# Relevant Cost for Decision Making

Pawan K. Taneja

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## Learning Outcomes

| | |
|---|---|
| Identify | Relevant costs and relevant income |
| Identify | Opportunity costs and relevant income |
| Undertake | Short-term organisational decisions such as whether to continue with a project; make or buy; closure of a project; special prices |

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- The future costs and revenues that will differ among alternative courses of action. It is a prediction of the future not a summary of the past.

Relevant Costs/Revenue

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## RELEVANT COSTS & INCOME

*MUST FULFILL ALL THREE CRITERIA*

- INCREMENTAL - extra costs or revenues which result from decision
- FUTURE
- CASH

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- **Avoidable costs**- incurred if a course of action is followed. Also referred to as incremental costs and (revenues).
- **Opportunity costs**- measures net cash benefit foregone from the next most desirable alternative course of action.
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## Types of relevant costs

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## OPPORTUNITY COSTS/INCOME

- ***OPPORTUNITY COST*** *– benefit lost by not taking alternative course of action*
- ***OPPORTUNITY INCOME*** *– costs saved by taking alternative course of action*

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## While making decisions….

- Stock items used by the are used in the decision- take replacement cost
- Stock that has no alternative use-relevant cost is scrap value
- Historic cost is not used at all

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## IRRELEVANT COSTS

- These are not relevant for decision making

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## NON-RELEVANT COSTS

- **SUNK COSTS** – *already incurred so decision does not affect them.*
- **COMMITTED COSTS** – costs have not been paid but legal obligation exists to pay in future in other words *will have to be paid regardless of decision (eg. wages)*
- **NOTIONAL COSTS** – *not "REAL" since they do not involve outflow of cash (eg. depreciation or head office charges)*

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## Decision Making

| Decision type | Relevant costs (Costs) | Relevant income (Benefits) |
| --- | --- | --- |
| Continuing with a contract | Future payments<br>Opportunity costs | Future receipts<br>Opportunity income |
| Make or buy | Buying-in price | Savings in manufacturing costs |
| Closure | 'Lost' sales | Savings in costs |
| Special sales | Costs associated with the order | Sales value of the order |

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## Opportunity Benefits

- Savings/benefits that may be created by taking a positive decision to go ahead with a project.
- The avoidance of cash cost is the same as cash income.
- Opportunity benefits are relevant and must be taken into account.

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## Qualitative factors

- Think like manager not an accountant
- All financial decisions have a qualitative element involved
- At times qualitative costs may be higher than quantitative returns
- A decision should aim to maximise returns both in quantitative and qualitative terms.

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