

Mental Accounting

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A concept first named by Richard Thaler (1980), mental accounting attempts to describe the process whereby people code, categorize and evaluate economic outcomes.

One detailed application of mental accounting, the behavioral life cycle hypothesis (Shefrin & Thaler, 1988), posits that people mentally frame assets as belonging to either current income, current wealth or future income and this has implications for their behavior as the accounts are largely non-fungible and marginal propensity to consume out of each account is different.

Mental accounting, utility, value and transaction

In mental accounting theory, framing means that the way a person subjectively frames a transaction in their mind will determine the utility they receive or expect. This concept is similarly used in prospect theory, and many mental accounting theorists adopt that theory as the value function in their analysis.

Another very important concept used to understand mental accounting is that of modified utility function. There are 2 values attached to any transaction - acquisition value and transaction value. Acquisition value is the money that one is ready to part with for physically acquiring some good. Transaction value is the value one attaches to having a good deal. If the price that one is paying is equal to the mental reference price for the good, the transaction value is zero. If the price is lower than the reference price, the transaction utility is positive.

Mental accounting cost

More generally, a mental accounting cost or mental transaction cost, a kind of transaction cost, is the cost of making a useful decision, especially of a consumer making a useful decision to buy, and may set a lower bound on useful price granularity in a market.

Fallacies and biases

Mental accounting is subject to many logical fallacies and cognitive biases.