Accounting for better decision making

A technical note by IESE's Gaizka Ormazabal and Eduardo Soler, explains how to arm yourself with numbers for better, more informed decision making.

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Decision time. How will your decision affect your company's bottom line? Analyzing decisions with numbers is the realm of managerial accounting, as IESE's Gaizka Ormazabal and Eduardo Soler explain in their technical note "Accounting for Decision Making."

Using examples, the authors walk through formulas for quantifying the impact of decisions, starting simply and then adding layers of complexity. Ormazabal and Soler explain how to quantify the impact of decision alternatives using two approaches: one based on cash flow and the other on income statements. They also discuss the decision's time horizon, questions of capacity and forecasting uncertainty — issues relevant to managers today.

Engines for growth?

To illustrate managerial accounting concepts, the technical note puts an example front and center.

PEAR produces diesel engines for garden tractors. In 2013, the company sold 100,000 engines for 500 euros apiece. In 2014 MERIBEL, an important retailer, asks PEAR to supply it with 1,000 engines in just one week. It will pay 400 euros per engine. Should PEAR accept MERIBEL's 400,000-euro order?

An executive at PEAR might first consider the 400,000-euro question by looking into the relevant costs. The question of which costs to consider arises immediately.

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Counting costs

PEAR's per-unit production costs (330 euros) are obviously relevant here. But what about its total production costs (450 euros per unit)? Are labor costs relevant? Manufacturing overhead? Not all expenses are affected by MERIBEL's single order, so they may not need to be included in the analysis — even if they are required on the income statement.

To analyze which costs are relevant, the authors turn to cost classifications. Namely:

- Fixed and variable costs
- Direct and indirect costs
- Sunk costs and opportunity costs

These categories are not mutually exclusive; they are mostly useful for managers to identify relevance to the decision at hand.

The simplest way to measure the economic value of the decision is to find the difference between the potential revenues and the relevant costs. If the value is positive, the order should probably be accepted. If it is negative, the order should probably be rejected.

The note starts with these simple computations to illustrate the basic reasoning of managerial accounting. Later, more layers of complexity are added to the mix. For example, is the company running at or under capacity? Is there a scarcity of resources to consider? Is this a short-term operational decision or are we thinking about a company's sustainability in the long run?

Setting the time horizon

The rule of thumb when deciding on an order's short-term impact is to consider the difference between revenues and variable (not fixed) costs. But what about the long term? Can PEAR continue as a viable company if all customers follow MERIBEL's lead and demand discounted engines?

Fixed costs that may not affect a short-term decision — when the company is operating under capacity — do matter in the long run. A company's investments in its production facilities or the hiring of workers become more relevant the longer the time frame viewed.

Long-term planning should also take into account the value of money over time and reflect a company's liquidity needs and cost of capital.

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Internal decisions and external eyes

From an operational point of view, a decision's impact on cash flow is very relevant to management. That said, the impact on the company's income statement matters, too. Investors' perceptions, potential financial contracts, taxes and even employee incentives may be at stake.

Working with the income statement, decision-making calculations should follow generally accepted accounting principles (GAAP). This requires handling the depreciation of fixed assets.

Inventory valuation policies may also affect the analysis, based on whether or not fixed costs are included in the decision-making calculations.

In sum, the differences between GAAP earnings and cash flow analyses can be significant. Both approaches are informative for optimal decision making, but care should be taken to perform the computations separately and not mix them. Managers who understand and use accounting to make decisions know what is at stake in getting the numbers right.

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