

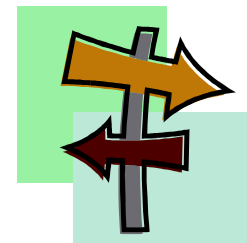


# Topic 9

## Relevant Costing

# Session Objectives

- Explain the concept of relevant costing
- Calculate the relevant costs for materials, labour and overheads
- Calculate the relevant costs associated with non-current assets
- Explain and apply the concept of opportunity cost



# Relevant costs and revenues

- Future cash flows that will differ between the various alternatives being considered.
- Relevant costs are:
  - Future costs
  - Cash flows
  - Incremental costs

# Terms Associated with Relevant Costs

- **Differential costs** or differences in total costs or revenue between two alternatives.
- **Opportunity cost** or value of the next best alternative that must be given up because of that decision.
- **Avoidable costs** or cost discontinued by changing or deleting an ongoing operation. Conversely, adding a product or department adds those costs.

# Relevant costs and revenues

o Relevant costs and revenues are required for special studies such as:

- Special selling price decisions.
- Product-mix decisions when capacity constraints exist
- Decisions on replacement of equipment.
- Outsourcing (Make or buy) decisions.
- Discontinuation decisions

# Non-relevant cost

- Already committed cost
- General fixed overheads
- Net book values
- Non-cash flow costs
- Notional cost or imputed cost
- Sunk cost
- Some variable costs

# Why are Sunk Cost not Relevant?

- Sunk cost is a past cost
- Principle underlying decision accounting is that management decisions can only affect the future.

# Are Variable Costs always Relevant?

- Variable costs will normally be relevant costs
- On some occasions variable costs may be irrelevant (when these are treated as sunk costs).
- Material already purchased and become obsolete and also has no scrap value. If an alternative use can be identified it is non-relevant cost

# Are Fixed Costs always Non-relevant?

- Fixed costs are mostly irrelevant to decision making unless they are directly attributable
- Directly attributable fixed costs are costs that:
  - Increase if extra activities are undertaken
  - Decrease if a decision were taken either to reduce the scale of operations or shut down

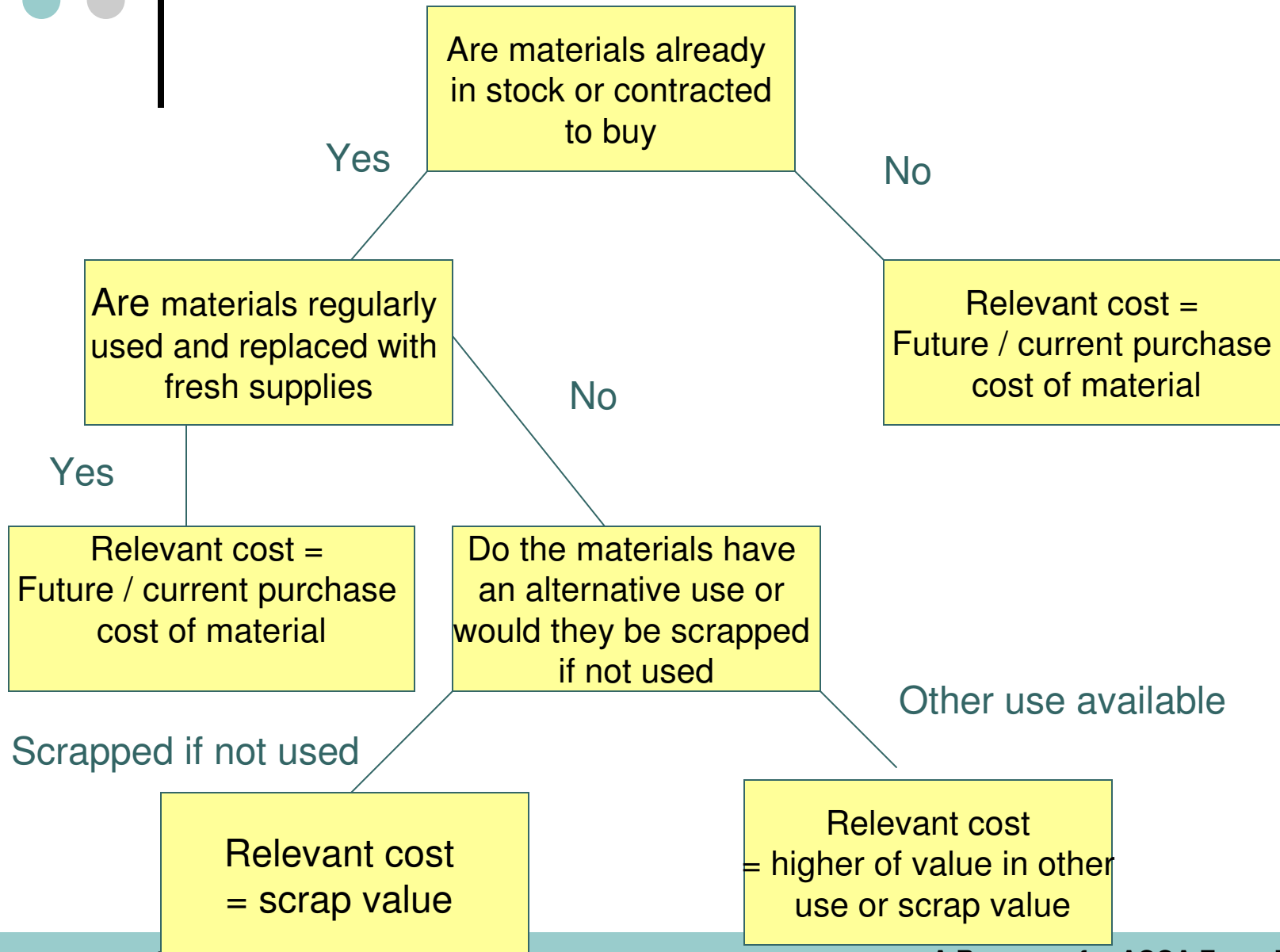
# Importance of Relevant costs and Revenues

- Special selling price decisions.
- Product-mix decisions when capacity constraints exist
- Decisions on replacement of equipment.
- Outsourcing (Make or buy) decisions.
- Discontinuation decisions.

## Identifying Relevant Costs: Machinery Cost

- Once a machine is bought its cost is sunk cost
- Depreciation is not a relevant cost because it is not a cash flow
- Using machinery may involve some incremental costs
- The costs might be referred to as user costs and include hire charges or any fall in resale of value of assets

# Identifying Relevant Costs: Material



# Identifying Relevant Costs: Labour

- Often labour force is paid irrespective of the decision made and the cost are therefore not incremental
- If labour force could be put to an alternative use, in which case the relevant costs are the variable costs of labour and associated variable overheads + contribution forgone from not being able to put it to alternative use

# Opportunity Cost

- The cost of pursuing one course of action measured in terms of the foregone return that could have been earned on an alternative course of action that was not undertaken.

# Outsourcing Decisions

- o Involves obtaining goods or services from outside suppliers instead of from within the organization.
- o The relevant costs for the decision will be the differential costs between the two options



# Replacement of Equipment

- o The original purchase cost of the old machine, its written down value and depreciation are irrelevant for decision-making.



# Special Pricing Decisions

- o Special pricing decisions are typically one-time only orders and/or orders below the prevailing market price.



# Discontinuation Decisions

- o Routine periodic profitability analysis by cost objects provides attention-directing information that highlights those potential unprofitable activities that require more detailed (special studies).



# Sample Exam Question

- Of the following, which costs can be ignored when making a decision?
  - A. Opportunity costs
  - B. Differential costs
  - C. Sunk costs
  - D. Relevant costs

# Answer

- C
- Management decisions can only affect the future. Therefore, the costs taken into consideration must be those that affect the future. Sunk cost is a past cost which is not directly relevant in decision making.

# Sample Exam Question

- Frontier plc is considering replacement of an old delivery truck with a new truck. While taking the decision, it will consider all of the following costs EXCEPT:
  - A. Purchase price of the old vehicle
  - B. Purchase price of the new vehicle
  - C. Savings in operating costs as a result of the new vehicle
  - D. Proceeds from disposal of the old vehicle

# Answer

- **A**
- Purchase price of the old vehicle is a sunk cost and is not a relevant cost for decision-making.