**Lesson 12 Hilton Video 2 of 2 Chapter14**

**CHAPTER 14: DECISION MAKING, RELEVANT COSTS & BENEFITS**

Chapter 14 concerns decision making. In one sense, the entire book leads to this chapter.

**THE DECISION-MAKING PROCESS**

The decision process consists of the six steps that follow.

1. Clarify the decision problem.
2. Specify the criterion upon which the decision will be made.
3. Identify the alternatives.
4. Develop a decision model that brings together the criterion, the constraints, and the alternatives.
5. Collect the data.
6. Select an alternative

**RELEVANT INFORMATION**

The information gathered should be relevant to the opportunity or problem at hand.

**Relevant information** involves costs and benefits that

1. Differ among the alternatives being considered
2. Are future oriented.

**Both guidelines must be met.**

**Sunk costs** are past costs that have already been incurred.

* Such costs are irrelevant in decision making because the amounts cannot be changed by any of the alternatives under review.

A **differential cost** is the net difference in cost between two alternatives.

An **opportunity cost** is the cost of a forgone alternative.

* Companies must frequently pass up profitable (beneficial) projects. The profit (benefit) forgone becomes an opportunity cost to the firm, and such costs are relevant in the decision-making

**SPECIAL DECISION SITUATIONS**

Note: The *decisions in this chapter* are *primarily short-term in nature.*

The text covers for common decision making situations that confront mangers.

* Accept a Special Order
* Make or Buy
* Add or Drop a Product, Service, or Department
* Joint Products: Sell or Process Further

**SPECIAL ORDERS**

In this situation, a manager considers an order (often a one-time order) at a special price. Key issues to evaluate include:

**Cost behavior**: Unless told otherwise, students should assume that total fixed costs remain fixed and only total variable costs change.

**Qualitative considerations**: These include, among other things,

The reaction of present customers should they hear about the special price,

An organization's available capacity

Regulations that guard against price discrimination.

**Organization with Sufficient Capacity**

* Opportunity costs not an issue
* Assume that unused capacity exists to meet the special order unless otherwise indicated

**Organization at Capacity**

* *The opportunity cost of the lost contribution margin from regular, higher-priced sales must be factored into the decision.*

**MAKE OR BUY (PRODUCE IN-HOUSE OR OUTSOURCE)**

This situation requires careful consideration of fixed costs.

The total cost per unit of a product or service includes a unitized portion of fixed cost, a cost that may continue even if the item or service is purchased elsewhere at a lower price.

**ADD OR DROP A SERVICE, PRODUCT, OR DEPARTMENT**

The key is the proper handling of fixed costs and determination if such amounts are **avoidable** or **unavoidable**.

The manager should isolate costs that will disappear with that line.

In many cases, fixed costs are not avoidable, particularly allocated common costs.

The contribution margin lost from the activity to be dropped must also be considered.

**JOINT PRODUCTS: SELL OR PROCESS FURTHER**

A **joint production process** results in the commingled manufacture of two or more products, called joint products.

The products become identifiable from each other at the **split-off point.**

Management must frequently decide whether to sell the products at split-off or, alternatively, incur additional cost beyond split-off (called **separable cost)** and then sell the goods for a higher price.

**Joint costs incurred prior to split-off are not relevant when making the sell-at-split-off or-process-further decision**, because these costs will be incurred regardless of the alternative selected.

Compare the separable cost incurred to process further against the amount of increased sales revenue.

**OTHER FACTORS IN DECISION MAKING**

**Allocation Of Limited Resources**

Decisions may involve the use of limited labor hours, limited materials, and limited machine time.

When only one limited resource is present, **a company should focus on products that have the greatest amount of contribution margin per unit of the scarce resource**.

A tool called the *theory of constraints* may be useful for identifying limiting constraints and seeking ways to relax them.

**Theory of Constraints.** A management approach that focuses on identifying the constraints that limit an organization’s ability to reach a higher level of goal attainment and to relax that constraint to allow higher activity.

**Uncertaint**y

Analysts can incorporate uncertainty into the decision process by weighting an alternative with its probability of occurrence.

**Expected Value.** Multiplying the alternative by a probability and then summing the results will yield the **expected value,** an average that is used to make the decision.

Many businesses use **sensitivity analysis** to determine what would happen in a decision analysis if a key variable or assumption proved to be incorrect.

**OTHER ISSUES IN DECISION MAKING**

Several helpful hints in decision making:

**Pitfalls to Avoid**

* Ignore sunk costs.
* Beware of unitized fixed costs, i.e., the average fixed cost per unit, although fixed costs do not change in total.
* Beware of allocated fixed costs; identify the avoidable costs.
* Pay special attention to identifying and including opportunity costs in the analysis of alternatives.