

□ Chapter 14: Short Term Planning Decisions

Decision Making

- Critical thinking
 - Recognize the need for a decision (define the problem)
 - Identify alternative solutions
 - Evaluate alternative solutions
 - Make the decision choose the best alternative
- Evaluation-very important
- Important area where decision alternatives make a difference is in a company's profit
 - Affect on employees, community, environment, etc.

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□ Relevant Costs and Revenues

- To understand the profit impact of a decision, managers must carefully analyze the costs and revenues that the decision affects-or the relevant costs and revenues.
- **Relevant costs** and **relevant revenues** are future costs and revenues that will change as a result of a decision.
- a cost or revenue that is relevant for one decision may not be relevant for another
- important part of preparing an analysis for a decision is to identify the costs and or revenues that are relevant for that decision.
- Incomplete profit information could result in an incorrect decision
- Costs and revenues that are not relevant should be omitted from analysis

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□ Determining Relevant Costs and Revenues for a Decision

- Two questions
 - 1.What activities are necessary for the company to carry out the decision?
 - 2. By how much will the costs and/or revenues be affected if the company undertakes the activities?

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□ What Activities are necessary for the company to carry out the decision?

- The key to identifying potentially relevant costs is to have a good understanding of the company's activities that are necessary to carry out the decision
- Activities are the cause of all relevant costs
- Only costs that the company incurs as a result of performing these activities can be relevant
- No cost incurred prior to making the decision is relevant
- All costs that the company incurs as a result of the activities must be future costs
- Past costs=sunk costs, eliminated from consideration
- Future costs that a company will incur for activities that are not necessary to carry out the decision are not relevant
 - These costs relate to other activities that would be undertaken regardless of the outcome of this decision

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□ By how much will the costs and/or revenues be affected if the company undertakes the activities?

- Costs required by decision remain for further analysis
- A specific cost is relevant only if the total amount that the company will incur is affected by the decision
- This fact cannot always be determined until the amounts of potential relevant costs are estimated
- Cost estimation has two purposes: to provide estimates of relevant costs and to further eliminate irrelevant costs

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□ Exhibit 14-1 Three Step Process of Identifying Relevant Costs

- Step 1: Eliminate past costs
- Step 2: eliminate costs not necessary to carry out decision alternatives
- Step 3: eliminate costs that would not differ from one alternative to another

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□ Other Cost (and Revenue) Concepts for Short Term Decisions

- Incremental costs

- o Additional activity usually causes additional costs
- o **Incremental costs:** cost increases resulting from a higher volume of activity or from the performance of an additional activity
- o Always relevant when the higher volume of activity, or the additional activity, is not necessary for all of the alternatives
- Avoidable Costs
 - o When a company discontinues an activity, or when it decreases its volume, it may reduce certain costs necessary to support that activity or may no longer incur them.
 - o **Avoidable costs** are the costs that a company must incur to perform an activity at a given level, but that it can avoid if the company reduces or discontinues the activity.
- Opportunity Costs
 - o Performing activities needed for one of the alternatives in a decision sometimes disrupts a company's other profitable activities or reduces its opportunity to engage in other future profitable activities.
 - o The profit impact of this disruption or lost opportunity must be included in decision analysis.
 - o Done by including opportunity costs
 - o **Opportunity costs:** the profits that a company forgoes by following a particular course of action

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□ Deciding Whether to Drop a Product

- Managers may decide to drop a product for a number of reasons
 - o Changing technology, no longer profitable, customer interest decreases, product is becoming obsolete, poor safety record, new information indicates the product may harm the environment, etc.
- Ordinarily, products do not become unprofitable over night.
- Gradual decline in profitability
- Consider management accounting info that will highlight the profitability (or the decline in profitability) of individual products