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Accounting fraud and the role of emotions

By ***Frank Hartmann***

The traditional view of accountants has become almost a caricature. They prefer numbers to people. They do not understand business. They are incapable of formulating strategic vision. In order to address this perception, the long-term trend in modern people management has been to encourage the development of greater humanity in the world of bookkeeping. Our contrarian view is that this is not necessarily a good thing.

Our view – backed up by scientific evidence – is that selecting people to become accountants who are more emotional and empathetic than the traditional representation of the profession's members as unthinking calculating machines could in fact lead to unforeseen problems. In certain business conditions emotional social pressure can lead to the manipulation of corporate performance and investment numbers. And what might start as a minor, misguided misrepresentation of reality could well terminate in outright lying, cheating and fraud.

The dangers inherent in the potential for – and the impact of – even minor infractions to strict accounting rules and other formal constraints on corporate behaviour cannot be overestimated. Enron springs immediately to mind as an example of the former, abusing as it did accounting devices to overstate profits and mislead outsiders as to the actual source of those profits. Business unit (BU) controllers play a fiduciary role in ensuring the integrity of financial reporting; however, they often face social pressure from their BU managers to misreport.

It is against this backdrop that a number of colleagues and I carried out a laboratory-based brain study to establish scientifically whether some people are biologically inclined to resist social pressure or whether they can be swayed in the direction of this pressure.

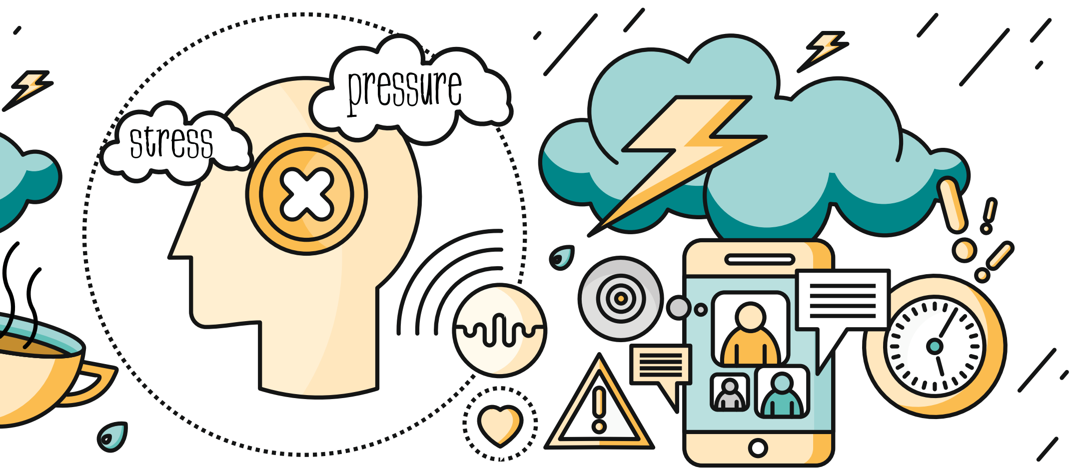
In our paper, Philip Eskenazi, Wim Rietdijk and I considered the results of this unique brain study in formal academic terms. We set out to determine if we could draw a relationship between the personality and likely behaviour in a defined set of commercial circumstances that involved manipulating data and sentiment (the human mirror neuron system – hMNS – is the part of the brain responsible for processing emotions).

Yielding to pressure

We measured the reactions of 29 professional internal financial controllers during an emotional expressions observation task. Their inclination to misreport was measured using scenarios in which controllers were being pressed by their manager to misreport. We observed brain responses and identified a positive association between the mirror neuron system functionality of controllers and their inclination to yield to managerial pressure.

In one scenario, Jim is a business unit manager and direct supervisor of BU controller Carl. For most of the current year, the BU's performance was quite good. In large part this is due to Jim's excellent management skills. However, a major production problem in December threatens the BU to face a loss this year. This would cost Jim his full bonus for the year. He was counting on the bonus, so this prospect seriously distresses him, as his family situation is problematic. Jim proposes to release part of an existing provision to improve the BU's bottom line. The provision is in a grey area, so that accounting rules allow interpretation both ways.

In another scenario, Victor is BU manager and direct supervisor of BU controller Bob. The BU has shown three years of solid performance. Victor has been working very hard in this period and turned the BU into a successful business. However, this year the BU is about to end below the sales target. This would strongly decrease Victor's



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chances of getting the promotion he was hoping for. Victor is very excited about a possible step up the hierarchy in the company, and is very keen on making the target. Victor asks Bob to authorise a sharp price discount for a sales promotion in December, which would ensure the BU meets its target, even though sales in early next year would suffer.

Conclusions

What can we conclude from the scientific evidence gathered? The lessons are both academic and practical, although it has to be conceded that while our theory and method are fully in line with state-of-the-art investigations in this field of neuroscience, some care is required in interpreting our findings. The very use of an EEG-based analysis to test a neurobiological theory limits the ease of understanding the implications of our findings. Neuroscience is a rapidly developing field that continues to discuss the nature, consequences and measurement of fundamental neurobiological processes.

Nevertheless, the findings show that we should be careful to always consider humans as rational beings who will consciously respond to management instructions. In certain circumstances people will act according to instinct rather than in a conscious manner and fail to heed instructions. People do not realise they are doing anything wrong (or at least anything more wrong than other people are doing) and the sensitive types gave in more easily.

It is no exaggeration to say that for operational and commercial success it is essential to be able to determine at which end of the behavioural spectrum an individual will most likely sit. As socially skilled people are more likely to give into manipulation to deliver accounting reports that are not entirely truthful, companies who value such attributes in their accountants might want to reconsider their modern hiring practices.

To put it in formal terms, the recruitment of more socially competent controllers may come at the cost of an increased fiduciary duty threat. In simpler language, an excess of emotions causes accounting fraud. The inescapable conclusion is that it might be better to cherish coldness and aloofness in a prospective accounting employee. ■

This article is based on the paper *Why controllers compromise on their fiduciary duties: EEG evidence on the role of the human mirror neuron system* written by Philip Eskenazi, Wim Rietdijk and Frank Hartmann, and published in the journal *Accounting, Organizations and Society*, Vol 50, April 2016, p41–50.
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