“THE CASE OF THE IRRATIONAL AUDITOR”

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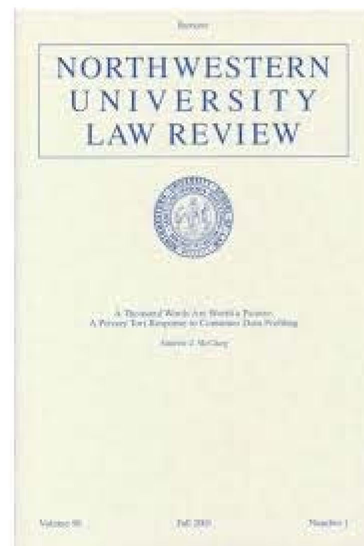
Nov. 20, 2014

"Accounting firms—as with all rational economic actors—seek to maximize their profits….[Therefore,] it seems extremely unlikely that [defendant audit firm] was willing to put its professional reputation on the line by conducting fraudulent auditing work for [its client]."

--*Melder v. Morris*, 27 F.3d 1097 (5th Cir. 1994)

Robert A. Prentice, "The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation," 95 NORTHWESTERN UNIVERSITY LAW REVIEW 133 (2000).



Thesis: Contrary to popular belief, accountants are human beings and therefore their decisionmaking is affected by several nonrational factors, including:

- **Cognitive heuristics and biases**
- **Social and organizational factors**
- **Situational factors**

My article (87 pages & 477 footnotes)

<u>+ 14 years of additional research</u>

= A lot of evidence that auditors are not strictly rational actors

The article asked four questions:

ARE INDIVIDUALS (INCLUDING AUDITORS) RATIONAL ACTORS?

1. Bounded Rationality
2. Rational Ignorance
3. Perception Limitations
   - Confirmation Bias
   - Hindsight Bias
   - Cognitive Dissonance
4. Memory Limitations
5. Undue Optimism and Overconfidence
6. Framing.
7. Inability to Estimate Probabilities
   - Representativeness Heuristic
   - Anchoring and Adjustment
   - Recency and Vividness Effects and the Availability Bias
8. The Self-Serving Bias
9. Behavioral Traps
   - Sunk Cost Effects
   - Time-Delay Traps
10. Bounded Willpower

ARE ACCOUNTING FIRMS RATIONAL ACTORS?

1. Organizations and Their Behavior
2. Why Corporations Defraud
3. "Subgoal Pursuit" and Related Problems

IS IT IRRATIONAL FOR INDIVIDUALS TO AUDIT RECKLESSLY OR FRAUDULENTLY?

1. Financial Incentives
2. Observability
3. Stress
4. Rewards and Relational Capital

IS IT IRRATIONAL FOR ACCOUNTING FIRMS TO AUDIT RECKLESSLY OR FRAUDULENTLY?

1. Countervailing Pressures to Reputational Capital
2. Damage to Auditor Reputation

These may help answer the enduring question:

Why is it that such a small percentage of frauds are ever uncovered by external auditors?

Just a couple of examples….

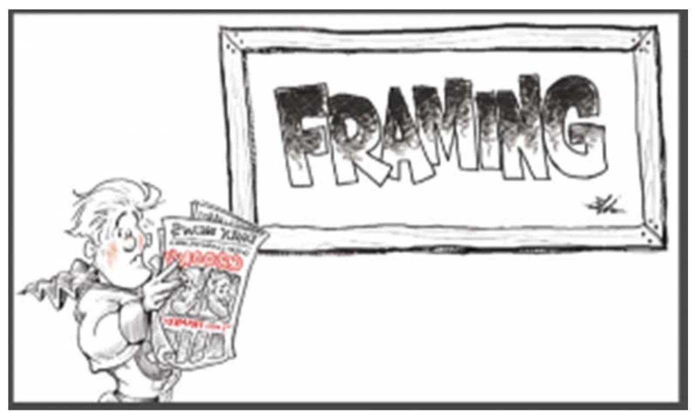
<u>Self-serving Bias</u> affects how people gather, process, and even remember information.

- **Affected by what's in their perceived best interest**
- **Affected by existing beliefs**

Selective Attention means people tend to see what they expect to see

Confirmation Bias means that people tend to look for and believe information that supports the conclusion that is consistent with their own self-interest or pre-existing position.

<u>Framing</u> means that how we look at a question heavily impacts how we answer it.



Undue Optimism and **Overconfidence** exacerbate all the other factors.

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