Applications of Psychology and Economics – Econ 219B
Spring 2005
Wednesday 12-3, 639 Evans
Instructor: Stefano DellaVigna, 515 Evans. sdellavi@econ.berkeley.edu.

Homework 7.
Due on April 17 at 6pm

This homework will be a brief (one-page) report on firm reaction.

On the Contract Design paper:

- Does it make sense to assume that firms are perfectly rational while individual consumers have self-control problems and are naïve?
- Can you think of ways to look empirically at firm learning? For example, firms learning how to exploit naïve consumers?
- Can you use the same setting on rational firms/consumers with biases for different 'biases'? What kind of theoretical/empirical implications can you sketch?

On accounting:

- One interpretation of this paper is that accountants rationally react to a bias of the market that interprets any loss differently from any gain. Does this make sense?
- What is likely to be the bias involved, if any? Lack of attention? Prospect theory?
- If this was the right interpretation, should there be a market for 'unbiased accounting'? How should markets react to a small gain, to a large loss, etc., relative to who they should react in a fully rational world?
- What are other implications of these findings for accounting? For example, can firms 'trick' the market by putting losses in a footnote and gains in a prominent position in bold characters?

The readings for next week are:

*Degeorge, Francois, Patel, Jay, and Zeckhauser, Richard. "Earnings Management to Exceed Thresholds", *Journal of Business*, 1999.
http://ksghome.harvard.edu/~.RZeckhauser.Academic.ksg/em8.pdf

*DellaVigna, Stefano and Malmendier, Ulrike. "Contract Design and Self-control: Theory and Evidence", *Quarterly Journal of Economics*, May 2004.
http://emlab.berkeley.edu/users/sdellavi/wp/self_control_dec03.pdf

*MacKinley AC. 1997. Event studies in economics and finance. *Journal of Economic.Literature*, 35(1): 13-39.

The homework is due on Sunday by 6pm. See you next week!