

# Cost Estimation

Cost estimation refers to how firms determine their costs. Surprisingly, this is much more difficult than might be imagined. It is useful for investors to be aware of the different methods used. The most successful investors are those who analyze and invest in companies as if they were the owners or managers.

Firms normally estimate their costs three different ways: engineering method, accounting analysis method, regression method.

## **Engineering Method**

In the engineering method, engineers study the inputs and production function of the firm and determine what costs *should* be.

## **Accounting Analysis Method**

In contrast to the engineering method, the account analysis method tries to determine what costs actually were by studying *actual* accounting data. This method is very judgmental. It is not always clear which costs should be assigned where.

## **Regression Method**

Regression analysis method is a method that uses statistical analysis to determine costs. It is very cost effective, but it too is very subjective.

In practice, it is best to use a mix of all three. Each provides at least some insight the others do not.