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Cognitive biases in financial decision-making: implications for audit and risk management in large corporations: A conceptual review

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Abstract

The study covers how cognitive biases are involved in financial choosing and considers their possible effect on auditing and risk management in large organisations. When organisations face highly dynamic and important situations, anchoring, overconfidence, confirmation bias, herd behaviour, framing effects and the availability heuristic make it difficult for decisions to be made wisely. Bias in companies can change the way they handle financial matters such as budgeting, making forecasts and investing, creating problems that auditors and risk managers must handle. Prospect theory, behavioural finance, agency theory and internal control frameworks are used in this review to blend and expand ideas that explain how biases appear in finance, audit and risk management. They show that negative thinking patterns are shared throughout an organisation and can cause conflicts between departments. For example, being too confident about financial estimates can make audit scepticism less effective if people have confirmation bias. On the other hand, well-organised approaches such as clear decision-making, learning new ways of behaving and using AI systems can help solve bias at various places. The review further points out that boards and audit committees help detect and prevent biased choices and create a culture that encourages people to challenge them. Apart from suggesting actions for businesses, the review points out there are few studies and little publicly available data on how cognitive biases play out in organisations and on testing strategies to overcome them. Working on these deficiencies would be important for further academic work. All in all, the study supports the idea that tackling cognitive biases benefits decision-making, the organisation's abilities to withstand stress and stakeholder trust in major companies.

Keywords: Cognitive Biases; Financial Decisions; Behavioural Finance; Auditing; Risk; Organisational Behaviour; Behavioural Risk

1. Introduction

Decisions related to financial matters are very important for determining how successful a company will be now. Firms that are considered large corporations deal with busy markets, competitors who are always pushing them and technological upheavals combined with strict rules set by the government (Kahneman, 2011; Tversky & Kahneman, 1974). In these kinds of conditions, maintaining profitability and stability largely depends on good financial decisions in areas such as investments, budgeting, acquisitions, risks or reporting (Hilary & Hsu, 2011; Thaler, 2018). Decisions about money not only involve numbers but are strongly affected by the judgement, experience and perceptions of involved people (Bazerman & Moore, 2013). When overwhelmed by too many facts, people often turn to mental shortcuts instead of relying on computational models and charts (as Kahneman states in 2011). Sometimes, people make money-related decisions using shortcuts in thinking which can bring about systematic errors, often called cognitive biases (Tversky & Kahneman, 1974). Many organisations now pay more attention to cognitive biases because they understand that pure rationality alone is not enough in business (Bazerman & Moore, 2013; Thaler, 2018). Being pushed to produce constant results can cause corporate leaders, financial managers, auditors and board members to

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act in a biased manner (Hilary & Hsu, 2011). When anchoring bias is at work, executives often stick with their initial estimates even despite newer information telling them to update their decisions (Furnham & Boo, 2011). As a result of overconfidence, some risk managers may think important risks are unlikely (according to Moore and Healy, 2008) and confirmation bias causes people to pick out data that is consistent with what they believe, despite obvious evidence to the contrary (pointed out by Nickerson, 1998).

Because of these biases, businesses in serious financial situations may deliver problematic reports, misspend budgets, make poor choices about risks and experience serious corporate collapses (Kahneman, 2011; Thaler, 2018). Since corporate finance has become more complex recently, recognising such behaviours helps to improve audit and risk management efforts (Bazerman & Moore, 2013; Hilary & Hsu, 2011). The need to add behavioural insights systematically into auditing and risk procedures is the main reason for this conceptual review. There is a gap between the research on cognitive biases in behavioural economics and finance and the design of control systems, governance and audit practises by companies. Several audit and risk frameworks still rely on the idea that people are logical, relying mostly on technical or procedural procedures. Because of this, organisations miss opportunities to deal with factors influencing financial mistakes and reckless behaviour. In addition, although many researchers look into behavioural risk, academia still lacks an organised way to look at cognitive bias, financial decision-making, auditing and risk management as they apply to large organisations. This review tries to fill the gap by combining important research and insights into a unified framework that can guide both research and practise.

The main purpose of this review is to study how cognitive biases impact the way large companies make financial decisions and discuss how this impacts their audit and risk management systems. For example, how do common mental mistakes show up in company financial choices? What difficulties do financial managers and auditors have in preserving the integrity of financial statements? How can organisations change their audit and risk practises to address the impact of bias? To give a solid overview, the review looks into these questions and helps develop practical tools, rules and agendas for studying behavioural risks in corporations. This study is centred on large corporations because their scale and complex structure raise the importance of handling financial decisions properly. Even though small firms and start-ups deal with cognitive biases, the problems of how organisations function and are controlled differ a lot. The presence of set governance, formalised audit committees and dedicated risk management groups allows large corporations to explore the impact of cognitive biases on corporate actions. It brings together useful insights from psychology, finance, auditing and risk management by merging management, psychology and auditing perspectives. Nevertheless, the focus is still more on ideas than experiments, focusing on joining different ideas instead of providing original study designs or results.

2. Theoretical Foundations

Understanding what security is means labelling the concepts that this review will centre on. Cognitive biases are regular ways people's views, interpretations or choices can be affected by mental shortcuts, emotions or how others affect them (Kahneman, 2011; Tversky & Kahneman, 1974). By way of example, when anchoring happens, individuals stick to their first impressions which can result in not noticing new information (Furnham & Boo, 2011). Because of overconfidence, people often exaggerate their skills and abilities in controlling what happens (Moore & Healy, 2008), while confirmation bias makes individuals pay more attention to facts that back up what they believe (Nickerson, 1998). Another bias, called loss aversion, means that people usually pay more attention to avoiding losses than gaining things of equal value, resulting in risk-averse or risk-seeking actions depending on the situation (Kahneman & Tversky, 1979). It is not accidental that these biases happen; they come from clear psychological processes needed to handle complexity, but usually with the penalty of being wrong or inaccurate (Bazerman & Moore, 2013). Within corporations, different frameworks structure the way investments are reviewed, resources are divided, money is handled and results are reported (Brigham & Ehrhardt, 2022). Discounted cash flow, cost-benefit analysis and risk-adjusted returns are used to help follow financial frameworks, but human judgement limits their proper application (Thaler, 2018). Because of this, the strongest models can still be influenced by biased information or explanations. For example, top managers may cling to optimistic numbers, while those choosing what to invest may be influenced by the group's views (Janis, 1982).

Audit principles and risk management practices are used by organisations to preserve their financial stability and ability to survive (COSO, 2013). The process of auditing is to examine financial statements, check internal controls and verify that policies and regulations are obeyed. It is based on objectivity, questioning things professionally and using evidence in decision making (Messier et al., 2022).

Unlike assurance, risk management is concerned with discovering, evaluating and reducing dangers that may hurt an organisation, focusing on financial, operational, strategic and reputational risks (COSO, 2013). Both fields depend a lot on the use of models like the COSO Internal Control-Integrated Framework which describes ways to manage

governance, control processes, information sharing and monitoring. Nevertheless, these frameworks are strong, but they usually assume that people act logically and consistently which does not take into account how much human bias impacts the planning and running of a system (Kahneman et al., 2011). Several explanations and frameworks let us view financial decisions from different behavioural angles. According to behavioural finance, rather than making decisions based on facts and logic, people in finance often rely on mental shortcuts and feelings to choose courses of action (Thaler, 2018). When people evaluate gains and losses, they do not act the same way, according to prospect theory developed by Kahneman and Tversky (1979). According to agency theory and the main principal-agent problem, situations can arise when organisational actors (such as managers and shareholders) have different views and goals (Jensen & Meckling, 1976). Because of biases, agency problems can get worse since managers may present false reports or take more risks and auditors and boards should pay close attention to such behaviour (Eisenhardt, 1989). Finally, using frameworks such as COSO, organisations are guided in handling risk by paying attention to control environments, assessing risks, carrying out control activities, communicating and sharing information and monitoring results (COSO, 2013). Even so, these frameworks usually put more emphasis on structure and not enough on how people perceive dangers, follow policies or see auditing and oversight (Power, 2007). Adding views from behavioural theories to these models looks very promising because it might help organisations overcome cognitive bias in their daily activities, not just with paper requirements (Kahneman et al., 2011).

3. Review of Cognitive Biases in Financial Decision-Making

Large corporations often act without a clear sense of rationality when making financial decisions thanks to cognitive biases which often affect their outputs and governance (Kahneman, 2011; Thaler, 2018). Among the leading cognitive shortcomings are anchoring and adjustment, overconfidence, confirmation bias, herd behaviour, framing effects and the availability heuristic and every one of them introduces unique kinds of errors into choices (Bazerman & Moore, 2013). When individuals depend on the first piece of information they have even when it is no longer accurate, that's called anchoring and adjustment (Tversky & Kahneman, 1974). Managers in corporate budgeting may use last year's results as a reference and only slightly modify their forecasts, regardless of big changes around them (Furnham & Boo, 2011). Because of this bias, plans might remain unchanged despite new risks or opportunities arising. Anchoring may make companies hold on to their initial estimates when making investment decisions, though assumptions later on may differ (Northcraft & Neale, 1987).

When people have overconfidence bias, they tend to believe their abilities, knowledge or control over outcomes are better than they truly are (Moore & Healy, 2008). Because of this, executives might be more willing to take big risks, since they feel they can overcome problems better than their competitors (Malmendier & Tate, 2005). As an example, some CEOs might make risky acquisition moves without recognising how difficult it can be to integrate the new entity into the company (Hayward & Hambrick, 1997) and overly confident traders may forget to keep their risks in cheque, exposing the company to big losses in the market (Barber & Odean, 2001). In terms of predictions, overconfidence leads people to narrow the range they consider which means that unexpected negative outcomes are often ignored (Ben-David et al., 2013). Confirmation bias makes a person search for, explain and keep in mind evidence that matches what they already believe, ignoring information that goes against their beliefs (Nickerson, 1998). This problem appears in corporate finance when managers pay attention only to good performance and disregard any concerns (Russo and Schoemaker state). An illustration is that a group promoting an expensive project may point to likely positive revenues and overlook cost risks (Staw, 1981). Paying attention to tasks that we find interesting can reduce our good decision-making and cause the project to fail (Lovallo & Kahneman, 2003).

When individuals follow the lead of a large group and forget to make their own decisions, this is known as herd behaviour (Banerjee, 1992). Herd behaviour in large corporations may lead to choices like entering popular markets or adopting trendy technologies, though they might not be good for the company's strategy because others are doing the same (Bikhchandani et al., 1998). People may end up diverting resources or be involved in market bubbles, like in the dot-com boom (Shiller, 2000) or when cryptocurrencies were rising (Cheah & Fry, 2015). Framing effects point out that how a description or question is given can affect choices, despite the information remaining the same (according to Tversky & Kahneman, 1981). For example, handling a project that is said to have either a 70% or a 30% chance of success or failure could be seen differently by managers (Levin et al., 1998). Financial reporting can be influenced by frame, making stakeholders view the performance differently through the main highlight of adjusted earnings (Hirst et al., 2004) or the careful arrangement of risk items (Li et al., 2011).

According to Tversky and Kahneman (1973), with the availability heuristic, an individual measures the possibility of an event by how much it can be recalled (Tversky & Kahneman, 1973). There is a risk that companies will pay too much attention to uncommon events (such as corporate fraud), but not enough to common but less noteworthy risks (such as gradual inefficiencies in operations) (Hertwig et al., 2005). Often, people in charge of risk management concentrate on

what makes the news, rather than on the real causes behind the problem (Slovic et al., 2004). These biases are often seen through the examples and case studies given. A combination of overconfidence and a plan for risky financial manoeuvres helped lead to the collapse of Enron, according to Swartz and Watkins (2003). Anchoring bias influenced the events of the 2008 financial crisis by causing institutions to trust historical patterns of rising house prices, even though a housing bubble was becoming more obvious (Glaeser, 2013). A number of companies disregarded internal audit warnings and looked instead for information that made them feel more secure (Beasley et al., 2010). Fear of missing out pushed many investment banks into engaging in complex derivatives, following the actions of others in the industry (Acharya & Richardson, 2009). Looking at these cases together reveals the threats cognitive biases present for financial decisions in organisations (Kahneman et al., 2011).

4. Implications for Audit and Risk Management

The presence of cognitive biases can lead to problems for auditors and risk managers because it threatens the accuracy of financial statements, reliable controls and proper risk detection (Kahneman et al., 2011; Power, 2007). When managers are overly confident or believe in the same facts, they may report better results than what is true, use aggressive guesses and overlook their weaknesses (Schrand & Zechman, 2012). Detection of these distortions is not an easy task, as senior management may sometimes deliberately bypass the controls to hit their targets (COSO, 2013). Auditors may be subject to anchoring or confirmation bias while analysing the evidence in their work (Messier et al., 2022). The missing of certain risks can happen in internal audits when patterns affect how the team handles audits (Mendel & Brühl, 2013). When managing risks, cognitive biases change how people view and react to dangers. If a firm is overconfident, it may think it is less exposed to risks than reality or take risks that are very risky (Moore & Healy, 2008). Moreover, the availability heuristic means decision makers pay more attention to news-making risks over the major risks they face (Tversky & Kahneman, 1973). How risk is reported to executives or board members through framing can either make a situation appear better than it is or worse than it is (Kahneman & Tversky, 1979). That is why risk managers should combine technological tools with approaches that address how humans react to risks (Thaler & Sunstein, 2008). Handling these issues, organisations can provide training that highlights bias, carry out premortem reviews to reduce confidence bias and utilise tools such as checklists or decision matrices in decisions. AI principles provide support by finding differences and testing opinions against stats, but they should be used with proper management. According to corporate governance, the main role of boards and audit committees is oversight. Organisations should promote individual thought, allow staff to disagree with each other and challenge the ideas of management to prevent groupthink. Including behavioural insights into their framework and relying on behavioural risk tools, boards help the company become stronger and more resilient.

5. Integrative Discussion

Analysing cognitive biases in finance shows that corporate finance, auditing and risk management are all linked and dependent on people's judgments, so they can be distorted. Financial managers can be affected by anchoring and overconfidence when they are uncertain, auditors in charge of reviewing finances might suffer from confirmation or familiarity bias and risk managers checking upcoming dangers may be swayed by availability heuristics and herd behaviour. Since these functions are connected, any weakness or bias in one area can quickly worsen the organisation. There are some problems: auditors are supposed to criticise management's outlook, but thinking in the same way could lessen their critical nature; bias from the way risk models are described can also distort the results. Also, using set routines, clear documents and monitoring behaviours helps finance, audit and risk teams together minimise system bias. Issues relating to how organisations display biases and the interactions between AI and people's tendencies have not yet been understood fully. Future studies could analyse the ability of debiasing to reduce biases and how they react to different rules or market changes. In short, managing cognitive biases needs companies to keep working together, all the time, to raise the quality of decisions and ensure they are prepared for risks.

6. Conclusion

The review emphasises the role of cognitive biases like anchoring, overconfidence and confirmation bias in financial choices by big businesses which influence auditing and risk management. As a result such biases spread throughout organisations which makes risks bigger and reduces how effectively the company is governed. To deal with operational and financial risks, organisations must use awareness, planned decision-making, behaviour training and oversight by the board, apart from technical skills. AI tools and fostering a disciplined attitude support reducing bias. Taking care of these issues goes a long way in improving decisions, organisational strength and trust from customers, but continuing study is needed to develop better ways to intervene.

Recommendation

There are several useful suggestions from the perspective of practice. If auditors regularly learn about common biases in thinking and use helpful checklists and decision tools, they will be more likely to practise professional scepticism. Using practises like red-team exercises or premortem analyses can help CFOs and financial teams find hidden assumptions. Behavioural risk tools like debiasing and using AI-driven analytics could help risk managers make their risk assessments more impartial. It is very important for all functions to embrace a culture where questions and opposition are encouraged; governing bodies should always challenge management's decisions and encourage diverse thinking.

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