

- Decision making
- 1. Recognizing the need for a decision (defining the problem)
- 2. Identifying alternate solutions
- 3. Evaluating the alternative solutions
- 4. Making the decision

What difference does it make?

Relevant Costs and Revenues

- **relevant costs and revenues** are *future* costs and revenues that will change as a result of a decision
- all relevant costs and revenues should be included in an analysis for a decision because incomplete profit information could result in an incorrect decision
- Determining Relevant Costs and Revenues for a Decision
  - What activities are necessary for the company to carry out the decision?
    - There are activities that cause all relevant costs. Thus only the 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
    - Future costs that a company will incur for activities that are not necessary to carry out the decision are not relevant
  - By how much will the costs and/or revenues be affected if the company undertakes the activities?
    - A specific cost is relevant only if the total amount that the company will incur is affected by the decision
- Other Cost and Revenue Concepts for Short-Term Decisions
  - **Incremental costs:** increases resulting from a higher volume of activity or from the performance of an additional activity
    - They are *always* relevant when the higher volume of activity, or the additional activity, is not necessary for the alternative
  - **Avoidable costs:** 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

- o **Opportunity costs:** the profit impact of the disruption or lost opportunity; profits that a company forgoes by following a particular course of action
- Illustration of Determining Relevant Costs and Revenues (Special Order)
  - o Step 1 and 2: either accept or reject the deal
    - Decide which costs are relevant and which are not, eliminate what is related to activities that are not necessary to carry out the decision (Step 2)
    - Incremental costs may be an example of shipping costs
  - o Step 3: After deciding what costs are relevant, estimate the costs and eliminate factory overhead from the analysis because although it would be a future costs incurred to support manufacturing activity, the amount would not be affected by the decision
- Deciding Whether To Drop a Product
- The key to evaluating the profit effects of a company's decision to drop a product is to determine the costs that it would incur (i.e., the avoidable costs) and the revenues that it would not earn if discontinued production and sale of the product
  - Avoidable costs are *always* relevant to this evaluation
  - These costs are the only future costs that the company would not incur if it drops the products
- A company should drop a product if the avoidable costs are more than the revenue it would lose if it dropped the product
- Deciding Whether to Make or Buy a Part
- Quality, supplier reliability, and costs advantages are go into the decision
- Requires an analysis of the relevant costs for each alternative
- Deciding Whether to Sell a Product or Process it Further
- Consider: difference in company's profits between the two alternatives, whether the customers who like the product "as is" will refuse to buy the product when it is processed further, whether the further processing will have a negative affect on the environment, whether the company has access to employees....
- Decisions Involving Product Mix

- Deciding how many units of each product to produce and sell
- Involves two issues:
  - A company can influence the sales volume of each of its products in many ways, such as by sales activities, promotional campaigns, and the number of sales personnel used for each product
  - Many companies operate with limited productive capacity and, as a result, cannot produce as much of every product as they can sell
- Deciding How to Spend Advertising Dollars
  - When the increase in fixed costs (the additional advertising money is a fixed amount) does not change between alternatives, the company earns highest profit from the alternative that produces the largest increase in contribution margin above the increase in fixed costs
- Deciding How Many Units to Produce
  - The company earns the highest profit by using up the scarce resource to manufacture the product mix that produces the highest total contribution margin