Audit Committee Roundup

Good Judgment Requires Discipline, Awareness of Traps and Biases

By Dennis T. Whalen and George Herrmann

It used to be that exercising good judgment largely meant “using common sense.” But today, while common sense is still essential, exercising good judgment—consistently—in a business environment that is increasingly complex and dynamic, volatile and uncertain, and under high pressure requires a disciplined process. It also requires an understanding of common traps and biases that can undermine the judgments of even seasoned professionals and boards.

Clearly, many audit committee members are attuned to the issue of judgment—particularly as they sharpen their focus on accounting judgments and estimates, to understand how management arrived at a particular estimate, alternatives that were considered and, ultimately, the quality of the decision. Of course, applying a sound judgment process to every key business decision is essential, whether it’s about corporate strategy, acquisitions or risk. Yet, in our surveys, audit committee members continue to cite “groupthink” as a concern, and many express the need to hear more “dissonant views, particularly from down-the-line” to support a more rigorous dialogue about the risks facing the company.

To this end, highlighted here are insights from Enhancing Board Oversight: Avoiding Judgment Traps and Biases, a new COSO paper co-authored by KPMG and Brigham Young University professors Steven M. Glover and Douglas F. Prawitt, on the keys to a robust professional judgment process.

A good judgment process followed consistently can help improve decision-making and oversight, but “traps and biases” can undermine the process. Consider using a formal judgment process as described in the COSO paper (adapted from KPMG’s Professional Judgment Framework): 1) define the problem and identify fundamental objectives; 2) consider alternatives; 3) gather and evaluate information; 4) reach a conclusion; and 5) articulate and document the rationale. Steps like these seem simple, yet each is vulnerable to common traps and biases.

Our “intuitive” judgment can betray us. As with optical illusions, intuitive judgments—even by even the most seasoned professionals—can fall prey to cognitive illusions, undermining good judgment. As discussed in the COSO paper, being aware of judgment traps and biases, and applying certain logical steps, can help reduce their impact.

Beware of three particularly common judgment traps: “groupthink” (suppression of divergent views and/or acceptance of dominant board members’ views expressed early on, and striving for early consensus, often to avoid conflict); “rush to solve” (a desire to appear decisive can lead to “solving the wrong problem” by not precisely defining the problem); and “judgment triggers” (when an alternative is presented as the solution and is selected without fully defining the problem or fully considering other alternatives).

How you “frame” an issue largely determines how you see it (or don’t see it). Judgments can be improved by identifying and understanding the frame(s) through which management and other board members view the issue (e.g., while management may frame a particular risk as a strategic opportunity to be pursued, board members and others may see it more as a major risk to be managed). Considering the issue through multiple frames—a “fresh lens”—can help provide important alternative perspectives.

Beware of four common biases that can undermine good judgment (unwittingly): “Overconfidence” (a tendency of decision makers to overestimate their abilities to consistently make good decisions and achieve deadlines, and the likelihood of success); “confirmation” (seeking out or putting more weight on information that supports an initial opinion); “anchoring” (being too closely “wed” to an initial numerical figure and reluctant to adjust sufficiently away from it); and “availability” (considering information that is easily retrievable from memory as more likely, more relevant or more important). Making the opposing case, seeking disconfirming evidence, questioning the experts and testing their assumptions, and encouraging opposing points of view can help mitigate the effects of such biases.

Directors can use these and other insights provided in the COSO paper to test and improve the consistency and quality of judgment processes and outcomes—by rigorously challenging perspectives and assumptions, and by actively applying a systematic judgment process while staying vigilant to the traps and biases that can undermine good judgments.

Dennis T. Whalen is partner in charge and executive director of KPMG’s Audit Committee Institute. George Herrmann is a national office partner, KPMG LLP, and co-author of the COSO paper. The full paper is available at www.coso.org.

1Committee of Sponsoring Organizations of the Treadway Commission