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Cost analysis for pricing: Exploring the gap between theory and practice

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Abstract

There has been much discussion over many years of the alleged gap between management accounting theory and practice. Whereas researchers sympathetic to neoclassical economics have sought to rationalise the gap in terms of information economics and have proposed constrained optimisation as the norm, Scapens [Scapens, R.W., 1994. Never mind the gap: towards an institutional perspective of management accounting practices. Management Accounting Research 5, 302–321.] and Ahmed and Scapens [Ahmed, M.N., Scapens, R.W., 2000. Cost allocation in Britain: towards an institutional analysis. European Accounting Review 9(2), 159–204.] have suggested that the old institutional economics framework might better explain management accounting practice.

Old institutional economics originated at about the same time as neoclassical economics and in opposition to it. It largely rejects rational optimisation as the basis for much of human behaviour and stresses instead, adherence to custom and rule following.

This paper reports on the findings of two cases studies undertaken as part of a programme of case studies, intended to examine the power of the old institutional economics framework to explain the gap between management accounting theory and practice, in the realm of costing for pricing. The paper concludes that much observed management accounting practice is difficult to reconcile with *ex ante* constrained optimisation, but is explicable in terms of conditioning by various institutions.

Keywords: Cost accounting; Pricing decisions; Institutional economics; Case study

1. Introduction: the history of the reality gap

Much has been written, over a prolonged period of time, about the alleged gap between the conventional wisdom of the management accounting textbooks, academic/professional journals and management accounting practice. Nowhere has the ‘reality gap’ attracted more attention than in the area of cost analysis for pricing and product mix decisions.

The textbooks recommend a decision relevant approach to cost analysis for pricing decisions. Empirical research, on the other hand, has consistently suggested that such an approach is not widely used in practice.

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The 'reality gap' became apparent as soon as accounting researchers began to systematically conduct empirical studies of management accounting practice. Examples of such studies in the UK include Coates et al. (1983) and in the US Gordon et al. (1981). Such studies have been regularly replicated up to the present day, for example, Drury and Tayles (2005). (Full) cost plus pricing appears to be common. Most studies also suggest that demand and competition are often taken into account. However, 'cost' as defined by accountants (typically full cost as measured for external financial reporting purposes) was shown to be a very important benchmark in pricing—adjustments in response to demand and competition certainly did not constitute equivalence to the full application of marginalist/incrementalist principles.

From the 1980s onwards, the conventional wisdom has also advocated the use of target costing as a way of dealing with increased competition. Survey evidence, however, suggests this approach is not widely used in practice (Drury et al., 1993; Garg, 2003).

As recently as 2005, Drury and Tayles attempted to explain management accounting practice in terms of cost-benefit contingencies (i.e., in terms of information economics). Their approach was consistent with the arguments of Demski (1972), Feltham (1972), Demski and Feltham (1976)—drawing on the earlier work of Arrow (1963)—and Horngren (1990), that sophisticated techniques are often costly to implement and the benefits may not justify the costs. They concluded, however, that the contingent variables suggested by theory (e.g., Cooper, 1988) could not satisfactorily explain divergences between theory and practice. The cost-benefit contingency (i.e., constrained optimisation) approach assumes a degree of rationality and consensus that is often not present in group decision-making contexts—in which pricing decisions are often made. Consequently, these authors called for further research, using case studies, to provide insights into why accounting practice differs from accounting theory.

2. Alternative research frameworks

Other researchers have suggested that the 'reality gap' results from the fact that the world in which management accounting is practised, is different from that of neoclassical economics, on which the conventional wisdom of accounting is based (Scapens, 1994; Ahmed and Scapens, 2000).

In this view, either the competitive conditions differ from those assumed by the conventional theory, or the decision-making context differs (or both). The former would include tacit collusion among oligopolistic firms rather than price competition (Tool, 1991). The latter would include group decision-making under conditions of uncertainty and ambiguity, rather than the 'rational mode' of decision-making assumed by neoclassical theory (Stacey, 1996). Group decision-making is different from individual decision-making. In addition to scope for different interpretations of the decision problem, there is likely to be a lack of goal congruence among the group members—each of whom has their own functional responsibilities. Also, there is likely to be an unresolved agency problem between group members collectively as agents and the shareholders as principal.

Under such circumstances, the techniques prescribed by the management accounting textbooks may be irrelevant to the needs of managers in practice.

2.1. *The institutionalisation of cost accounting*

Scapens (1994) and Ahmed and Scapens (2000) have suggested that the reason for the reality gap is that the world in which management accounting is practised is better explained by the old institutional economics framework of Veblen (1899), Commons (1931, 1934) than by the neoclassical economics framework on which the conventional wisdom of the textbooks is based.

'Institutions' are important for economic life and have been defined by North (1990) as the rules of the game with organisations as the players. They are credited with establishing patterns of human action by excluding some types of behaviour and encouraging others. Institutions facilitate and maintain patterns of habitual behaviour (Hodgson, 1988), as opposed to rational behaviour. They can be considered a response to the high information and computation costs that so-called rational behaviour would have and a coordinating device for human actions (Loasby, 1999). Hodgson (2006, p. 2) has defined institutions as:

> the systems of established and prevalent social rules that structure social interaction.