Accounting Tools and Measures for Decision Making

Prepared by: Marc S. Galli, BSBA, GCBM

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Sunk Cost, Opportunity Cost, and Accounting Cost

Many management decisions are heavily impacted by cost. There are three primary classifications of costs, to wit; sunk cost, opportunity cost, and accounting cost (Walden University, 2021). Sunk costs are those that were incurred in the past and cannot be changed or recovered (Walden University, 2021). Examples of sunk costs include the purchase of new manufacturing equipment, marketing expenses, and employee salaries (Theus, 2022).

Conversely, opportunity costs represent the value of a missed opportunity or the value of company profits that could have come if an alternative had been chosen (Walden University, 2021). An example of opportunity costs includes the value of profits that could have come from expanding into other cities, states, counties, or countries than were actually chosen. Additional examples include the profits that could have come from manufacturing different products, designs, or styles or lost profits that could have come had the firm retained any other consultant (Boyce, 2022).

Finally, accounting costs are the actual costs of an activity as recorded in a business ledger (Accounting Tools, 2022). Accounting costs include fees associated with renting such as lease payments, or fees associated with owning such as mortgage payments, property taxes, and insurance. Examples of accounting costs also include wages, salaries, costs associated with providing employee benefits, costs associated with manufacturing, and utility bills, to name a few.

Costs and Decision Making

As aforementioned, many management decisions are heavily impacted by cost. Managerial accounting is about gathering and processing the information necessary to make good fiscal business decisions (Walther, 2022). Making good decisions requires developing the available managerial accounting information which consists of cost information for some of the above mentioned types of costs. Managerial work with sunk costs is unique because contrary to popular belief, sunk costs actually should not be included in future decision-making (Tuovila, 2003). This is because consideration of sunk costs can often cause managers to latch on to financially-poor decisions solely based on the money that has already been spent chasing the endeavor (Tuovila, 2003). This is a bad practice.

Opportunity costs, however, are relevant costs and should be considered when making decisions. When managers are making decisions and have narrowed down the available choices, analyzing the projected financial benefits and profitability of the remaining choices can be quite helpful (Indeed Career Guide, 2021). Although, managers should be cautioned that opportunity cost does not take into account non-monetary benefits such as time-spent or emotional benefit. As an example, choosing to spend a portion of the annual budget on renovating the employee breakroom may be outweighed by other options' opportunity costs, but this is only because it does not account for the improvements in employee morale and satisfaction. Different options have different financial outlooks, some are more optimistic than others, and this should be considered in management's decision-making.

Finally, accounting costs (or actual costs) such as fixed and variable costs play the greatest role in managerial decision-making because they provide numerical values which can be easily measured and compared against other alternatives' accounting costs (Garrelts, 2022). One such factor is the ability to compare whether costs will go up or down among various choices. Predicted and projected accounting costs help managers set budgets and create forecasts mid-year to more effectively make decisions. It may be a little easier for managers to make decisions based upon fixed costs because they don't change with company activity; however, even variable costs can be evaluated by predicting the increases based on projected company activity (Garrelts, 2022). Knowing accounting costs also aids with adjusting pricing, inventory, and production levels (Garrelts, 2022).

Understanding Costs

As previously stated, developing the available managerial accounting information is required to make good decisions. Managers must have cost information and understand each type to lead the business into more profitable operations (BDC Canadian Bank, 2022). There are three essential steps which managers can use to do this better. First, managers need to understand the cost per unit, known as the cost object, which is the cost per product, service, or project (BDC Canadian Bank, 2022). Second, managers ought to be able to distinguish between direct and indirect costs and understand how unit costs can be controlled and what influences them (BDC Canadian Bank, 2022). This helps to control profitability. Third, learn to either favor job costing or process costing depending on what the situation calls for, based upon such factors as order size and customization requirements (BDC Canadian Bank, 2022). When managers begin to understand these concepts they will become adept at optimizing costs.

Fixed and Variable Costs

Accounting costs were described above as the actual costs of an activity as recorded in a business ledger (Accounting Tools, 2022). However, accounting costs can be further subdivided and classified as either fixed or variable costs (Franklin et al., 2019). Fixed costs are the same over time regardless of the corporation's level of activity (Franklin et al., 2019). Contrarily, variable costs go up or down based on usage or activity. Examples of fixed costs include the cost of building rental, insurance, and managers' salaries (Franklin et al., 2019). Conversely, variable costs include hourly staff wages, costs associated with constituent components of manufactured goods, and utility bills such as the electricity or water bill.

Classifying Fixed and Variable Costs

As stated above, fixed costs do not change with increases or decreases in the changes in units of production; conversely, variable costs do (Corporate Finance Institute, 2022). By analyzing the two categories of accounting costs, managers can make decisions about whether to invest, or not, in long-term, fixed assets categorized on the balance sheet as PP&E (property, plant, and equipment) (Corporate Finance Institute, 2022). Two key factors influence the decision to invest in long-term fixed assets, to wit; volume capacity and volatility (Corporate Finance Institute, 2022).

Additionally, classification of fixed and variable assets is a requirement before four key financial statements can be prepared, the Cost of Goods Manufactured, Finished Goods Inventory, Cost of Goods Sold, and Income Statement (Corporate Finance Institute, 2022). The latter three each require preparation of the prior report as its prerequisite. Preparing financial statements gives a more complete picture of the state of the company, upon which managers can rely to make better decisions.

Understanding variable costs becomes critical when a firm intends to scale or when a company experiences frequent fluctuations in production due to seasons, or product virality, or options/customizations. Not all variable costs adjust fluidly or in lock-step with production (Iowa State University, 2020). Some variable costs are further classified as step-variable costs and increase or decrease, by way of example, per 10,000 units or by some other incremental amount of production capacity (Iowa State University, 2020). Having a working knowledge of the finer distinguishing details between fixed and variable costs aids in informing decision-making.

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