Direct Costs

In order to forecast the future profitability of a firm, it is very useful to make at least rough estimates of a firm's fixed costs, variable costs, and marginal costs. By doing this, an investor can more easily determine how profitable a firm will be under different scenarios and the chances those scenarios will unfold in the future.

One of the first steps in determining these costs is first determining a firm's direct costs. A direct cost is any cost a manager can directly attribute to a cost object (i.e. any item for which an accountant wants to measure a cost). A direct cost is very similar to a variable cost, and the two terms are sometimes used interchangeably. However, they are not exactly the same.

There are costs that are variable but not direct. When a plant is up and running, lights are on and electrical costs tend to be higher. These extra costs are considered variable manufacturing costs. However, they are not direct. They are not directly tied to whatever cost object (e.g. bike, motorcycle, or car) was being manufactured in the plant at the time.

Direct costs are not readily available. Firms are not required to make them public and so they usually reserve them (and the important managerial financial reports that incorporate them) for top management and a privileged few.

But it is as beneficial for private investors to try to estimate these direct costs as it is beneficial for public firms to keep this information proprietary. Doing this usually requires reading footnotes and special reports in the 10-Ks or even the glossies (i.e. financial reports meant for the public). It is here that investors can pick up tidbits of information with which they can piece together an estimate of valuable information like direct costs.