Cognitive Biases in Functional Analysis Interviews – Part 2: Biases Affecting Pre-Interview Briefing and Actual Interview

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 second 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 to Part 2

This trilogy (or series) of articles discusses “cognitive biases” in the context of functional analysis interviews. “Cognitive biases” were defined in Part 1 of the series¹ as “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.”

The objective of this series is to avoid a suboptimal outcome in functional analysis interviews. In Part 1 of the series, a suboptimal outcome was defined as “the result of the interview does not achieve the desired purpose.” This term, being a defined term, will be used as such in Part 2 as well.

In Part 1, the scene was set, and the cognitive biases affecting Phase 1 of the functional analysis interview process (Selecting the persons to be interviewed) were covered. In this part, the cognitive biases affecting Phases 2 and 3 of the functional analysis interview process, namely “pre-interview briefing” and “actual interview” will be discussed.

By way of a refresher, pre-interview briefing is the phase where 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.

The actual interview phase is self-explanatory. 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.

It might be useful to repeat a few cautionary disclaimers from Part 1 of the series:

For the sake of simplicity, the term “participant” is used to mean “the participants of the functional analysis interview”. The terms “interviewer” and “person(s) interviewed” will also be used separately as the context requires.

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 behavioural blind spots, or (unconscious) cognitive biases. The author does not mean to suggest that readers are consciously biased in any way.

2. Biases Affecting Phase 2: Pre-Interview Briefing

2.1. Sleeping dogs that are left to lie

Modern organizations are action focused. The performances of executives are measured by the effectiveness of the actions that they take; and the tax or transfer pricing function is not an exception. However, in many circumstances (particularly in tax), inaction is preferred over action. This is called omission bias,² where inaction is perceived as less harmful than action, and is therefore preferred. “If it ain’t broke, don’t fix it” is the motto of many tax managers.

However, functional analysis interviews are a curious phenomenon. By definition, a person who is expert in their job is tasked with explaining the intricacies of their job to persons who may not be experts. Moreover, the person interviewed is unclear, and often wary, of conclusions the interviewers may or may not draw from the interview. Consequently, there is a risk that the person interviewed might “clam up”. (Alternatively, there is also a risk that the person interviewed might respond from the opposite end of the communication spectrum and become excessively chatty.)

It would be wrong on the part of a transfer pricing manager to “let sleeping dogs lie”, i.e. assume that the person interviewed knows all about the functional analysis interview. It is always advisable for a transfer pricing manager to engage in a pre-interview briefing with the


person to be interviewed. The pre-interview briefing session need not necessarily be a formal meeting – many things could be achieved over a cup of coffee. However, it should ideally cover the following: (i) the background as to what has prompted this interview; (ii) the objectives of the interview (i.e. what the participants expect to achieve); (iii) broad/typical questions that might be asked; (iv) how would the information be used; and (v) the interviewer’s profile, if known.

The author has observed a tendency, particularly within the tax authorities, to scoff at a pre-interview briefing, observing that this session easily turns into a “coaching session” that influences the outcome of the functional analysis interviews. The author does not subscribe to this theory. Even if the pre-interview briefing turns into a coaching session, an interviewer who is sufficiently skilled will clearly be able to see through the veneer of a coached interview. The job of the transfer pricing manager is to prepare the person interviewed with what to expect in the interview; not what is expected (from them) in the interview.

2.2. “But… you said that yourself!”

It is important for the transfer pricing manager to position the pre-interview briefing as a guideline rather than a prescriptive to-do list. There is a risk that the person interviewed relies too heavily on something said in the pre-interview briefing and may proceed to the interview with that context firmly in mind. This is called anchoring or focalism, where people rely too heavily on an initial piece of information offered (the “anchor”).

To cite an example: the pre-interview briefing mentions that one of the objectives of the functional analysis interview is "to assess the importance of the logistics management function" relative to other functions performed by the persons interviewed. The person interviewed may place a mental “anchor” that “logistics management” will be the focal point of the interview and attends the interview with that preconceived notion. In this particular instance, it is the job of the transfer pricing manager leading the pre-interview briefing to make it clear that (i) talking about logistics management is one of the (many) objectives of the functional analysis interview, and (ii) even when speaking about it, logistics management needs to be put into the context of the wider activities, so as to assess the relative importance of it. This diligence exercised by the transfer pricing manager would avoid the suboptimal outcome.

Anchoring or focalism, paired with conservatism bias, also affects Phase 4 (Post-interview processing of information), which will be addressed in Part 3 of this series of articles.

2.3. “Well, everyone knows Juanita…”

As stated above, a functional analysis interview is where a functional expert speaks at length about their area of expertise. However, experts often speak in a jargon-heavy style specific to their own field and with presupposition of knowledge of their field of expertise. For instance, in a functional analysis interview, a data scientist might talk about “completely random forests”. Although this has a specific meaning for the students of artificial intelligence, namely the “ensemble method of decision making”, it does not make a lot of sense to interviewers drawn from the general public. This is known as the curse of knowledge,\(^4\) where the person interviewed unknowingly assumes that the interviewers possess the necessary knowledge to understand the person’s area of expertise (which may not be the case). As a result, the interviewer’s perception of the interview might be obfuscated with these “knowledge gaps”, which could ultimately lead to a suboptimal outcome.

This bias affects multiple phases of the functional analysis interview, including the actual interview, and post-interview processing of information. What is worse is that such knowledge gaps arising from the curse of knowledge often become apparent very late in the process, which makes it unwieldy to backtrack. The best solution to a problem is the one that avoids the problem in the first place. Therefore, care must be taken to address the curse of knowledge in the pre-interview briefing stage itself. This is where knowing the interviewer’s profiles could come in handy – the level of the interviewer’s familiarity with the subject matter can be gauged before the interview, and the discourse can be planned accordingly.

2.4. Centre of the world

Readers familiar with social media\(^5\) are aware of how people broadcast trivial and inconsequential moments of their life for the world to see (and like/share). Such people seem to have immense confidence that they are at the centre of the world. This is the spotlight effect,\(^6\) where people tend to believe they are being noticed more than they really are.

The organizational equivalent of this effect can sometimes be observed in functional analysis interviews. An organizational function overstating their importance, describing themselves as being at the forefront and centre of the organization can be commonly observed.

There can be little doubt that the very existence of a function implies that it is important to the organization in


\(^5\) Is there a reader not familiar with social media? If so, please contact the author on Facebook.

some way. (If it were not, it would have long been terminated.)

The person interviewed falling prey to the spotlight effect, and therefore overstating the contribution of their function in the value creation process can lead to interviewers obtaining skewed impressions and therefore, to a suboptimal outcome. This is predicted and best managed at the pre-interview briefing stage. An effective way to manage this, in the author’s experience, is to ask the person interviewed to spend some time in the interview describing how their function interacts with other functions within the organization. This will reveal, for instance, how R&D’s exciting new product is made viable by market research studies, allowed market entry owing to the efforts of the regulatory team and is brought into existence by the production design team. Such descriptions have the dual advantage of putting the value chain into context and avoiding the spotlight effect.

3. Biases Affecting Phase 3: Actual Interview

3.1. That swan among ducks

Most people working in an office would attest to the fact that the most memorable people in an office environment are the ones wearing a flamboyant suit or with a quirky hairstyle. These people stand out from typically dressed office workers. They are exceptions to the rule, and exceptions tend to remain in public memory. This is called the von Restorff effect. The theory was coined by German psychiatrist and paediatrician Hedwig von Restorff (1906–1962), who, in her 1933 study, found that when participants were presented with a list of categorically similar items that contained one distinctive, isolated item, their memory of that item was improved.

In the context of functional analysis interviews, if a person interviewed makes a statement that is contrary to the overall facts presented in the interview, it is more likely to be remembered (and ultimately find its way in the functional analysis write-up). For instance, a statement that “the company protects its patents and trademarks in all countries except for country A and country Z” focuses the attention on countries A and Z, rather than “all minus two” countries in which the patents and trademarks are protected.

The question then is how important is the exception, as compared to the rule? Is it sufficiently important to anchor (see section 2.2) the discussion to the exceptions of countries A and Z? This is a question that should be noted down and investigated further. In the above example, the sales in these countries may be minuscule, and therefore the exceptions do not really mean anything, in which case the von Restorff effect would waylay the functional analysis discussion and miss focusing on important things.

3.2. The importance of having experiences

A frequently observed occurrence connected to the above is where a person interviewed starts their answer with the words “In my experience…”.

The primary objective of a functional analysis interview is to identify how the person interviewed performs functions, deploys assets and manages risks relating to the activities. The focal point is, clearly, the person interviewed. The experiences of the person interviewed are important and rightfully so. However, personal experiences and isolated examples cannot replace compelling evidence. The tendency to rely on anecdotal evidence is called the anecdotal fallacy. There is ample literature to suggest that statistical and causal evidence is more persuasive than anecdotal evidence.

In summary, the personal experiences related by the person interviewed are important; but should be cross-referenced by statistical and causal evidence wherever possible. The easiest way to corroborate a statement such as “In my experience, a lot of important decisions are taken in weekly XYZ meetings” would be to ask for sample meeting notes of random weekly meetings and perusing them to verify the personal experience.

3.3. The halo around him

In a 1920 article, psychologist Edward Thorndike observed that when he asked commanding officers to evaluate soldiers, the ratings for physical qualities (e.g. physique) often influenced personal qualities (e.g. leadership.) He termed this the halo effect. This effectively describes situations where things are assumed or concluded based on impressions that are often unconnected with the thing that is assumed or concluded. Authority bias, which is described in section 3.1. of Part 1 of this series, is a type of halo effect, where the halo comprises the authority of the person interviewed.

Without overgeneralization, people in certain functions (e.g. marketing) may be better conversationalists than some in other functions (e.g. accountants). There is a possibility that interviewers may conclude a person who is well prepared and a good communicator to be important to the organization. Whether accountants are more important than marketers, however, is specific to the organization, but leaning one way or the other based on impressions in a functional analysis interview might be erroneous.

3.4. Worth a thousand words

Pictures and images are more likely to be remembered than words, which is known as picture superiority effect.

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Therefore, functional analysis interviews with visual aids (videos, slide decks, etc.) are more effective. Some functions lend themselves more easily to a graphic mode of description (e.g. a production process) than others (e.g. a data protection algorithm). Using a visual aid in the interview also reduces the possibility of confabulation, which is a disturbance of memory, and is defined as the production of fabricated, distorted or misinterpreted memories about oneself or the world, without the conscious intention to deceive. This means that the written representation of a functional analysis interview (meeting notes and/or functional analysis write-up) is a more accurate representation of the information transmitted during the interview.

3.5. How “material” is it?

Those readers who have ever been (or faced) a financial statements auditor would be familiar with the perennial question of auditing: “how ‘material’ is it?” Materiality is the auditor’s way of determining whether an amount of money is sufficiently large to impact the financial statements and, consequently, worthy of the auditor’s attention. This helps auditors avoid money illusion, i.e. thinking of money in nominal, rather than real, terms. The term was coined and popularized by economist Irving Fisher. Tax (and transfer pricing) audits seldom have explicit materiality thresholds, although the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) encourage tax authorities to be flexible and not demand from taxpayers a precision in their transfer pricing that is unrealistic given all the facts and circumstances.

It is fairly clear that an amount might be material for one taxpayer, while it might not be for another. A similar observation applies in respect of functions within an organization. For a pharma company, a clinical trials project worth 2% of its net worth might not be a large investment for the R&D function, but a tax project half the size might be considered a major project for the tax function. A function-specific spending budget can be a useful indicator of the relative value of each function.

3.6. Leading the witness

While it is detrimental to think of functional analysis interviews as a witness examination or cross-examination in a court of law, there is one attribute that is often found in the courtrooms and functional analysis interviews alike. The interviewer/attorney approaches with a preconceived notion of what they would like to hear and phrases the question in a way such that the response of person interviewed/witness confirms the preconceived notion with which the question was asked. This is known as interviewer bias. Interviewer bias is the opinion or prejudice on the part of an interviewer, which is displayed during the interview process and thus distorts the outcome of the interview. This happens when interviewers pursue only a single hypothesis that supports what they already think and ignore any information that counter their hypothesis. The goal is not to derive the truth, but to simply corroborate what is already believed.

Consider the following question, where the person interviewed is a regional HR leader:

Q: Do you think experienced executives from [company A in country B] are often promoted to take on regional or global responsibilities, so that they can apply their “success mantra” elsewhere in the world?

This question asks confirmation about a very specific point, but subtly prompts the expected answer (“Yes!”), showing interviewer bias. Moreover, this question has direct relevance to some of the hot topics that are being discussed under BEPS Actions 8-10.

In the same circumstances, a question without interviewer bias may be framed in the following manner:

Q: Could you please tell us about the global mobility policies of company A?

3.7. Echo chambers

A close relative of interviewer bias is confirmation bias, i.e. the tendency to search for, interpret, favour and recall information in a way that confirms one’s pre-existing beliefs or hypotheses. This is something very commonly seen on social media, aptly described as an “echo chamber”, which is an enclosed (virtual) space where the user’s opinions reverberate, and the user declines to consider alternative ideas. The corollary of this is selective perception, where people tend not to notice and more quickly forget information that contradicts their prior beliefs.

In the context of functional analysis interviews, an interviewer with a confirmation bias not only asks leading questions (see interviewer bias) but also (i) amasses information to buttress their preconceived belief, and (ii) places relatively less importance on (or simply ignores) contradictory evidence. For instance, an interviewer who has already made up their mind that a particular function has a desired level of substance is likely to seek confirmation from the interview and ignore/disregard any contradictory evidence.

In summary, a prejudiced interviewer is bad news, and is likely to create a suboptimal outcome.
3.8. Playing to the gallery

The effects of a prejudiced interviewer may be exacerbated by an interview participant who is willing to "play to the gallery". This is an example of social desirability bias, where the interview participant may answer questions in a manner that will conform to the interviewer’s expectations. Again, this is likely to create a suboptimal outcome. If a prejudiced interviewer is bad news, an interview participant willing to feed the interviewer's biases is even worse news.

3.9. "It was the only viable option"

No one likes to admit their failures and wrong choices. People always find a way to justify their choice, post-facto. This is known as choice-supportive bias or post-purchase rationalization.

Bad decisions are part of the commercial world. Making a bad decision that might have resulted in heavy financial losses is not a non-arm’s length behaviour per se. The consequences of bad commercial decisions and how an organization deals with their aftermath may give valuable insights into how risks are allocated in practice. However, in a functional analysis interview, the person interviewed is seldom likely to talk about (let alone elaborate upon) their failures. The examples quoted and experiences described are likely to be success stories, giving the impression that the person interviewed is a decision-making automaton who instinctively knows the right path to take. This is also an example of selection bias (discussed in Part 1 of this series of articles).

One way to avoid this bias is by asking "What happens if things don’t go according to the plan?", and how the new situation is handled. Often, formulating the question on a hypothetical basis (e.g. "What would happen if your next product launch is a failure?") may also be helpful.

As a side note, chapter IX of the OECD Guidelines elaborates on the concept of options realistically available (ORA) to the MNE. As a further research, the interaction of choice-supportive bias with ORA is something that should be explored in more detail.

3.10. The system

"Participants of the functional analysis interviews ignoring contradictory information available to them" can be paraphrased as one of the recurring themes of section 3. This can also manifest itself as participants placing (over) reliance on an automated system, ignoring the contradictory information coming from elsewhere. This is called automation bias, typically found (and studied) in decision aids in critical systems such as automated aviation.

The author has stressed the importance of corroborating the insights gained from the functional analysis interviews with other sources of information, such as the organization’s ERP system. However, there are times when a participant places blind trust in data generated from "the system" and asserts that it must be correct “because it has come from the system”. For example, the ERP system may demonstrate a particular budget being managed from country X (by way of approving numerous invoices, signing contracts, etc.). However, the advisable way would be to corroborate this fact in the functional analysis interview with the person in charge of the cost centre.

3.11. Knowing it all

One unexpected downside of getting the persons interviewed to talk about their interactions with other people (see section 2.4. for the spotlight effect) is where people assume authority and talk about other functions, sometimes misplaced, conviction. People perceive their knowledge of others to surpass other people’s knowledge of them. This is called the illusion of asymmetric insight.

This is common in functions that frequently interact with each other on specific tasks or activities, for example, sales and marketing, or tax and legal. The tax department may speak authoritatively about the activities of the legal department (insofar as is apparent from their interaction with the legal department!) but might possibly be dismissive of what the legal department thinks of the tax department’s work (i.e. "I know what they do; but they haven’t got a clue what I do."). Sometimes, this is observed through spanning geographical boundaries, where local teams may end up misjudging (and misrepresenting) the work done by regional/headquarter teams; or vice versa. Sometimes, this is horizontal, between persons at an equal level responsible for two geographical areas.

The outcome of this illusion of asymmetric insight could be a skewed representation of a function that is described only by hearsay. This might lead to a suboptimal outcome if the output of functional analysis interview is finalized without cross-referencing the function in question.

3.12. All that glitters

Another frequent occurrence in a functional analysis interview is where a person interviewed waxes lyrical about the "exciting new initiative/project/product" that their team is working on, and how it is going to be valuable to the organization in the future. The person interviewed seems to downplay the risks, uncertainties, limitations or weaknesses of the proposal (or at least, does not voice them in the functional analysis interview.)

References:

is termed pro-innovation bias,\textsuperscript{19} where the innovator sup-
poses that the adoption of the innovation should be wide-
spread, while not appearing to be mindful of its limita-
tions. Also, people tend to have proprietorial pride in their
pet project, and often tend to overestimate its benefits and
virtues. This is an instance of the IKEA effect.\textsuperscript{20}

During a functional analysis interview, the persons inter-
viewed may tend to talk at length about certain proj-
ects/aspects of their job, often dwarfing the other proj-
ects/aspects in comparison. This may present a skewed
picture of the functions performed, assets deployed and
risks managed, thus resulting in a suboptimal outcome.
One way to avoid this bias is to look at external, corrobo-
rative evidence such as the job description of the person
(sourced from HR), composition of the person’s team, etc.
to ensure that all aspects of the function are covered.

3.13. Trivial things

The very fabric of a functional analysis interview is where
the persons interviewed are expected to describe the intri-
cacies of the activities they undertake in their job, in a
non-technical fashion. The ability to explain complex,
technical topics in an easy-to-follow manner is a rare skill.
Not everyone is a good teacher (see also section 2.3. for the
curse of knowledge).

There may be situations where a person interviewed
is unable to explain their work in an easy, non-technical
way that an interviewer might understand; and as a
result, spends time explaining relatively trivial but easy-
to-grasp issues. On the other hand, the interviewers might
consider that they themselves lack knowledge in a par-
ticular domain of the person interviewed, and therefore
focus on a relatively less important, but easy to under-
stand, non-technical topic. This is called Parkinson’s law
of triviality or the bike-shed effect.\textsuperscript{21} In a famous example,
C. Northcote Parkinson described how a committee in a
nuclear power plant spent a disproportionate amount of
time deciding to build a bike shed worth GBP 350, whereas
a bid to build a GBP 10 million nuclear reactor was passed
in 2.5 minutes.

This could make the interviewer undervalue and/or
underestimate the person’s contribution to the value
chain, leading to a suboptimal outcome.

4. Concluding Remarks for Part 2

This article has described the biases that affect the second
and third phase of the functional analysis interviews,
namely pre-interview briefing and the actual interview.
In the forthcoming final part of the series (Part 3), the
biases affecting the post-interview processing of informa-
tion will be addressed, along with the concluding remarks
for this series of articles.

\textsuperscript{19} E.D. Glor, Innovation traps: Risks and challenges in thinking about inno-
vation, in Workshop on Public Sector Innovation (Feb. 2002).

\textsuperscript{20} M.I. Norton, D. Mochon & D. Ariely, The IKEA effect: When labor leads

\textsuperscript{21} C. Northcote Parkinson, Parkinson’s Law: or the Pursuit of Progress ch. 3. (John Murray 1958).