

# **Topic 4**

## **[week 6]**

# **Use of Cost for Short-Term Decision Making**

# Learning Outcomes

**Upon completion of this topic, the students should be able to:**

- **Describe the use of cost for short-term decision making**
- **Describe the meaning and application of key factors, opportunity costs, sunk costs, and differential costs**

# Decision Making

**Decision making is concerned with the future and involves a choice between alternatives. Many factors, both qualitative and quantitative, need to be considered and for many decisions, financial information is a critical factor. Hence, it is important that relevant information on costs and revenues is supplied.**

# Relevant Information

- **Future costs and revenues**

**It is the expected future costs and revenues that are of importance to the decision maker. This means that past costs and revenues are only useful in so far as they provide a guide to the future.**

- **Differential costs and revenues**

**Only those costs and revenues which alter as a result of a decision are relevant. Where factors are common to all the alternatives being considered they can be ignored, only the differences are relevant.**

# **Short-run Tactical Decision**

**These are decisions which seek to make the best use of existing facilities. In the short-run, fixed costs remain unchanged so that the marginal cost, revenue, and contribution of each alternative is relevant. In these circumstances, the selection of the alternative which maximises contribution is the correct decision rule.**

# Key Factor

**Also known as the limiting factor or principal budget factor. This is a factor which is a binding constraint upon the organisation. This factor prevents the organisation from indefinite expansion or unlimited profit. Where a single binding constraint can be identified, then the general objective of maximising contribution can be achieved by selecting the alternative which maximises the contribution per unit of the key factor.**

# **Marginal Costing Decision Making Steps**

- **Check that fixed costs are expected to remain unchanged**
- **If necessary, separate out fixed and variable costs**
- **Calculate the revenue, marginal costs, and contribution of each of the alternatives**
- **Check to see if there is limiting factor which will be the binding constraint, and if so, calculate the contribution per unit of the limiting factor**
- **Finally, choose the alternative which maximises contribution**

# **Types of Decision Making Situation**

- **Acceptance of a special order**
- **Dropping a product**
- **Choice of product where a limiting factor exists**
- **Make or buy**

# Acceptance of a Special Order

**This is meant whether to accept or reject an order which utilises the business's spare capacity. However, the order is only available if a lower than the normal price is quoted.**

# **Dropping a Product**

**If a company produces a range of products, and one of the product is deemed unprofitable. Hence, the management of the company may need to consider whether to continue producing the product or to drop it.**

# **Choice of Product Where a Limiting Factor Exists**

**In this situation, the company has a choice between various types of products to produce. However, there exists a single limiting factor that prevents the company to produce all the products. The company has to decide which combination of product to produce that deem to be most profitable.**

# Make or Buy

**Frequently, management are faced with the decision whether to make a particular product or component or whether to buy it from outside supplier. Apart from overriding technical reasons, the decision is usually based on an analysis of the cost implications. In general, the relevant cost comparison is between the marginal cost to produce and the buying price. However, when producing the product displaces existing production, the lost contribution must be added to the marginal cost of production of the product before comparison with the buying in price.**