MANAGERIAL ACCOUNTING



MEASURING COSTS & REVENUES FOR DECISION-MAKING

Learning Outcomes

1. Identify and discuss the concept of relevancy in managerial accounting.
2. Understand how managerial accountants use relevancy to make decisions.
3. Identify the important relevant as well as irrelevant costs.
4. Calculate and interpret decisions using relevancy.

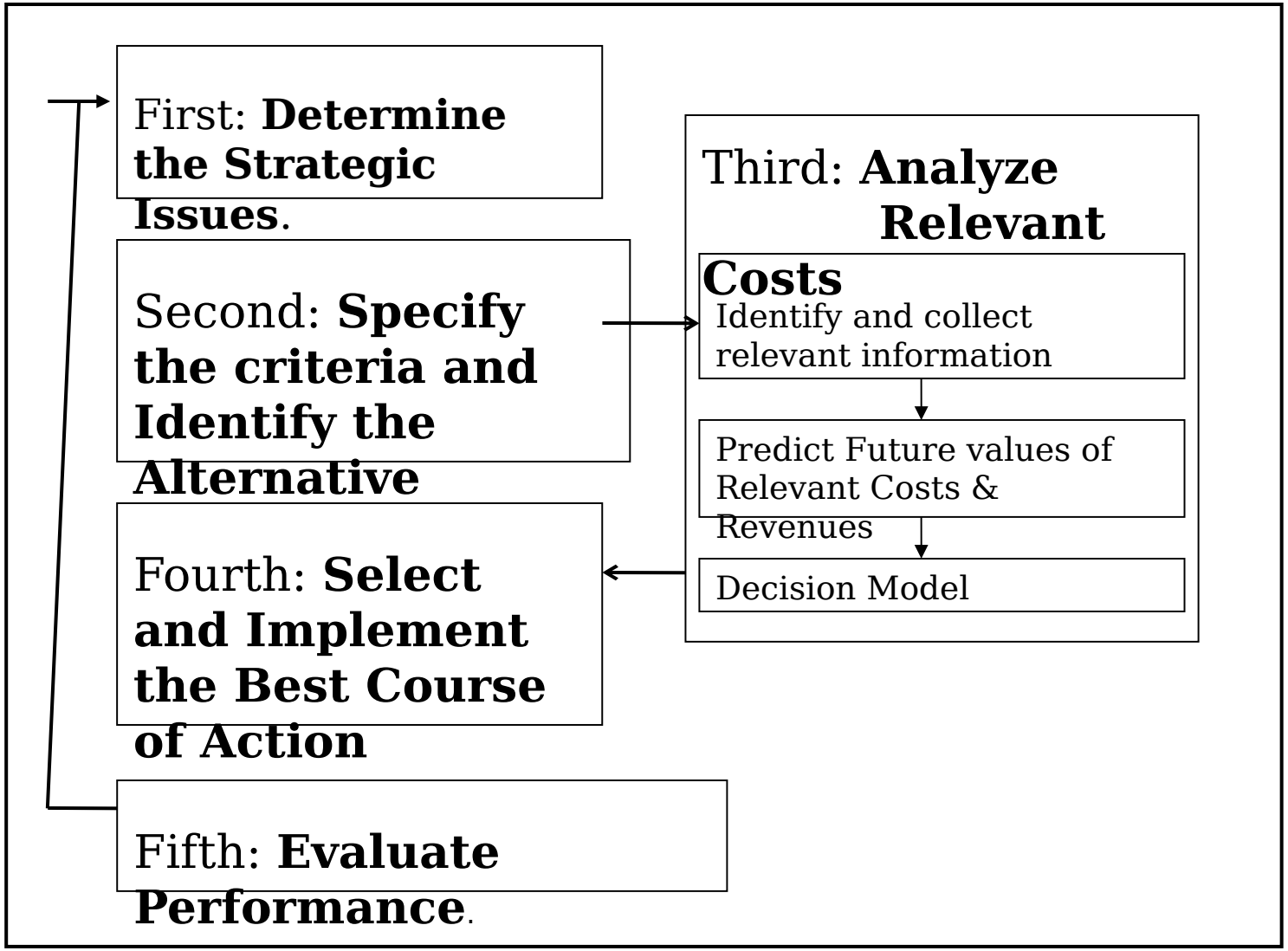
Introduction

- Understanding how to identify and use relevant costs is critical to effective decision-making. It is essential to understand the concept of relevance.

- Relevant costs are expected future costs and relevant revenues are expected future revenues that differ among the alternative courses of action being considered.

- In deciding among alternatives choices for a given situation, managers employ a five step process outlined in the figure. (Next Slide):

The Decision-Making Process



The concept of relevance

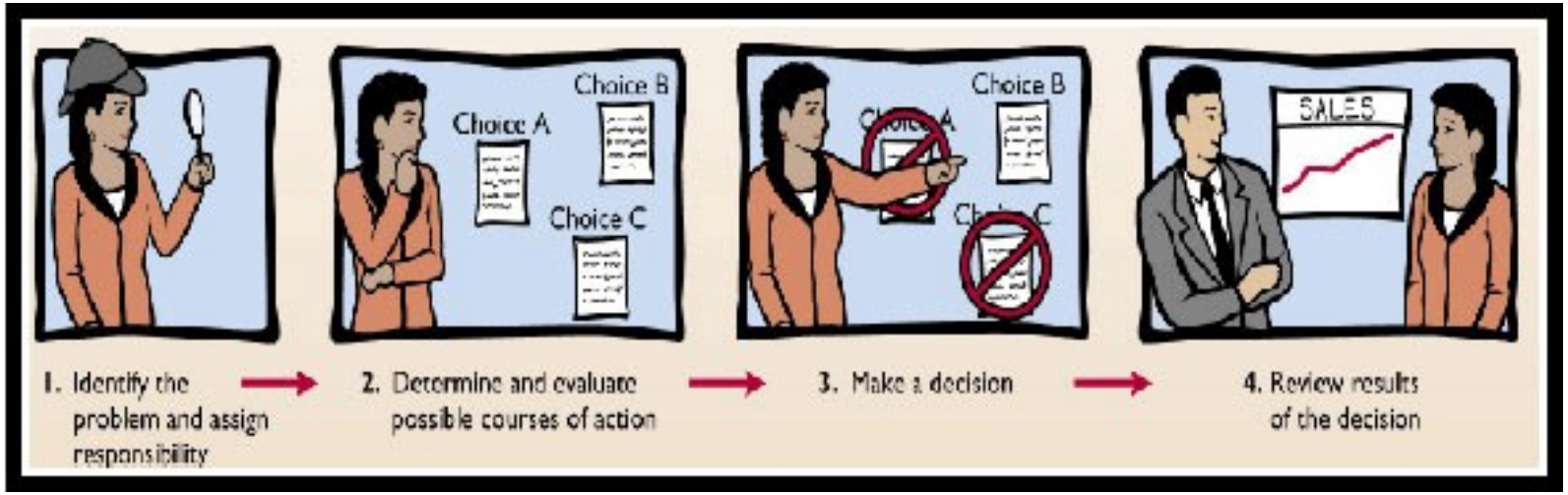
- Relevant information has two characteristics:
  - It occurs in the future
  - It differs among the alternative courses of action.
- Relevant costs are expected future costs.
- Relevant revenues are expected future Revenues.
- Past costs (historical costs) are never relevant and are also called sunk costs.

Relevant costs and revenues

- The relevant financial inputs for decision-making are future cash flows that will differ between the various alternatives being considered.
- Therefore only relevant (incremental/differential) cash flows should be considered.
- Relevant costs and revenues are required for special studies such as:

1. Special selling price decisions.
2. Product-mix decisions when capacity constraints exist
3. Decisions on replacement of equipment.
4. Outsourcing (Make or buy) decisions.
5. Discontinuation decisions.

The Decision-Making Process



What Information is Relevant for Decision Making?

- Information is relevant if:
  - it concerns the future, and
  - it varies across the alternatives.

- Avoidable cash flows are future cash flows that differ across the alternatives.
  - also called incremental cash flows
  - also called relevant cash flows

- Unavoidable cash flows are non-incremental and are therefore also called irrelevant cash flows.



- **Relevant cost** In incremental analysis, the only factors to be considered are those costs and revenues that differ across alternatives. Those factors are called **relevant costs**. Costs and revenues that do not differ across alternatives can be ignored when trying to choose between alternatives.



- **Opportunity cost** Often in choosing one course of action, the company must give up the opportunity to benefit from some other course of action. For example, if a machine is used to make one type of product, the benefit of making another type of product with that machine is lost. This lost benefit is referred to as **opportunity cost.**



- **Sunk cost** Costs that have already been incurred and will not be changed or avoided by any future decision are referred to as **sunk costs**. For example, if you have already purchased a machine, and now a new, more efficient machine is available, the book value of the original machine is a sunk cost. It should have no bearing on your decision whether to buy the new machine. **Sunk costs are not relevant costs.**