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Notes – Chapter 14

Decision Making: Relevant Costs and Benefits

I. Decisions
   a. Characterization of Decision
      i. Frequency: One-Time or Special ✍ Regular / Routine
      ii. Risk: High ✍ Low
      iii. Relative Difficulty: Challenging ✍ "Proverbial No-Brainer"
      iv. Interested Primarily in one-time, high-risk, challenging decisions
   b. Approaches
      i. Analytical / Systematic (more informed)
      ii. Emotional (less informed)
      iii. "Spock doesn't rule, necessarily." Use intuition too.
      iv. Looking primarily for an analytical approach.
   c. Process
      i. Example: Choosing a University
      ii. Clarify the Problem
      iii. Specify the Criterion
         1. What are the objectives? (education, quality)
         2. What are the constraints? (high school GPA, cost)
         3. Consider intangible forces (your impression)
      iv. Identify the Alternatives
         1. Develop a short list that meet the criteria
         2. Consider all options initially
      v. Develop a Decision Model
         1. Develop an approach to analyze the data
         2. Weight criteria, perhaps
      vi. Collect Data
         1. What is the cost? How will it change?
         2. Research objective evaluations of quality
      vii. Make the decision
   d. Collecting the Data
      i. The key role of accountants in the process is in collection of data
      ii. Criteria
         1. Must be relevant
            a. Future perspective
            b. Must differ among alternatives
            c. If in the past, it's a sunk cost. Ignore it.
            d. If it doesn't differ it has no relevance.
            e. The key is in defining what's relevant.
            f. Doing a core dump isn't helpful.
         2. Must be accurate
         3. Must be timely
            a. May be a tradeoff between time and accuracy
            b. Consider Normal vs. Standard costing

II. Key Cost Concepts
   a. Relevant Costs (see criteria above)
   b. Sunk Costs
      i. Never relevant
      ii. Have already been incurred and cannot be affected by any future action
   c. Opportunity Costs
      i. Amount discarded by choosing one option over another.
      ii. With excess capacity there usually aren't any opportunity costs.
   d. Beware of unit cost data since fixed costs must be interpreted differently.

III. Issues

a. Dealing with Uncertainty
    i. Sensitivity analysis
    ii. Change the numbers, observe the effects, decide the point at which a different decision would be better.
    iii. Expected Value
        1. Have one variable and a lack of clarity. What to do?
        2. Establish probability for any particular value of that variable.
        3. Define expected value as the predicted value times its probability.
        4. Sum all such values to get a useful measure for that variable

b. Incentives for Decision Makers

c. Short vs. Long Run decisions

d. Pitfalls
    i. Don't ignore sunk costs!
    ii. Watch for unitized fixed costs
    iii. Understand what allocated fixed costs are avoidable
    iv. Consider opportunity costs.