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Prospect Theory predictions in the field: Risk seekers in settings of weak accounting controls

A. Rashad Abdel-khalik

The University of Illinois, United States

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ABSTRACT

In his review of 30 years of research in *Prospect Theory*, Barberis (2013) notes that support for *Prospect Theory* had come mainly from the laboratory. In this paper, I write about a recurring phenomenon in real life that is consistent with *Prospect Theory* predictions in decision-making loss domain. The 60 cases noted in this paper are associated with specific risk seekers that had cost more than $140 billion (an average of $2.33 billion per case). Given space consider–ations, I provide synopses for 14 cases. A few of these cases have been discussed in the extant literature in connection with internal control, but were not considered from the perspective of *Prospect Theory*. It is striking that these cases are costly, all participants are young men, and almost all had followed the gambler's martingale strategy – i.e., double down. While these cases are informative about risk-seeking behavior, they are not sufficiently systematic to be subjected to stylized archival research methods.

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1. Introduction

Twenty-five years after Allais (1953) published what we now call "Allais Paradox," Kahneman and Tversky (1979) offered *Prospect Theory* as a framework for decision-making under uncertainty. While both approaches share the conclusion that people do not behave in a manner consistent with *Expected Utility Theory* (EUT), *Prospect Theory* has some unique features.

E-mail address: rashad@illinois.edu.

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i. Changes in wealth rather than levels: *Prospect Theory* is concerned with changes in wealth (or welfare) rather than the levels of wealth.
ii. Loss aversion: for a given value function of the decision maker, the absolute value of a loss is greater than the value of a gain with the same magnitude.
iii. Duality of risk disposition: at any point in time, decision-makers can be both risk averse and risk seeking, depending on the outcome of different prospects. If the outcome of an event or a prospect is positive (gain), decision-makers would be averse to taking on excessive risk that might undo the gain. Conversely, if the outcome of an event or a prospect is a loss, decision-makers would escalate taking on more risky projects that have a probability of large payoffs, even if the probabilities of these outcomes are low, in the expectation of offsetting the accumulated losses.

Tversky and Kahneman (1992) explain risk-seeking prediction as follows:

> *Risk seeking*: risk aversion is generally assumed in economic analyses of decisions under uncertainty. However, risk-seeking choices are consistently observed in two classes of decision problems. First, people often prefer a small probability of winning a large prize over the expected value of that prospect. Second, risk seeking is prevalent when people must choose between a sure loss and a substantial probability of a large loss (1992, p. 298).

At first glance, the predictions of *Prospect Theory* may appear unintuitive; one might expect that losing money once would make decision-makers extra cautious in choosing projects so that realization of losses would be only history – but that is not what numerous experiments have revealed.

2. Realism of the theory

A relevant issue in accepting the tenets of *Prospect Theory* appears to be the absence of evidence about the extent to which its predictions are valid outside the laboratory where decision-making situations are not highly stylized and where the stakes are high. Barberis (2013) aptly highlights this shortcoming in his comprehensive review of 30 years of *Prospect Theory*. He notes that

> While it is widely agreed that *prospect theory* offers an accurate description of risk attitudes in experimental settings, some have questioned whether its predictions will retain their accuracy outside the laboratory, where the stakes are often higher and where people may have significant experience making the decision at hand. Some direct evidence bears on this issue (Barberis, 2013, p. 179).

The issue remains an empirical question that requires investigation by different authors and different methods. In this paper I offer some preliminary evidence from the field. In general, the cases presented here are offered as observations consistent with the predictions of *Prospect Theory* in the loss domain. However, they should not be taken as a representative sample of the population; these cases had evolved in environments of weak management and accounting control systems.

3. Commonalities among risk-seeking situations

Looking into cases of decisions made in real life may shed light on our understanding of the extent to which *Prospect Theory* predictions have external validity. However, the search led me to numerous cases that could not be covered in this essay. As a result, I selected some of these cases with the intent of diversifying the time period, nationality, locale, and the nature and organization of business. I also limited the choice to cases with large direct loss by the identified risk seekers. The threshold was a minimum loss of $200 million (excluding externalities and collateral damage). I also included a couple of educational institutions that have suffered smaller amounts of losses.

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