



# **“THE CASE OF THE IRRATIONAL AUDITOR”**

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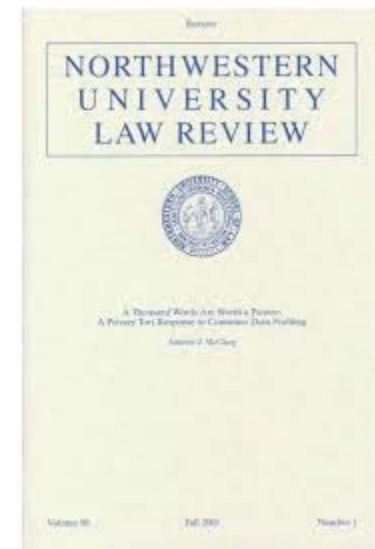


**“Accounting firms—as with all rational economic actors—seek to maximize their profits....[Therefore,] it seems extremely unlikely that [defendant audit firm] was willing to put its professional reputation on the line by conducting fraudulent auditing work for [its client].”**

**--*Melder v. Morris*, 27 F.3d 1097 (5<sup>th</sup> 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)**

**+ 14 years of additional research**

**= 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....**



**Self-serving Bias affects how people gather, process, and even remember information.**

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





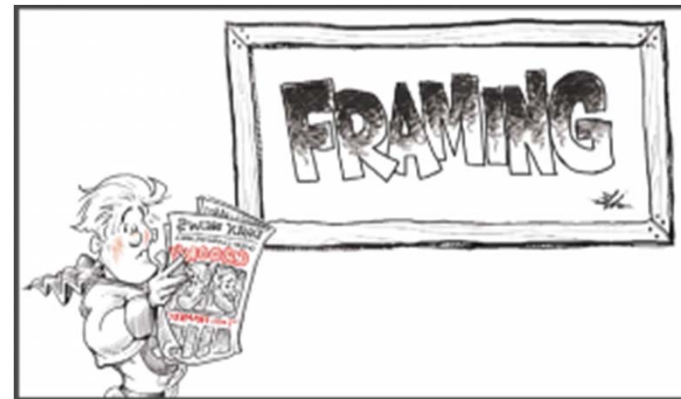
**Selective Attention means people tend to see what they expect to see**



**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.**



**Framing 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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