Chapter 10: Relevant Information for Decision Making

Cost Accounting: Foundations & Evolutions, 9e

Kinney and Raiborn
Learning Objectives

- What factors determine the relevance of information to decision making?
- What are sunk costs, and why are they not relevant in making decisions?
- What information is relevant in an outsourcing decision?
- How can management achieve the highest return from use of a scarce resource?
- What variables do managers use to manipulate sales mix?
- How are special prices set, and when are they used?
- How do managers determine whether a product line should be retained or discontinued?
**Relevant Costing**

- **Relevant costing** focuses managerial attention on a decision’s relevant information

- **Four step decision process**
  - Step 1: The necessity of making a decision becomes evident
  - Step 2: Decision choices or alternatives are identified
  - Step 3: The relevant costs and benefits associated with each decision alternative identified in step 2 are calculated
  - Step 4: The decision alternative providing the largest net benefit to the organization is selected
Relevant Costing

- **Incremental Revenue**—the amount of revenue that differs across decision choices
- **Incremental Cost or Differential Cost**—the amount of cost that varies across decision choices
- **Incremental Profit or Loss**—the difference between incremental revenue and incremental cost
Relevant Costing

- **Opportunity Costs**—benefits foregone because one course of action is chosen over another

- **Sunk Costs** are
  - costs incurred in the past to acquire an asset or a resource
  - not relevant because they cannot be changed regardless of future actions
  - not recoverable

**SUNK COSTS ARE IRRELEVANT**
Relevant Costing and Business Decisions

- Outsourcing a product or part
- Allocating scarce resources
- Determining the sales/production mix
- Accepting special orders
Outsourcing—Make-or-Buy Decisions

Quantitative Factors

- Incremental production costs per unit
- Cost to purchase outside
- Number of available suppliers
- Production capacity available
- Opportunity costs of production facilities
  - Space available for storage
  - Inventory carrying costs
  - Increase in throughput from buying components
Qualitative Factors

- Reliability of supply sources
- Ability to control quality of items purchased outside
- Nature/importance of the work to be subcontracted
- Impact on customers and markets
- Future bargaining position with supplier(s)
- Perceptions about future price changes
- Perceptions about current product prices
Scarce Resources

- Choose product or service with highest contribution margin per unit of scarce resource
- When there are several limiting factors, use linear programming to choose product or service
Sales Mix Decision

- **Sales Mix**—relative quantities of the products that make up the total sales of a company

- Factors affecting sales mix include
  - Product selling prices
  - Sales force compensation
  - Advertising expenditures
Special Order Decisions

- Sales price should
  - Cover variable production and selling costs and incremental fixed costs
  - Generate a profit
Special Order Decision

- Low-ball bid
  - To introduce product or service to particular market
  - Sales price at or below cost
  - Cannot be continued over the long run
Special Order Decision

- Private label order
  - Buyer’s name (not producer’s) attached to the product
  - Accept during slack periods to use available capacity
  - Fixed costs usually not allocated
  - Variable selling costs often reduced/eliminated
  - Sales price set to generate a positive contribution margin
Special Order Decision

- Special prices can also be considered for:
  - Unusual quantity, delivery, packaging, or customization of product
  - One-time job such as an overseas order that will not affect the domestic market
Special Order Decisions

Qualitative Factors

- Impact on future prices and sales
- Sufficient contribution margin to justify the additional burden on workers and management
- Impact on scarce resources and throughput
- Keep workforce employed during slow times
- Consider Robinson-Patman Act
Special Order Decisions

- Robinson-Patman Act
  - Prohibits companies from pricing the same product at different levels when those amounts do not reflect related cost differences
  - Requires that cost differences result from actual variations in the cost to manufacture, sell, or distribute because of different methods of production or quantities sold
Product Line Decisions

Separate costs by

■ Product Line
  □ Revenue
  □ Variable costs
  □ Avoidable direct fixed costs
  □ Unavoidable direct fixed costs

■ Common Costs
Questions

- What are some relevant financial considerations when making an outsourcing decision?
- How are prices set for special orders?
- What types of decisions require segment margin income statements?
Potential Ethical Issues

- Ignoring qualitative factors in decisions
- Going offshore to exploit lax environmental and labor standards
- Making decisions based on financial earnings impact rather than on relevant information
- Using bait-and-switch advertising techniques
- Setting prices that violate the Robinson-Patman Act or other pricing regulations
- Substituting materials that pose health or environmental risks in a scarce resource situation