Liar, Liar — Seven "Bet the Company" Risk Management Cues

BY RON POL

New research offers lawyers on the highest level "bet the company" risk management work.

Finding early evidence of Enron-style financial skulduggery seems largely the preserve of accounting-based models designed to uncover irregularities and financial manipulations. A slew of new financial market regulations have added more layers of oversight and accounting rules. So it's little wonder that many lawyers and other risk management professionals decide largely to leave it to the accountants to find evidence of the most important risk management issues; with lawyers mostly just helping deal with the aftermath.

This is a mistake. A denser thicket of accounting-based rules may help avert the next crisis, but if the first rule of good investment is diversification, different risk management tools might also help at least as much as "more of the same."

An interesting study[1] reveals an opportunity for other professionals to help their accounting and finance colleagues, using tools based on deception detection research.

When researchers studied the transcripts of nearly 30,000 quarterly earnings conference calls, they found that the language composition of chief executive and chief financial officer participants provided important cues helping identify lying or deceitful behavior. These cues and subsequent significant income restatements formed the basis for a prediction model focused on the likelihood of deception in quarterly financial statements.

The language used by CEOs and CFOs in quarterly earnings conference calls can be used to help identify an increased likelihood of deceptive financial reporting. Language is the "holy grail" of "big ticket" corporate risk management.

How can you tell when it might be a good idea to dig a little deeper before the brown stuff hits the proverbial fan and potentially drags your company down? Armed with knowledge of what to look for, simply listen carefully to senior managers explaining the company's financial position, or read the transcript afterwards. Here's what the researchers found from deceptive corporate leaders:

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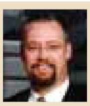
1. More references to general knowledge, such as "you folks know," "investors well know," "shareholders know" and "everyone would agree." References to general or audience knowledge is used to build credibility; overuse may signal the opposite.
2. Fewer references to shareholder value and value creation. The researchers hypothesise that deceptive leaders might minimise use of words like "shareholder welfare," "creating value" and "unlocking value" to help mitigate the personal consequences from shareholder lawsuits if restatements are later made or misfeasance discovered.
3. CEOs use more extreme positive-emotion words, such as "fantastic," "huge," "tremendous," "first-rate," "definitely" and "unquestionably," and correspondingly, fewer non-extreme positive-emotion words such as "nice" and "accept." Although positive emotions do not necessarily indicate deception, differentiating between extreme and non-extreme emotions resulted in a finding that extreme positive emotions appeared more frequently in the language of deceivers, presumably to sound more persuasive.



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4. CEOs use notably fewer self-references such as "I," and more third-person plural and impersonal pronouns such as "everybody," "anybody" and "nobody." This confirms the hypothesis that "the use of first-person singular pronouns implies an individual's ownership of a statement, whereas liars try to dissociate themselves from their words because of lack of "personal experience" of the fabricated story.
5. CEOs use fewer extreme negative-emotion words such as "awful," "atrocious," "careless," "challenging," "ludicrous," "unlucky" and "unsuccessful."
6. CEOs use fewer certainty words, such as "always" and "never." The researchers observe that liars lack conviction and differ from truth-tellers on the degree of certainty in their statements.
7. CEOs use of hesitation words also falls. More likely to have been coached or having carefully prepared more persuasive falsehoods, deceptive bosses use fewer hesitations such as "um," "ah" and "er."

These are, however, not direct indicators of deceit; only of a higher likelihood of deception. And if some seem uncannily close to the usual markers of "larger than life" CEOs, best not accuse anyone too quickly; you'll still need the accountants to find evidence of any misfeasance.

Ironically, these findings might also affect their own future validity. The few executives who know they're stretching the truth to meet financial targets may now seek more extensive coaching. And with fewer "fantastic" results, more reference to shareholder value, self-reference and personal stories, it may become increasingly difficult to separate the liars.

In the meantime you might also use these cues to help tell if the person across from you in a meeting is being somewhat economical with the truth, or is simply a garrulous extrovert hoping to be the next charismatic CEO.

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NOTES

1 "Detecting Deceptive Discussions in Conference Calls," by David F Larcker & Anastasia A. Zakolyukina of the Graduate School of Business, Stanford University.