Accounting 12/08/2012

- 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.

- 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

- 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?

- 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
  - Pasts 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

- 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

- 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

- Other Cost (and Revenue) Concepts for Short Term Decisions
  - Incremental costs

    - Additional activity usually causes additional costs
    - **Incremental costs:** cost increases resulting from a higher volume of activity or from the performance of an additional activity
    - Always relevant when the higher volume of activity, or the additional activity, is not necessary for all of the alternatives
- Avoidable Costs
    - 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.
    - **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
    - 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.
    - The profit impact of this disruption or lost opportunity must be included in decision analysis.
    - Done by including opportunity costs
    - **Opportunity costs:** the profits that a company forgoes by following a particular course of action

Deciding Whether to Drop a Product

- Managers may decide to drop a product for a number of reasons
    - 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