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Opportunity costs in the accounts

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OPPORTUNITY COSTS IN THE ACCOUNTS

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Opportunity costs are addressed in considerable detail in accounting and economic literature and are commonly defined as the rate of return or potential benefits that could be realized from the best forgone alternative investments. Accountants recognize the existence of opportunity costs but do not record such costs in the accounting records because an outlay cost has not been incurred. Outlay costs are defined as past, present or future cash outflows.[1] Economists, however, do not differentiate between opportunity costs and outlay costs. The difference in treatment of opportunity costs and the importance of such costs is evidenced by the following comments in the literature.

> The decision impact of opportunity costs is of interest to accountants, economists and behavioral scientists. From an economic point of view these costs are generally considered relevant and explicitly reporting them for decision making could improve the quality of future decisions.[2]
>
> Incremental cost and opportunity cost are particularly important concepts, since they provide the foundations for the accountant's contribution to decision-making.[3]

Accounting literature has stated that "An important question for accountants is whether information about opportunity costs should be provided by the accounting process."[4] This question was answered affirmatively in the late 1890's when a dry goods and groceries store (hereafter referred to as the Store) located in Water Valley, Mississippi considered the recording of opportunity costs in rental property accounts to be important. The purpose of this paper is to examine the recognition and recording of such opportunity costs in the rental property accounts of the Store.

Historical Background

The following comment taken from the back of one of the Store's ledgers (hereafter referred to as the ledger) indicates that the construction of houses to be rented to the negroes was completed in the latter part of 1897:[5]

> This Jan 1 1898
> Cost of building new houses on Lots 1 & 2 Block J for negrow renters and finished in the latter part of 1897 is $550.32
> Respectfully
> R. M. Embry

An examination of the ledger indicates that rental activities with the negroes began in 1898.

Continued on page 34

OPPORTUNITY COSTS . . .

Continued from page 1

The rental property activities created a need for rental property accounts and bookkeeping procedures. Documented in the ledger were instructions for the establishment of such accounts and the bookkeeping procedures to be used for 1898 and 1899. The only differences in the instructions between the two years were that the 1899 instructions were given a formal title, "Instructions for Opening and Keeping Realestate Ledger for Negrow Houses," and the 1899 instructions contained significantly more detail.[6]

Accounts

The instructions stated that a real estate ledger was to be opened which would contain the following accounts: Cash, Expense, an account for each renter and Houses "Vaccant."[7] Through the use of the Houses "Vaccant" account, opportunity costs became an integral part of the rental property accounting system.

The Houses "Vaccant" account was used to record the losses that resulted from houses setting vacant. When a house became vacant, the house number and the date of vacancy was recorded in the account. The loss from vacancies was determined by amortizing the month's rent over the number of days that the house had remained vacant. Exhibit I, shown below, is an excerpt of the Houses "Vaccant" account for 1899 which illustrates the above procedures.[8]

Exhibit I

Houses Vaccant

1899		1 2 3 4 5 6 7 8			
Mar. 1	No. 1	Mar.-1-99.	Apr.-1-99	3.00	
	No. 2	Mar.-1-99.	Mar.-10-99	1.00	4.00

There is no question that vacancies represent a loss of revenue to the owner of rental property. Losses due to vacancies, however, are never recorded in the books of an entity since a historical transaction has not occurred. These losses should become apparent in the financial statements as rental revenue would decrease because of the vacancies.

Economists, however, would refer to the vacancies as implicit or opportunity costs and would consider such costs in the calculation of net income. Economic theory states that the funds used to purchase the rental houses could have been invested elsewhere to earn a normal rate of return. When the houses remained vacant, a normal rate of return was not being earned and this represented a cost to the store. The following definition of opportunity costs illustrates this point.

> Opportunity cost is the revenue sacrificed by not using the system in its most profitable alternative use.[9]

The problem that arises is the determination of a normal rate of return or the revenue sacrificed. Determination of a normal rate of return or the revenue sacrificed requires some subjectivity. The subjectivity involved in determining opportunity costs has been an influencing factor as to why accountants do not record such costs in the accounting records.

The Store's calculation of the opportunity costs resulting from vacancies, however, was fairly objective. The amortization of a month's rent was an adequate measure of a normal rate of return or revenues sacrificed.

The opportunity costs that resulted from vacancies were also considered in the determination of total costs. The 1899 instructions stated that "to get at the full amount you are out in the whole property for the year," the following items were to be totaled:[10]

1. The footing of the Expense Account
2. The footing of the Houses "Vaccant" Account
3. The total of the write-offs accumulated from the renters' accounts.

The inclusion of opportunity costs in the rental property accounts and calculation of total costs substantiates the fact that opportunity costs resulting from vacancies were considered to be important by the Store.

It is interesting to note that while opportunity costs were considered costs, opportunity costs were not considered in the calculation of net income. The 1899 instructions stated that in order to determine the amount "cleared off of houses during the year "the monthly deposits in the Cash account were to be totaled."[11] The monthly deposits in the Cash account represented net cash receipts. Thus, net income was calculated on a cash basis. The only difference in the Store's treatment of opportunity costs and current treatment is that the Store recorded such costs in the accounts.

Conclusion

Current accounting literature and textbooks recognize the importance of opportunity costs and the impact that such costs can have in decision making. Since accounting systems usually do not record opportunity costs, such costs are sometimes "incorrectly ignored in decision making."[12] This was not a problem for the Store located in Water Valley, Mississippi in the late 1890's.

The Store recognized and recorded the opportunity costs resulting from vacancies in the accounts. This provided the Store with documented information that could be used for decision making. Since the Store did not use opportunity costs in the calculation of net income, it appears that the recording of such costs in the rental property accounts was solely for informational purposes. This indicates that the Store felt the recording of opportunity costs in the accounts was cost beneficial. This is in direct contrast with the treatment of opportunity costs by most current accounting systems.

Footnotes

1. Deakin, Edward B. and Maher, Michael W., *Cost Accounting* (Homewood, Illinois: Richard D. Irwin, Inc., 1984), p. 22.
2. Haskin, Robert E., "Opportunity Cost and Behavior," *Journal of Accounting Research*, Spring 1983, p. 78.
3. McRae, T. W., "Opportunity and Incremental Cost: An Attempt to Define in Systems Terms," *The Accounting Review*, April 1970, p. 315.
4. Becker, Selwyn W., Ronen, Joshua and Sorter, George H., "Opportunity Costs—An Experimental Approach," *Journal of Accounting Research*, Autumn 1974, p. 317.
5. Quinn and Goodwin—Water Valley Ledgers, Collection of ledgers and business records for a firm which became Goodwin Hardware Co. and later became Quinn and Goodwin in the period 1891-1909. All archival materials referred to in this paper are housed in the Archives Library at the University of Mississippi.
6. Ibid.
7. Ibid.
8. Ibid.
9. McRae, p. 320.
10. Quinn and Goodwin.
11. Ibid.
12. Deakin and Maher, p. 22

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