King Fahd University of Petroleum and Minerals

College of Industrial Management

Department of Accounting & MIS

Managerial Accounting (ACCT 510)

MBA Program

Chapter 5 (Lecture Notes)

Decision Making and Relevant Information

- Managers evaluate the impact of managerial decisions and actions that affect the organization's activities and processes
- To support decision making, they must identify the alternatives available and determine how relevant costs and revenues differ for each.
- Managers, for example, must evaluate the financial implications of decisions that require trade-offs between the costs and the benefits of different alternatives.

Managers usually follow a decision model for choosing among different courses of action. A decision model is a formal method of making a choice, and it often involves both quantitative and qualitative analyses. (see p.379)

- ➢ Management accountants work with managers by analyzing and presenting relevant data to guide decisions.

Types of Decisions

- One-Time-Only Special Orders: Accepting or rejecting special orders when there is idle production capacity and the special orders have no long-run implications.

- Make- or-Buy Decisions: a decision in which managers must decide whether their companies should manufacture some parts and components for their products in-house or subcontract with another company to supply these parts and components.
- Outsourcing and Idle Facilities: The process of buying resources from an outside supplier instead of manufacturing them in-house
- Product-Mix Decisions Under Capacity Constraints: the decisions made about which products to sell and in what quantities (has only short-run focus)
- Adding or dropping a product line or a business segment/ adding or dropping customers (focus on analysis of relevant- revenue and relevant-cost analysis)
- Equipment Replacement Decisions (issues to discuss e.g. historical cost (sunk costs), book value, salvage value, cash inflow and outflow, financing.
- Special pricing decisions

The Concept of Relevance

When choosing among different alternatives, managers should concentrate only on the costs and revenues that differ across the decision alternatives. These are the relevant cost/revenues. The costs that remain the same regardless of the alternative chosen are not considered relevant for the decision.

Relevant Costs and Relevant Revenues (Definitions)

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

- Occur in the future: every decision deals with selecting a course of action based on its expected future results and
- Different among the alternative courses of action – costs and revenues that do not fifer will not matter and, hence, will have no bearing on the decision being made.

<u>Avoidable costs</u>: Those costs eliminated when a part, product line, or business segment is discontinued.

Other relevant concepts:

- Incremental Revenues/ Incremental Costs
- Differential Revenues/ Differential Costs

- Marginal Revenues/ Marginal Costs
- Sunk Costs