The Institute of Finance Management
Accounting and Finance Department
Lecture Notes
Measuring of Relevant Costs and Revenue
BACC 3 and BAIT 3

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1.1 Introduction

Managers are charged with the responsibility of managing organizational resources effectively and efficiently relative to the organization's goals and objectives. Making decisions about the use of organizational resources is a key process in which managers fulfill this responsibility.

Decision making involves making a choice between two or more alternatives. The decision will be 'rational' profit maximizing. All decisions will be made using **relevant costs and revenues**

In making a choice among the alternatives available, managers must consider all relevant costs and revenues associated with each alternative. One of the most important concepts discussed in this topic is the relationship between time and relevance

Hence: Relevant revenue and costs are those revenues and costs that change as a result of making a particular decision. In simple terms, a relevant revenue or cost is a future cash flow arising as a direct consequence of a decision.

Therefore, whenever a financial decision is made, it is essential that the relevant costs are considered, the costs and benefits must be evaluated and the decision taken should maximize the benefits. Sometimes, it is necessary to take ***non*-financial factors into consideration**

1.2 Elements of Relevant Revenue and Costs

In order for a revenue or cost to be relevant to a decision, it must therefore meet the following criteria

1. *Cash flows*. To evaluate a decision, actual cash flows should be considered. Noncash items such as depreciation and interdivisional charges should be ignored.
2. *Future costs and revenues.* This means that past costs and revenues are only useful insofar as they provide a guide to the future. Costs already spent, known as sunk costs, are irrelevant for decision making
3. *Differential costs and revenues*. Only those costs and revenues that 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
4. Opportunity cost – this is the value of the best alternative that is foregone as a result of making a decision

1.3 Relevant cost of specific items

1.3.1 Relevant Cost of Material Requirement

The cost of using materials can be summarized as follows

- If the material is purchased specifically i.e. out of stock then the relevant cost for this material is the current price. The current price or replacement cost (price) can be used
- If the material is already in stock and is used regularly, then the relevant cost for this material is the replacement cost (price) or current price
- If the material is already in stock but is surplus as a result of previous overbuying, the relevant cost for this material is the opportunity cost, which may be its scrap value or its value in any alternative use, net realizable value (NRV)

Note: Any historic cost given for materials is always a sunk cost and never relevant unless it happens to be the same as the current purchase price

Replacement cost = current purchase cost.

Deprival value applies where materials are scarce

1.3.2 The relevant cost of labour

- If work can be done by idle time of labour, then relevant cost of that labour is zero.
- If labour is fully employed then the relevant cost is the additional payments required:
  - to hire additional labour;
  - Overtime payments.
- If labour is fully employed and no further labour is available: then the relevant cost is
  - direct cost of labour (wages);
  - **Plus** lost contribution from other production.

This is equivalent to revenue foregone less costs (other than labour) saved.

1.3.3 Overheads

- All Variable overhead costs are relevant
- Additional (e.g. stepped) fixed overheads or those that can be saved are relevant.
- Reallocated/apportioned overheads are **not** relevant.
- Overhead absorption is **not** relevant (arbitrary).

1.4 Relevant Costs - Asset Replacement

- An example of the use of relevant costs is in the decision to replace plant and equipment. Once again, the concern is with future incremental cash flows, not with historical or sunk costs or with non-cash expenses such as depreciation
- Asset should be replaced only if replacement cost is **lower** than the original cost before replacement