The science behind why people commit financial deception

Board Leadership Center (India)

In the world of corporate governance, the specter of financial deception looms large, posing a significant threat to companies, investors, and stakeholders alike. While traditional approaches to combating fraud often focus on strengthening controls and regulations, understanding the underlying behavioural science can provide valuable insights into the motivations and mechanisms driving deceptive behaviour.

At a recent session led by the Board Leadership Centre, KPMG LLP U.K., Dr. Andries Terblanche shed light on this interesting topic, offering a captivating exploration into the science behind this behaviour. Focusing on behavioural finance and economics, Andries unpacked five scientific principles (including Nobel Prize winning theories) that board members could use to understand why individuals make unethical financial decisions and perform malpractices.

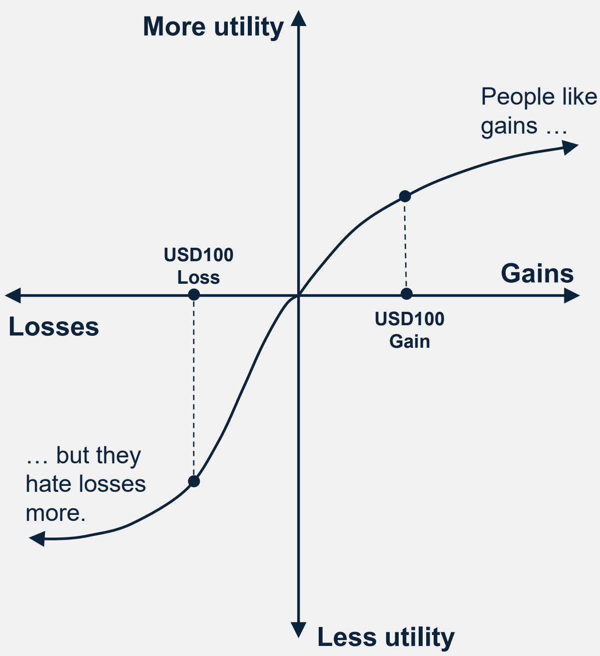
01 Prospect theory

Developed by Daniel Kahneman and Amos Tversky, Prospect theory is a psychological model that describes how people make decisions involving risk and uncertainty. It suggests that individuals do not make decisions based on rational calculations of expected utility, as traditional economic theory assumes, but instead evaluate potential outcomes in relation to a reference point (usually the status quo). Significantly, the theory posits that people are more sensitive to losses than gains of the same magnitude (loss aversion). Also, they experience diminishing sensitivity, which means that the marginal utility of gains or losses diminishes as the magnitude increases.

In the business context, prospect theory tells us that losses are experienced more, or 'deeper', than gains of the same quantum. As a result, people who are behind budget, out of the money on stock options, trailing in the bonus profiling, etc. will experience emotional discomfort, to the point that they will exhibit a comparative higher risk appetite towards (say) non-compliance than individuals who are 'in the money'.

Useful questions for the board : Where are we behind budget, who won't receive a bonus, and where will there be commensurately lower pay rises? All these areas present a heightened risk of circumventing controls and committing fraud. Ultimately, individuals in the 'domain of losses' should attract a 'red flag'' as the board start to build their risk appetite profile.

The value function



02 Plural rationality theory

Plural rationality theory posits that individuals rely on different cognitive mechanisms to navigate various situations effectively. This leads to decisions being driven by diverse rational behaviours shaped by a range of factors, including individual beliefs, emotions, cultural norms, and environmental influences.

Consider the following four risk profiles.

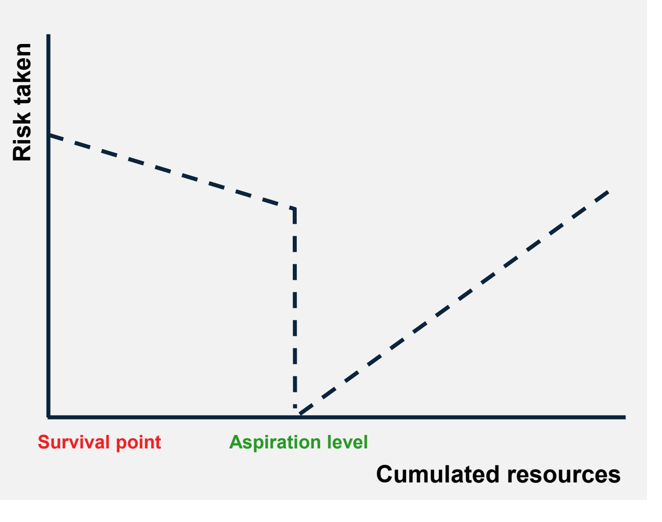
1. **The Maximiser:** Maximisers are profit orientated - the risk is not as important. The Maximiser will accept risk 'as long as the price is right'. Furthermore, they typically hold that risk is mean reverting (which we now know is not always the case), so that gains will follow losses and the best companies will have larger gains and smaller losses over time. (We also know this no longer to be an unassailable notion). CEO's are typically maximisers, as their role requires them to pursue growth and profits.
2. **The Conservator:** To the Conservator increasing profits are not as important as avoiding future losses. The Conservator therefore believes it imperative to tightly limit risks, viewing the world as in delicate balance so that a major (or structural) change can send it into ruin. Ideally the CRO should be a Conservator to balance the Maximiser profile of the CEO. Conservators are sticklers for detail when it comes to compliance: they hardly require any motivation to be meticulous about processes and procedures.
3. **The Manager:** The Manager believes that risks are measurable and controllable; and that risk and reward should be carefully balanced. To this end experts are helpful to find risks offering the best rewards and to manage the risks to keep the firm safe. The CFO is frequently a Manager, providing reason and balance between the CEO's risk appetite and the CRO's caution. To have each one of these profiles in the CEO, CRO and CFO (in the right offices of course!) constitutes sound fundamentals for good corporate governance.
4. **The Pragmatist:** The Pragmatist believes the future to be totally unpredictable. From this departure point, one cannot control the risks involved, so there is no point in trying to do so. This implies that it is best to avoid major commitments, keep options open and seek freedom to react to changing conditions. The Pragmatist, in essence, believes in 'black swans' and therefore wishes to sit less volatile periods out in order to capitalise on opportunities as these arise at times of upheaval. The profile is largely unhelpful in business.

Individuals of a Maximiser or Pragmatist profile should attract closer scrutiny.

03 The March-Shapira dual focal point framework

The March-Shapira Dual Focal Point Framework holds that risk taking declines as people get closer to reaching their goals and, conversely, increases as they fall further from their goals. This makes risk taking behaviour sensitive to how far the individual is from where they aspire to be, and whether the individual focuses on survival (higher risk appetite) or on meeting targets (lower risk appetite).

Any individual / department / business unit in survival mode will require closer scrutiny when it comes to monitoring compliance, whereas those that have reached their goals require less scrutiny as their risk appetite (propensity for non-compliance) is commensurately lower. It is worth noting that if an individual's goals are increased – or if someone achieves what they want and then loses it (say they are declared bankrupt) – then their risk appetite (propensity for non-compliance) will rise again, signalling that greater scrutiny may be required.



4.1 Group behaviour: study of obedience

Stanley Milgram's obedience experiment, conducted in the 1960s, involved participants serving as "teachers" who were instructed to administer electric shocks to a "learner" every time they made a mistake in a memory task. The key focus was on how far participants were willing to go in obeying an authority figure, in this case, the experimenter, even as the shocks increased in intensity to potentially harmful levels.

The results were shocking, as a significant portion of participants obeyed the authority figure despite evident distress from the learner, suggesting a propensity for obedience to authority even if it meant causing harm.

Milgram concluded that ordinary people, under certain circumstances, could act in ways that contradicted their moral beliefs due to the influence of authority figures.

What does this look like in corporate life?

Dominant authority figures, be that the CEO or a department head, can exert undue influence on others and circumvent an otherwise positive compliance culture. In such circumstances, an effective whistleblowing function is paramount, as is the need to protect whistle-blowers.

4.2 Group behaviour: conformity theory

Solomon Asch's conformity experiment, conducted in the 1950s, focused on the impact of group pressure on individual decision-making. Participants were asked to match line lengths in a visual perception task. However, in a group setting, confederates purposely gave incorrect answers. The study sought to determine if participants would conform to the group's incorrect judgments despite the obvious correct answer. Results showed that a significant percentage of participants conformed to the group's incorrect responses, even when they knew the answer was wrong. This demonstrated the power of social influence and the tendency of individuals to conform to group norms to avoid standing out or appearing deviant.

The experiment highlighted the significance of social conformity and the pressure to fit in with the group, even at the cost of disregarding one's own perceptions. It shed light on the importance of individual independence and critical thinking in the face of social pressure and emphasised the need to balance conformity with personal judgment.

Boards should ensure their organisations are alert to signs of enforced conformity, for example, a ‘voluntary’ corporate uniform’ (white shirts black socks), tolerance or otherwise with dissenting views, selections for promotions, etc. The greater the enforced conformity, the more closely compliance will need to be investigated and assured.

05 Nudge theory

Richard Thaler's Nudge theory, developed in collaboration with Cass Sunstein, proposes that individuals can be influenced to make better decisions through subtle, positive reinforcement and indirect suggestions without restricting their choices. The theory suggests that designing choice architectures can guide individuals towards more favourable decisions without mandating specific behaviours. Nudges, such as changing default options or providing information in a certain way, aim to steer individuals towards choices that benefit them in terms of health, finance, or other areas.

Thaler's theory highlights the importance of understanding human behaviour and decision-making biases in designing policies and environments that facilitate better choices.

The conclusions drawn from Nudge theory indicate that small behavioural interventions can have significant impacts on individual decision-making and outcomes. By incorporating nudges into policy-making and everyday settings, organisations and governments can help people make choices that align with their own long-term goals and well-being.

In the corporate context, what the board says at the top, the power that it gives to second and third line of defence, will transcend into changing behaviours within the organisation. Similarly, compliance functions should be alert to nudges to adhere to compliance procedures, or for nudges that achieve the opposite effect. If non-adherence to compliance processes do not have consequences, it provides a nudge not to follow the rules. Some organisations have regular, thorough compliance audits with serious consequences for failures - nudging individuals to do their work properly by following the prescribed processes.

	Assessment			
Prospect theory	**Domain of losses?**	**Domain of gains?**		
Plural rationality theory	**Maximiser**	**Conservator**	**Manager**	**Pragmatist**
March-Shapira dual focal point framework	**At survival point?**	**Left of aspiration?**	**Right of aspiration?**	
Group behaviour: study of obedience	**Authority 'in the room'?**	**Ability to speak out?**		
Group behaviour: conformity theory	**Overly strong sense of 'group'?**	**Non-group conformity?**		
Nudge theory	**Incentive structure?**	**Values-driven decision architecture?**		

In conclusion, awareness around the boardroom table of behavioural finance and the science behind why people commit financial deception can assist directors in determining whether the board is in dangerous territory. The red flags are illustrated above.

Questions for boards for consider

- ? How confident are we in our organisation's ability to prevent, detect and respond to financial deception?
- ? What measures do we have in place to identify and mitigate the risk of financial fraud or manipulation?
- ? Are our internal controls robust enough to prevent unauthorised access to financial data and transactions?
- ? How frequently are our internal control procedures reviewed and updated to address evolving risks?
- ? Do board members receive sufficient training and education on identifying potential signs of financial deception?
- ? How independent is our external audit process, and what steps do we take to ensure audit quality and auditor objectivity?
- ? Are there any conflicts of interest that could compromise the independence of our auditors?
- ? How do we assess the integrity and ethical behaviour of senior management regarding financial reporting?
- ? What actions are taken if concerns arise about the integrity of financial disclosures or practices?
- ? How do we monitor and address legal and regulatory risks related to financial deception?
- ? What steps are being taken to promote a culture of transparency and ethical behaviour within the organisation?
- ? Have we conducted a thorough risk assessment to identify potential vulnerabilities to financial deception?
- ? What strategies are in place to mitigate identified risks and enhance our resilience to fraudulent activities?
- ? What mechanisms does the board have in place to proactively identify and respond to early warning signals of potential frauds and financial deceptions within our organisation?

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