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The Effects of Accounting Knowledge and Context on the Omission of Opportunity Cost in Resource Allocation Decisions

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ABSTRACT

Economic theory stresses that opportunity costs are relevant to resource allocation decisions. Prior accounting research provides evidence that human decision makers tend to ignore or underweight opportunity costs; however, there have been no formal attempts to explain why. That is, existing empirical research lacks a unifying theoretical explanation within which decision makers' behavior with respect to opportunity costs can be understood. This study uses the cognitive theory of induction to develop and test predictions that may allow a better understanding of the role of accounting knowledge in prior studies of opportunity costs. The theory posits that existing knowledge structures stored in memory influence how external cues are combined with information available in memory to form a mental model of the problem. Application of the theory suggests that subjects in prior opportunity cost studies constructed an internal model that was a mental representation of their historical accounting knowledge which does not ordinarily incorporate opportunity costs. Thus, these subjects may have failed to attend to opportunity costs because their mental models of the problem did not include these costs. This study examines whether high accounting knowledge hinders decision makers in making theoretically-optimal, business resource allocation decisions that incorporate opportunity costs.

A between-subjects experiment involving a resource allocation task was conducted with different levels of two factors: accounting knowledge and decision context. Thirty-four graduate business students, and 46 graduate accounting students participated in the experiment, in which subjects evaluated information to make a resource allocation recommendation either in a business context or a personal context of equivalent structure and complexity. Consistent with the study's predictions, the results indicate that the number of opportunity costs ignored by subjects in resource allocation decisions increases significantly with increases in the subjects' accounting knowledge when the decision is posed in a business context. Also, as predicted, for subjects for high accounting knowledge, the number of opportunity costs ignored is higher for those in the business context than those in the personal context. This result tends to rule out poor general performance of high accounting knowledge decision makers across decision context.

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