ask a different question
- Ask: What would it take…..?
- Imagine you are someone else