Cognitive Biases in Functional Analysis Interviews – Part 1: Introduction and Biases Affecting Selection of the Persons to Be Interviewed

Functional analysis is a vital component of the transfer pricing analysis and functional analysis interviews are a popular way to perform it. However, functional analysis interviews often suffer from unintentional or inadvertent blind spots on the side of the participants to the interviews, known as “cognitive biases”. This is the first of a series of articles that describe some of the most commonly observed cognitive biases, their effects, and possible ways to avoid the impact of these biases.

1. Introduction and Background

The OECD’s Base Erosion and Profit Shifting (BEPS) Project has highlighted the importance of the functional analysis in the process of determining the arm’s length price, particularly in the area of analysis of commercial and financial risks.

The revised OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) define “functional analysis” as the analysis aimed at identifying the economically significant activities and responsibilities undertaken, assets used or contributed and risks assumed by the parties to the transactions.1

The outcome of the functional analysis is to describe the principal contributions to value creation by individual entities within the group, i.e. the key functions performed, assets deployed and risks assumed by the parties to the transactions.

The functional analysis focuses on what the parties actually do and the capabilities they provide. Traditionally, the preferred way of achieving this, along with a “passive” review of documents, is the “active” fact finding by interviewing the employees who perform the functions.

However, the outcome of the functional analysis interviews might be underwhelming in some instances, insofar as they fail to describe the principal contributions to value creation. In some cases, they might erroneously identify a set of functions, assets or risks as being core to the value creation (false positive or Type I error). In other cases, they may fail to identify a set of functions, assets or risks as being core to the value creation (false negative or Type II error). In some cases, the written record of the outcome is not consistent with the participants’ recollection of the interview. In short, the result of the interview does not achieve the desired purpose. This is termed a “suboptimal outcome” in the context of this article.

One of the key factors affecting the outcomes of human interactions and decision-making is “cognitive bias”. Cognitive bias is a mistake in reasoning, evaluating, remembering, or other cognitive process, often occurring as a result of holding onto one’s preferences and beliefs regardless of contrary information.2 Put simply, cognitive biases are mental habits or shortcuts that result in a distorted view of the situation at hand.

Humans have these “bad mental habits” or cognitive biases. Given that it is humans who conduct the functional analysis interviews and participate in them, the possibility cannot be ruled out that the functional analysis interviews could be affected by the cognitive biases of the participants. The functional analysis interviews, like any other human interaction, may be influenced by cognitive biases on the part of the interviewer(s) as well as by the person(s) interviewed.

In an ideal world, there would be infinite resources (including time and money) available. In perfect utopian circumstances, it would be feasible to interview every single person who performs functions, deploys assets and manages risks. Unfortunately, that is never the case, and a selection has to be made of the persons who are to be interviewed, in the limited time and with the limited resources available. In such situations, achieving the suboptimal outcome defeats the purpose of the entire exercise. There might be situations when the reasons for this suboptimal

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2. This is a written description of functions performed, assets employed and risks managed and assumed, according to the guidance specified by the OECD Guidelines.


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outcome can be traced back to cognitive biases on the part of the participants of the functional analysis interview.

The cognitive performance of human beings improves if fewer words are used in place of long text strings. Plainly put, short, crisp and simple sentences are preferable. Therefore, for the sake of simplicity, in this article, one word will rather be used instead of seven (“the participant” rather than “the participants of the functional analysis interview”).

At the outset, it is worth noting that the author is not suggesting that every human being is affected by all these biases, or even that most human beings are affected by some of these biases. However, the author believes there are instances when human beings fall prey to these biases, and by definition, may not be aware of them. The objective of this article is to make readers aware that human actions in the context of a functional analysis interview may be affected by something humans are not immediately aware of.

2. Typical Setting of a Functional Analysis Interview

This section describes the typical manner in which functional analysis interviews are carried out.

Fundamentally, a functional analysis interview consists of a group of transfer pricing experts meeting a person in business operations (such as sales, marketing, R&D, etc.) and asking questions to identify and document what economically significant activities and responsibilities were undertaken, what assets were used/contributed/managed, and what risks were assumed by that person.

The functional analysis interviews can be classified into the following categories, depending upon who is initiating the process. In practice, functional analysis interviews can be a combination of two or more categories.

Internal-led: These are the interviews led by the in-house or internal transfer pricing experts within the MNE. The reasons for carrying out such interviews might range from “simply trying to know the business better” to “preparing for an oncoming tax audit”. The level of trust, and therefore, the quantum of information made available in these interviews is typically more, given the fact that the person interviewed sees the in-house transfer pricing manager as “one of their own”, and therefore is likely to be more forthcoming in the interaction.

Adviser-led: These are the interviews led by an external transfer pricing adviser. This adviser might be engaged by the in-house transfer pricing manager to provide compliance or advice, but there are (admittedly few) instances when a tax authority engages an adviser to conduct a functional analysis. The level of trust from the perspective of the persons interviewed is slightly lower than for an internal-led functional analysis interview. Adviser-led interviews are beneficial when an adviser has expertise in a particular industry and uses it to glean insights that otherwise would not have been possible.

Tax authority-led: These are the interviews led by the tax authorities of a particular country (although there might be two or more tax authorities involved in some cases). They are either in the context of an audit or in the context of a mutual agreement procedure (MAP) or an advance pricing agreement (APA). The tax authorities usually do not specialize in a particular industry sector. The participant’s level of comfort in these interviews is the lowest, because no one particularly likes to be interviewed by the taxman.

As can be seen above, each category has different objectives and intended outcomes. Irrespective of the type of functional analysis interview, the functional analysis interviews follow a similar pattern.

The phases of a typical functional analysis interview are:

1. Selecting the persons to be interviewed: In this phase, the interviewers determine the list of persons whom they want to interview. It is easy to achieve this in an internal-led interview, given the familiarity of the interviewers with the organization. However, this is a critical task in adviser-led and tax authority-led interviews and it typically needs the inputs of the in-house transfer pricing manager.

2. Pre-interview briefing: In this phase, the persons to be interviewed are contacted, and are appraised of the objectives and the intended outcomes of the process. This is typically a job of the in-house transfer pricing manager, with the help of advisers. Tax authorities are seldom involved in this phase.

3. Actual interview: This can be performed face to face, over the phone or using a telepresence facility. It is poor practice to record the audio/video of the functional analysis interview without the express consent of the person(s) interviewed.

4. Post-interview processing of information: This involves writing up the notes of the interview. The ultimate objective is the “functional analysis report”, which lists and describes the economically significant activities and responsibilities undertaken, assets used or contributed, and risks assumed by the parties to the transactions. This phase is the responsibility of whoever is leading the interview (internal/adviser/tax authority). This write-up is the basis for further comparability analysis, etc.

The intensity of the phases might vary depending on the type. The participants of the functional analysis interviews participate directly or indirectly in each phase. Therefore, their cognitive biases affect the outcome of each phase.

Section 3. describes the biases that typically affect each phase of the functional analysis interview and suggests ways to manage this. It is worth noting that the cognitive biases described here are not intended to constitute an exhaustive list but rather reflect biases commonly observed in the author’s experience.
3. Biases Affecting Phase 1: Selecting the Persons to Be Interviewed

3.1. Does Mr Pichai know absolutely everything about Google?

A functional analysis starts with deciding who should be interviewed in order to understand more about the function. Typically, this decision is heavily influenced by the “leader” of the functional analysis interview who constructs the “interview roster”.

Fundamentally, a functional analysis is about knowing the business at the level of discrete activities that make up that business. The aim of a functional analysis interview is to find out what role the person interviewed plays in that business. It is implicitly assumed that the persons at higher levels of the organization know more about the business. For instance, to perform a functional analysis of Google, it would seem ideal to interview its CEO (i.e. Sundar Pichai). It is assumed that he is better placed to talk about Google’s business as compared to a person at a lower echelon. Information on Google coming from Mr Pichai is more likely to be taken at face value and less likely to be questioned. This is authority bias, a tendency to attribute greater accuracy to the opinion of an authority figure (unrelated to its content) and be more influenced by that opinion.¹

What is wrong with authority bias? Why shouldn’t Sundar Pichai know a lot about Google’s business? While this author has no reasons (and indeed, credentials) to doubt Mr Pichai’s knowledge, the information from him should not be relied upon for the sole reason that it has come from him. In other words, there is a high probability that interviewers will be blindsided by information provided by an authority figure, which might lead to suboptimal functional analysis conclusions. Therefore, it is good practice to corroborate the information received in a functional analysis interview.

It may be useful to build in these corroborative “checks and balances” already at the stage of selecting the persons to be interviewed. Such corroborative may be in the form of information available in the public domain, or information available from the company (e.g. internal emails, presentation slides), or could even be achieved by another functional analysis interview with a different person.

3.2. An abundance of AVPs

Another unfortunate, but commonly observed, result of authority bias is selecting the wrong people for functional analysis interviews, merely based on their job titles. The job titles might be misleading, or might project more authority than the person actually wields. This typically happens in an adviser-led or tax authority-led interview, where the person constructing the interview roster does not have enough knowledge about the industry practices. For instance, in financial services companies, an associate vice-president (AVP) is a fairly junior position. There might be literally hundreds (if not thousands) of AVPs in the organization. However, in a more traditional manufacturing business, anyone with “vice-president” in their title is quite high in the pecking order. Therefore, it could be a mistake to create an interview roster based on the person’s authority as perceived from their job title.

In this context, the decision to interview is taken on the basis of “I know that an AVP is a senior role, so I will interview the AVPs” This is the familiarity principle, where people tend to develop a preference merely because they are familiar with them. This can be misleading (i.e. leads to not interviewing an important person) when a person has a fairly neutral job title, such as “General Manager”.

The easiest way of ensuring that the right people are interviewed is using an organogram or organization chart, which provides an inverted tree-like structure of who reports to whom. This will diminish the possibility of being blindsided by role descriptions. Also, consistent with the insight from the paragraphs above, doing research on persons to be interviewed² might be useful in overcoming this bias.

The familiarity principle acts at a broader level, too. People tend to select functions that they think are important for interviews, without understanding the value chain of the underlying business. For instance, research and development (R&D) is usually seen as quite an important function. However, R&D might not be a very important function in some industries.

3.3. What do accountants know?

A typical piece of rhetoric while constructing the functional analysis interview roster is “We need to talk to the business”. This is typically followed by replacing the finance people from the interview roster with people from other functions.

The implicit reasoning behind this is a belief that organizations work in silos and some functions have a better overview of the business than others. In this example, the belief is that since Finance knows about numbers, it is best placed to talk about numbers, but to know more about the business means looking elsewhere. This is a case of implicit stereotyping,³ where particular qualities (or a lack thereof) are attributed to certain social groups.

The reality might be different. Many industries have roles such as “finance business partners”, who work in front-line, strategic finance roles for a particular segment or business unit. It is these people who are in charge of the profit and loss of their segment/business unit and know the business like the back of their hand. In many cases, it might be useful to start the interview process with such a person, to obtain an overall picture of the segment/business unit, and then delve deeper, where necessary, with relevant people from other functions.

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² This was done using social media such as LinkedIn, or scholarly sources such as academia edu or Google Scholar, if the persons to be interviewed are scientifically oriented.

3.4. When all you have is a hammer

A good thing about in-house transfer pricing experts is that they are familiar with the industry in which their company operates. A transfer pricing manager in AstraZeneca is supposed to be an expert not only in transfer pricing, but in the pharmaceutical industry as well. Such a level of industry specialization is seen to a lesser extent in tax advisers, and to an even lesser extent in tax authorities.

Advisers and tax authorities, more often than not, work across industries. Whilst it is advantageous in some respects, this broad, non-specialist perspective might create some unconscious distortions for functional analysis interviews.

Take emerging technology, for example. Technological advances are at the front and centre of many upcoming, technology-led businesses. CEOs and business leaders have lately been highly optimistic about how they see machine learning and artificial intelligence as an important driver for their businesses. Therefore, interviewers may have unconsciously created a “mental shortcut” that says, “technology is a key business driver”.

However, it would be naïve to assume that technology is a key business driver, or an equally important business driver for all businesses. For example, a local taxi service business in a tourist-friendly coastal town in Greece will rely less heavily on technology compared to Uber operating in a large city. Conversely, a physical logistics infrastructure that relies on trucks might be more important for a supermarket chain than a technology solution.

However, an adviser or tax authority who is not familiar with the industry may have recently come across a TED Talk on the importance of artificial intelligence in tomorrow’s world, and will rely on the mental shortcut. The person may end up interviewing people from the technology team whereas they would have been better off interviewing more people from supply chain management. This occurs because of the Baader-Meinhof phenomenon or frequency illusion.9 people who just learn or notice something start seeing it everywhere.

Related to these are other cognitive biases like the recency illusion: the belief that things noticed only recently are in fact recent. A linguist at Stanford University discovered this with the use of words,8 but it is equally applicable to the context of functional analysis interviews. This, coupled with the bandwagon effect,10 might lead to a belief that hearing about “technological disruption” throughout many media channels actually means that technology has suddenly become more important than it ever was. This may be true, but it is wrong to assume so without verifying it independently.

Given the availability of powerful search engines, it is incredibly easy to find information that corroborates with people’s existing beliefs. This is called confirmation bias,11 which is the tendency to search for, interpret, favour and recall information in a way that confirms one’s pre-existing beliefs or hypotheses. In the above example, this is where a person who watches the TED Talk on artificial intelligence one night suddenly starts seeing its applications everywhere (Baader-Meinhof phenomenon), believes that this must be something new (recency illusion), and consults a search engine to search for how artificial intelligence can revolutionize, say, the supermarket business. The results this person obtains are more likely to confirm the notion that technology is indeed the most crucial factor in business (confirmation bias).

This may then lead that person to select more people from the technology team for functional interviews, resulting in the selection bias, which assigns more importance to a function that, in practice, may be of less importance.

3.5. The roads less travelled

A functional analysis interview, consisting of identifying a person, meeting them face to face or over a telepresence facility, asking them questions and seeking information, has been a “traditional” form of conducting a functional analysis. There is a clear preference towards going through the motions of interviews while planning a functional analysis.

One reason for preferring the traditional method of functional interviews is information bias: the belief that the more information is provided, the better it is. This may become an issue when the functional profile can be determined by other methods or sources. There might be instances where non-traditional forms of seeking information on functions, assets and risks might be more effective than a traditional interview, but are not recognized as such because of this belief that more information equals better information. This typically happens when a person’s role is deterministic in nature; i.e. follows a well-defined process. Examples would include an IP infringement attorney, who follows a well-defined set of steps in order to address a potential infringement claim, or a treasury manager who reallocates the funds within the group in the most efficient manner.

Functional fixedness is a cognitive bias that limits a person to use an object only in the way it is traditionally used. Thus, interviewers may become fixated on the traditional form of conducting functional interviews and may neglect the easier methods with which the same results can be achieved.

If the IP infringement attorney or the treasury manager in this example were interviewed, they are likely to take the interviewers through a set of well-defined process steps which they follow. In such instances, analysing the evidence or outcome of the process followed might be

7. TED Talks are influential videos from expert speakers on education, business, science, tech and creativity.
10. The bandwagon effect is a tendency to do something because it is “in fashion” or “popular”, and is being done by the peer group.
a more efficient way to gauge the functions performed, assets employed and risks managed by the function, rather than conducting a full-fledged interview. Admittedly, this is easier in case of an internal-led functional analysis, where an in-house transfer pricing manager will have better access to the information within the organization.

4. Concluding Remarks for Part 1
This article has described the biases that affect the first phase of the functional analysis interviews – the selection of the persons being interviewed. In the forthcoming article (Part 2), the biases affecting pre-interview briefing and the actual interview will be addressed.