Case Study no. 1

Title of Case study / Good practice	**Acknowledging Cognitive Biases in Decision Making: Mental Accounting**
Keywords (meta tag)	Cognitive biases in decision making; mental accounting
Provided by	University of Economics – Varna Based on: Richard H. Thaler, *Mental Accounting Matters*
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Case study

The concept of mental accounting, developed by economist Richard H. Thaler, refers to the way we manage and organise our financial activities and it may well illustrate how cognitive biases impact the decision-making process.

Though Thaler defined mental accounting as 'the set of cognitive operations used by individuals and households to organize, evaluate, and keep track of financial activities' (Richard H. Thaler, *Mental Accounting Matters*, Journal of Behavioral Decision Making, 12: 183-206, 1999), he went on describing how mental accounting also impacted corporate financial decisions, (Ibid.) Thaler pointed out that 'the primary reason for studying mental accounting is to enhance our understanding of the psychology of choice.' (Ibid.)

It is argued that, if left unacknowledged, mental accounting may result in irrational decisions regarding investment or spending. For example, research has indicated that we are more willing to pay for goods when we pay by credit card, not in cash. We tend to differentiate between the ways we earn money and in case of any unexpected financial gain, such as gambling winnings or any windfall, we are more likely to spend the money or make a high-risk investment. Yet, once these cognitive biases are recognised and analysed, mental accounting may be used as a tool for reinforcement of positive behaviour.

Questions for discussion (based on Thaler's examples):

1. How would you decide if you could really afford that small treat of a cookie (2 euros) every working day at a coffee shop?
2. You have bought 100 shares of stock at $10 a share. Would you sell that stock when the price of stock fell, that is, would you sell the loser?

Reference Link	http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.174.2961&rep=rep1&type=pdf
Type of material	**CASE STUDY**

(Suggested answers on p. 2)

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Suggested Answers

1. It is best to add up costs over a month or even a year. That's how we can make a rational decision whether or not we can afford a product/service and avoid overspending on items we do not really need or want but we still tend to buy, just because, for example, they are heavily discounted. Lots of ads may exploit irrational spending, for example ads selling cars that cost 'only 2 euros a day.'
2. Thaler explains that 'a rational investor will choose to sell the loser because capital gains are taxable and capital losses are deductible.' He argues that 'because closing an account at a loss is painful, a prediction of mental accounting is that people will be reluctant to sell securities that have declined in value.'

   He further explains: '… suppose an investor needs to raise some cash and must choose between two stocks to sell, one of which has increased in value and one of which has decreased. Mental accounting favors selling the winner (Shefrin and Statman, 1987) whereas a rational analysis favors selling the loser.'

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