HULT International Business School
Managerial Accounting (ACC220)
Outline of the Required Book

Chapter 2 - Relevant costs and benefits for decision making

1. Cost-benefit analysis

➔ **Cost benefit analysis:** assess the likely outcome of each course of action being taken: prospective benefits vs the costs involved.

2. What is meant by cost ?

➔ **Opportunity cost**: the value of the opportunity foregone in order to pursue the other course of action

- rarely taken into account in the **routine** accounting processes (as they do not involved out-of-pocket expenditure)

➔ **Historic cost** → cannot logically ever be used to make a decisions on the total costs (never relevant)

- to say that historic cost is an irrelevant cost is not to say that the effect of having incurred that cost are always irrelevant.

3. Relevant costs

➔ **Outlay costs**: amount that will have to be spent in order to pursue a particular course of action.

➔ **Relevant costs** = satisfy all 3 of the criteria:

- must relate to the objectives of the business (must have a effect on the wealth of the business)
- must be a **future** cost
- must vary with the decision

4. Irrelevant costs

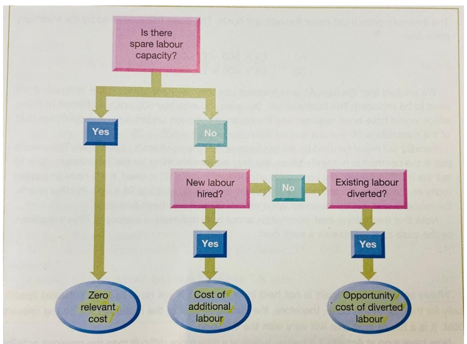
➔ **Sunk cost** = past cost

➔ **Committed cost** = irrevocable decision that has been made to occur (legally binded contract)

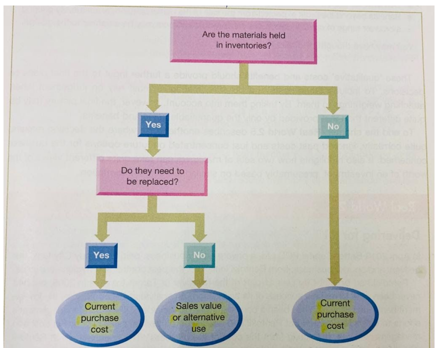
5. Sunk cost fallacy

➔ **Sunk cost fallacy:** the refusal to abandon an attachment to an irrevocable investment (behavioral economics)

6. Determining the relevant cost of labour and materials



The starting point is to determine whether there is temporary spare capacity. In these circumstances, the relevant cost of labour is usually zero. Relevant labour costs often only arise where the business is operating a full capacity.



The starting point is to determine whether the materials are held inventories. Relevant costs arise where inventories have to be replaced or where there is an opportunity cost involved in their use. Where materials are not held in inventories, the cost of purchasing them is the relevant cost.

7. Non measurable costs and benefits

[1] only actual increase of the cost should be taken into account as a result of accepting a new project

[2] general overheads (rent, utility cost, admin, etc) should always be ignored in the company's policy of allowing of the cost (fair share allocation).