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Judgment Sustained

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After the market closed on Friday, July 31, 2009, Huron Consulting Group dealt its shareholders a devastating blow. Discrepancies in the books were uncovered, so the organization announced its intention to restate its 2006–2009 financial statements. Four recent acquisitions involved earn-out agreements related to employee compensation. Rather than accounting for these otherwise-legal transactions as non-cash charges to earnings, which would negatively impact Huron’s net income, they were recorded to goodwill as part of the purchase price in what quickly became a textbook demonstration of faulty judgment.

Even in hindsight, the motivations behind this decision are difficult to pinpoint, but the facts suggest a lapse in judgment. Investors didn't take kindly to the news, and by Monday morning, Huron's stock price tumbled by a gut-wrenching 70 percent. Over the course of a weekend, nearly \$700 million in shareholder value vanished.¹

Is your company vulnerable to poor judgment by your financial and accounting managers? Most organizations would support their claims for safety by citing extensive and often rigorous governance practices. However, as we observe every day, human biases can undermine judgment, leading to regrettable choices. Governance processes typically do not account for these biases, which can result in huge errors that can impact the sustainability of a company.

Poor judgment in accounting can be costly. Despite the use of rules-based standards in the United States—Generally Accepted Accounting Principles (GAAP)—poor judgment is one of the leading reasons for failed financial reporting. A 2006 study suggests that judgment (presumably of the bad variety) is the second-leading contributing driver for restatements.

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(GAAP)—poor judgment is one of the leading reasons for failed financial reporting. A 2006 study suggests that judgment (presumably of the bad variety) is the second-leading contributing driver for restatements.² Flawed financial reporting is obviously a serious outcome in itself, but many other aspects of business performance, such as financial planning, brand and reputation, are also exposed to significant risk through poor managerial judgment.

Today, the adoption of principles-based International Financial Reporting Standards (IFRS) seems almost inevitable. The current U.S. administration is committed to making substantial progress toward a single set of high-quality, global accounting standards.³ In September 2009, the Group of Twenty (G-20) summit in Pittsburgh called upon international accounting bodies to redouble their efforts to achieve a single set of global accounting standards and complete their convergence project by June 2011. Also, both the chairman and chief accountant of the SEC indicated recently that the proposed IFRS roadmap was a renewed priority.

All signs seem to be pointing to its adoption by the United States.

The principles-based orientation of IFRS will require greater exercise of judgment on accounting decisions by more managers across more varied parts of a company. This raises some key questions paramount to successfully implementing IFRS and maintaining robust corporate governance. How will companies enable managers to drive sustainable judgments that address today's needs and protect or create future value?

Peter Drucker observed that “most discussions of decision making assume that only senior executives make decisions, or that only senior executives’ decisions matter. This is a dangerous mistake.” This seems to be more than true for companies, considering the impact of a principles-based set of accounting standards, which will require more people to participate in making decisions and applying a level of judgment that was not required for our rules-based standards in the United States. Moving away from rules, how will companies drive consistent and sustainable judgments on critical accounting issues? For all their complications, rules at least provided us with one ‘right’ answer – optimal or otherwise. Principles require a different mindset.

Our recent research suggests that we need to look within ourselves and re-examine our inherent biases, which can hinder sustainable judgments. Leaders and managers who recognize these biases may then implement a ‘judgment framework’ as a key component of their management practices. A judgment framework is a set of principles or guidelines, or a critical and good faith thought process that enables decision makers to consider a situation more holistically and drive more consistent decision making.⁴

As part of the study, we conducted a survey of nearly 200 highly experienced financial executives and officers, who were given a model judgment framework to bolster their decision making. The majority of these executives told us that the judgment framework was very helpful.

Judgment, at its core, is not formulaic. No judgment framework will result in consistently correct and effective decisions. However, using a judgment framework could lead to greater consistency in decision making and practice.

Frameworks have been used in other professions for a similar purpose. The application of our laws in the United States is made through *legal doctrine*. Legal doctrine is a framework, set of rules, procedural steps, or a test—often established through precedent in the common law—through which judgments can be determined in a given legal case. A doctrine comes about when a judge makes a ruling where a process is outlined and applied. This allows the doctrine to be equally applied to like cases. Applying this to financial reporting, companies will need to

determine whether they want their own doctrine or judgment framework in place. This may allow them to ensure that the results of their financial positions and operations are effectively and consistently reported within the boundaries of IFRS, while representing the underlying economics of the operations or transactions.

FROM THE GUT TO THE HEAD

To understand the biases that we carry around with us, it is important to know how the human mind works when it comes to making decisions. Broadly speaking, there are two ways in which we cognitively function.⁵ The first is our intuitive “gut feeling” about situations. This method of decision processing works quickly

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and instinctively, and it is sometimes an emotional reaction. The second is a more analytic, holistic, thoughtful approach to making decisions.

If you think carefully about the last ten decisions you’ve made, many of them would probably fall under the first category. In today’s fast and competitive work environment, we often find ourselves “under the gun” to make decisions. Sometimes, we jump to conclusions and rely on the gut, instead of gathering all of the relevant data and then considering all of the alternatives.

There can be severe consequences to not giving careful consideration to the major aspects of a decision. In the case of WorldCom in 2002, the board of directors was held responsible for its approval of multibillion-dollar mergers and acquisitions with little discussion. One such deal: A \$2 billion purchase of SkyTel was approved by the board after a 15-minute management presentation. Maybe after those 15 minutes were up, they felt confident that spending \$2 billion of shareholders’ money was prudent, but in hindsight, particularly given what ultimately transpired at WorldCom, it became difficult to provide evidence that the decision was properly thought-through.

One of the best examples of a fundamental change in decision making comes to us from professional baseball. In *Judgment in Managerial Decision Making*, Max Bazerman, describes how Billy Beane, the manager of the Oakland Athletics transformed team building in baseball from an exercise in intuition to a highly analytic

process to determine which baseball statistics actually predicted runs scored in the big leagues.⁶ This led his team to enormous success and significantly fewer dollars spent on payroll for players – a good, rational business outcome in any field. Michael Lewis’ book, *Moneyball*, asserts that baseball executives were guilty of three mistakes: 1) over generalizing from their personal experience; 2) being overly impressed by players’ most recent performances; and 3) putting too much weight on what they saw instead of looking at the statistical data for their multi-year performance.⁷

In short, their decisions were biased.

BIASES, BIASES

How can biases manifest themselves in accounting decisions? Consider the example of an IPO company that nearly succumbed to the bias of blindly following the practices of a competitor. In the preparation for its public spin out from its larger parent company, the IPO company was under pressure from the investment bankers to smooth its earnings, since it was highly susceptible to the volatility of fuel prices. It quickly entered into a multimillion-dollar derivative fuel contract, assuming that it could achieve hedge

accounting since its competitor was apparently able to do so. After difficult discussions with its auditor, the company reluctantly yielded to the fact that it would not be able to use hedge accounting. The very day that the IPO company was to file its registration statement on Form S-1, its competitor announced that it had to restate its earnings due to inappropriate use of hedge accounting. Due to thoughtful, reasoned decision making, the IPO company avoided a landmine, while its competitor suffered the consequences of a restatement, including blows to its stock price, brand, reputation and investor confidence.

Some very critical biases originate from how we apply *heuristics*—rules of thumb—to quickly arrive at the best possible answer. For example, while using a



heuristic like mimicking a competitor in the decision making process, one ends up using readily available information or assuming commonality between similar situations. This can lead to consequences ranging from simple statistical errors to major misinterpretation of regulatory standards. It is critical for managers to understand how common biases can arise from the use of heuristics in decision making. We can start by taking a hard look at the information influencing a decision.

Is the information at hand the right basis for your decision?

A critical bias often occurs when we arrive at a conclusion based on information from our memory—whether the most recent or the most easily available to us—rather than the information that is most relevant to the situation. This is the *availability heuristic*. We tend to base our decisions on how easily information is recalled – in other words, whatever comes to mind first. We are particularly susceptible to recency, grounding decisions on each new piece of information that comes along instead of considering the cumulative result of the entire fact-gathering process. We also tend to overestimate associations. For instance, to quickly account for an uncommon transaction, we tend to recall similar transactions that our companies or even competitors may have experienced. In the process, we may end up incorrectly comparing two irrelevant transactions because it is the only association our minds can make.

Is the information common or really, really uncommon?

Several biases fall in this category. Another bias arises from our insensitivity to the prior known probability of outcomes. Decision makers often tend to ignore pre-existing distributions of categories or base-rate frequencies and probabilities. For example, most people enter marriage thinking that the high rate of divorce does not apply to them, despite the widely publicized fact that the majority of marriages (more than 50 percent) end in divorce.

Back to business: suppose the standards from SEC or Financial Accounting Standards Board discuss an accounting treatment that, in rare circumstances, may be acceptable. Some accountants may read this and automatically assume their situation is one of those rare circumstances. By definition rare circumstances are unlikely. This bias arises from the use of *representative heuristics*, in which we tend to assume commonality between two objects or two sets of information based on similarity in appearances or between a piece of information and a set it appears to fit into, as depicted in the IPO company's story.

Another bias is *insensitivity to sample size*: we tend to draw strong inferences from a small number of cases. Many of us make choices in our everyday life based

on what seems to be statistical information. For instance, while shopping online, we tend to choose products with high average customer ratings. However, looking under the hood may reveal that ratings are not based on a statistically significant pool of feedback providers.

There was a period during the late 1990s when many technology companies were entering into puts and calls in their own stock. These transactions were meant to lock in the buyback price of their stock for their stock repurchase plans, thereby shielding themselves from what they thought was the endless, exponential appreciation of their stock. Many companies thought this was a good idea because one of the industry leaders was doing it successfully. However, with the volatility of the market, some of the much smaller companies using this strategy were burned with losses when they were forced to purchase their shares back at a significantly higher price after the market tanked. Statistically, small samples are always more likely to produce extremes than are large samples; hence, one company's ability to do this successfully did not translate into gains for all of its followers.

The *misconception of chance* is another bias. Often, especially while gambling, we interpret a 'normal' event as rare, believing that chance will 'correct' a series of rare events. For instance, every week you buy a lottery ticket and tell yourself that this is the week that you will become a multimillionaire – when the fact is that the odds of this happening are upward of one in several million. Maybe tomorrow will be better, but hope is rarely a viable business strategy. This misconception of chance sometimes aggravates errors and results in unethical behaviors. For example, in frauds such as Leeson at Barings, what started out small became a major fraud, as the company believed it was unlikely that they would be caught.⁸

The *regression bias* is the opposite of misconception of chance. We mistake 'rare' events for 'normal' ones and overlook the possibility that chance can cause extreme outcomes. The reality is that results tend to regress to the mean. This may be particularly relevant when watching a bull market: many people will believe that it will never end, but history shows that long-term investing in the stock market will produce approximately an 8–10 percent return on investment per annum over time. Companies may be more vulnerable to regression bias when they have a particularly stellar quarterly result due to a significant sale that is not likely to be repeated.

And, of course, Bernie Madoff's investors thought his steady results were normal.

Is the information "weighed down"?

The *anchoring heuristic* occurs when people rely too heavily on one trait or piece of information when making decisions. People initially estimate an answer or solution based on past experiences or what little information is on hand at that time.

They then find it difficult to deviate from or sufficiently adjust this initial estimate in developing their final answer. They become anchored to their initial analysis and preliminary conclusion.

The *overconfidence bias* presents another challenge. When dealing with complex issues such as those encountered in accounting, especially the principles-based standards of IFRS, people tend to be overconfident in their judgment – even when answering complex questions. They convince themselves that their answer must be correct. In a recent *New Yorker* article, Malcom Gladwell asserts that, “Investment

banks are able to borrow billions of dollars and make huge trades because, at the end of the day, their counterparties believe they are capable of making good on their promises. Wall Street is a confidence

When making a decision, first ask yourself if you have all the facts for the transaction or event you are analyzing. This may seem obvious, but too often, gut decisions are made with insufficient facts and too many hunches.

game, in the strictest sense of that phrase.”⁹ It may not be surprising then, that an industry could be toppled by the same overconfidence bias that dictates its winners and losers.

In the *confirmatory trap*, once individuals come up with a preliminary conclusion, they seek only confirmatory information and avoid information that will disconfirm or discredit this conclusion. Companies often use this strategy when they want to achieve a desired or preferred accounting result, which often is not the best answer. This strategy can often lead to errors in judgment.

Hindsight and the *curse of knowledge bias* can also disrupt judgment. This is also known as the “I knew that was going to happen” effect. After learning the outcome of a certain event or complex problem, people overestimate their ability to have predicted the correct outcome.

CREATING JUDGMENT FRAMEWORKS TO ALLEVIATE BIAS

Leaders are tasked with exemplifying good judgment and also coaching their subordinates in the art of good judgment. But few have formal training (outside the school of hard knocks) in addressing judgment biases. Research shows that experience matters; but it does not eliminate bias. As Gladwell states in his *New Yorker* article on overconfidence, “As we grow older and more experienced, we overrate the accuracy of our judgments.”¹⁰

So what is a company to do with IFRS lurking in the future? With principles-based accounting and fewer rules to follow, how can a company ensure that its management judgments will be more sustainable? The use of a judgment framework can help ensure that your company's values are more consistently embedded, with less bias in the judgments that employees make when applying principle-based standards to their accounting decisions. A judgment framework is not a silver bullet, but (at the risk of a representation bias) research shows that similar tools can work in other contexts, particularly ethics. For example, one study showed that having a written code of honor that individuals signed reduced the likelihood of unethical behavior.¹¹ Similarly a company's judgment framework would alert users to biases and suggest ways of overcoming them.

As part of our research, we crafted an illustrative judgment framework and used it as part of an experiment with a large group of accountants addressing a revenue recognition problem. This experiment and illustrative framework are discussed in the sidebar, and participants in the research noted the framework was very helpful in their analysis. Each organization will have to devise its own judgment framework. At the very least, these frameworks should trigger



more critical thinking and questions when making decisions about specific transactions, and eventually help the decision maker move from gut reactions to a more reasoned judgment. Judgment frameworks may vary somewhat across organizations, based on mission and values: some foundational questions for decision making can guide the design for a judgment framework.

Facts and Information

When making a decision, first ask yourself if you have all the facts for the transaction or event you are analyzing. This may seem obvious, but too often, gut decisions are made with insufficient facts and too many hunches. As part of gathering

and evaluating facts, you might assess the stability of the facts. Are they likely to change during the course of a transaction or in its aftermath?

As part of the fact base, you might also ask a third question: Do I understand the business reason or substance of the transaction? For instance, a straightforward judgment on recognizing revenue for a three-year fixed-price service contract would be prorating the total contract value over three years. However, to make appropriate revenue recognition judgment, it is important to understand when the costs are incurred to deliver these services, how they are distributed, and how the revenue recognition will affect the sales target for the account. This can help you decide what you and others are trying to accomplish in the transaction.

A fourth question to ask is whether you know the relevant principles to apply to the transaction. Have you completed a thorough review and analysis of relevant literature, including the underlying principles tied to the accounting for that transaction? In other words, two transactions may look very similar but may have different context and may require different treatment according to the regulatory guidelines. Hence, before arriving at judgment, it is important to thoroughly review supporting documents and verify accounting guidelines.

Challenging the Biases

While we all have biases, there are some explicit strategies that can ameliorate some of the most common ones:

1. *Have you looked at the transaction from a different stakeholder's point of view?* Taking an outsider's perspective when analyzing a transaction can uncover biases and reduce overconfidence.

2. *Have you framed a list of possible alternatives, with pros and cons for each option to simultaneously evaluate alternatives?* Considering alternatives simultaneously, as opposed to rejecting alternatives one by one, helps to counteract the availability heuristic. This strategy reduces the likelihood of overweighting information learned early in your problem-solving process (anchoring) and also reduces the susceptibility to recently learned information (availability).¹² People showed less willpower or more susceptibility to bias when they weighed choices separately rather than jointly.

3. *Have you considered the opposite alternative to your preferred choice?* This is another strategy to reduce overconfidence, the hindsight bias, and the anchoring bias. This strategy helps to move choices from a gut-based decision toward a more logical, fact-based decision.

4. *Should this transaction be evaluated by a designated expert group?* Research shows that working in groups increased decision accuracy on the whole. Specifically, increased accuracy comes from allowing up to three decision makers to collaborate, but more decision makers provide only small increases in accuracy.¹³

A JUDGMENT FRAMEWORK

Professional judgment should be based on a critical and reasoned evaluation made in good faith. The following judgment framework is meant to focus you on the issues to be addressed and to assist in reducing the biases that are inherent in decision making, thereby improving the quality and reasonableness of your judgments. Please consider each of the following steps when determining the proper accounting for this transaction:

- A. Remove yourself mentally from the specific situation; take an outsider's perspective (since you are the Controller, think of how an unbiased outsider would view this transaction — perhaps an SEC regulator or an investor).
- B. Analyze the transaction: What is the substance or business purpose of the transaction?
- C. Complete a thorough review and analysis of relevant literature, including the relevant underlying principle.
- D. Consider alternative views, including pros and cons for reasonable alternatives.
- E. Consider the alternatives simultaneously rather than accepting or rejecting them separately (one by one).
- F. Ensure that you also consider the opposite of whatever decision you are leaning towards.
- G. Consider whether you could explain the rationale for the selected choice to those to whom you are responsible (your company and its shareholders). This includes the reasons behind selecting this alternative, and how they link to the information needs of investor and the judgments of competent external parties such as the SEC and auditors.
- H. Ask yourself if you can link the alternative or estimate selected to the substance and business purpose of the transaction or issue being evaluated.
- I. Consider why there may be diversity in practice regarding the alternatives or estimates and the consistency of application of alternatives or estimates to similar transactions.
- J. Consider the impact of your judgment in the future (long-term and short-term). Would you continue to make the same decision if this became a recurring transaction for your company?

Two other questions can also help with improving judgments: first, can you explain the rationale for the choices you have made to those to whom you are accountable (such as your company leaders, shareholders, or competent third parties such as outside auditors or the SEC)? Research shows that accountability results in more effort by the decision maker to reduce biases such as the recency bias.¹⁴

A second question to consider is the impact of your judgment over time (long term and short term). Warren Buffet once said: “Only buy something that you’d be perfectly happy to hold if the market shut down for 10 years.” He has shown that taking a long-term view of investment decisions can help to avoid mistakes motivated by short-term thinking and greed. Also consider whether you would continue to make the same decision if this became a recurring transaction for your company. How would you reconsider if the consequences of your choice were to be immediate? We tend to be more responsive to immediate consequences than delayed ones, especially when delayed ones are uncertain.¹⁵

MOVING TO IFRS: BEYOND THE PRINCIPLES

The move to IFRS will be a major transition for the companies in the United States. Moving from rules-based accounting to principles-based accounting will require, at a minimum, greater training and familiarization with the underlying accounting principles that apply to different transactions. In addition it will require accountants to bring their experience and judgment to bear on interpreting the principles in the context of specific transactions. Nevertheless, as we have suggested, judgment is sometimes fallible and prone to various biases that can be costly.

Judgment frameworks can be a helpful addition to the transition to IFRS by triggering greater consideration for the facts and information used in decision making, strategies to reduce bias, and increased consideration of the accountability and sustainability of judgment. Each company will have to craft its own framework to support its staff. But, beyond the principles, judgment frameworks can be a useful tool to make decision makers more aware of common judgment biases, and to encourage more consistent, robust, sustained judgments.

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