

# **Accounting for Financial and Managerial Decision and Control [AFMDC]**

## **Unit 7**

### **Managerial Accounting for Decision Making: Make or Buy Decision and Accept or Reject a Special Offer Decision**

#### **Structure**

- Concepts, importance and objectives of decision making regarding alternative choices
- Cost classification for managerial decision-making perspectives: relevant and irrelevant cost
- Avoidable and unavoidable cost, opportunity cost, differential cost and sunk cost
- Decision regarding to:
  - Make or buy
  - Accept or reject a special offer

#### **After the completion of this unit, you should be able to:**

- Understand the concept of decision making under alternative choices
- Describe the importance and objectives of decision regarding alternative choices
- Explain relevant and irrelevant cost, avoidable and unavoidable cost, opportunity cost, differential cost and sunk cost
- Make decision regarding to: Make or buy, and accept or reject a special offer

#### **7.1 Concept**

Decision making is a fundamental part of management. The management has to make the different decisions regarding the various activities of an organization. It has to make decision about the mix of products, method of production, acquisition of equipment, dropping a product line, pricing decision and so on.

Decision making is a future oriented activity. It involves forecasting, planning and decision under alternative choices. It is the process of evaluating two or more alternatives leading to a final choice. Decision making is closely involved with the planning for the future and is directed towards a specific objective or goal. In other words, the act of selecting one course of action among various feasible available alternatives is decision making.

#### **7.2 Importance of Decision Making Regarding Alternative Choices**

Decision making is the selection of one alternative from the different available alternatives. An alternative should be a financially attractive one. Thus, decision making plays a vital role in management. Decision making is important for the following purposes:

- Decision making is very important to implement the managerial function. Different managerial functions such as planning, organizing, directing, controlling and staffing cannot be conducted without decision making.
- Without decision making any kind of function is not possible. The decision is made in all managerial activities as well as in all functions of the organization.
- Decision making evaluates the managerial performance. The correct decision indicates that the manager is qualified and efficient. Whereas wrong decisions show that the manager is not efficient and qualified.
- Decision making is an important process which is helpful in planning and policies. Any policy or plan is established through decision making.
- Decision making is very important for the selection of the best alternative among the different alternatives. All the alternatives are evaluated in so many factors like cost factors, risk, benefits, facilities or capacity utilization etc. Only after evaluating and analyzing the all alternatives, the best alternatives are selected.
- Correct decisions help in successful operation of the business. The organization can exist when the correct and appropriate decisions are made.

### **7.3 Objectives of Decision Making Regarding Alternative Choices**

Management is basically decision-making process. An organization can accomplish its short-term and long-term goals through making decision. The success or failure of an organization is depending on decision making. When taking a decision, the managers have a purpose. They propose and analyze the alternative course and finally make a choice that is likely to move the organization in the direction of its goals. Hence, correct decision is very important. The main objective of decision making is to make correct decision. Correct decision reduces complexities, uncertainties and diversities of the organizational environments.

The main objectives of Decision Making are:

- To choose best alternatives among the different alternatives
- To identify and define the provision the problem for making the decision effective
- To develop the different alternatives available at present
- To evaluate all the alternatives
- To analyze the quantitative and qualitative facts of alternative
- To consult experts and specialists if the alternatives demand
- To make decision with close security and deep thinking
- To take decision for the future course of action on the basis of past experience and present circumstances.

### **7.4 Step for Decision Making Regarding Alternative Choices**

A manager should take the following steps to make decisions intelligently and skillfully

Step 1: Define the problem

Step 2: Identify the alternatives

Step 3: Identify the costs and benefits

Step 4: To find out total costs and benefits

Step 5: Assess qualitative factors

Step 6: Select an alternative (consider quantitative and qualitative factors)

## **7.5 Classification of Costs for Decision Making**

The important costs which are relevant to decision making are as under:

### **Relevant and Irrelevant Cost**

Relevant costs will change with decision. The relevant costs are the expected future costs which differ between the decision alternatives. Those costs which will be affected by decision are known as relevant cost. Examples of relevant costs are direct material, direct labour, variable manufacturing overhead etc.

On the contrary, irrelevant costs are those costs that would remain unaffected by the decision. Those costs which will be same for more than one alternative are termed as irrelevant Cost. For an effective decision, a decision maker should have an ability to identify the relevant and irrelevant cost.

### **Sunk Costs (Committed Costs)**

Sunk cost is a historical cost which has been already incurred by the firm. The sunk costs do not affect any future costs and cannot be altered by any current or future decision. Therefore, they are irrelevant in decision making.

### **Differential Costs**

Differential cost is the difference in total cost between two alternative choices. The amount by which the cost of one alternative exceeds that of another is known as incremental cost.

### **Avoidable and Unavoidable Costs**

Avoidable cost is the cost which can be eliminated by selecting one alternative and rejecting next. Therefore, avoidable costs are relevant costs, when particular decision alternatives are compared. On the contrary, those costs which cannot be eliminated by alternative decisions are unavoidable cost. An unavoidable cost is an irrelevant cost for decision making.

### **Opportunity Costs**

An opportunity cost is the benefit given up or sacrificed when one alternative is chosen over another. It is the sacrifice of value from a missed opportunity. Actually, it is a theoretical concept. It is not incurred cost. Usually, opportunity cost is not recorded by the accountant. Nevertheless, it is useful in decision making situations. The decision maker should not consider only the cost and benefits of the proposed alternative in making a decision but (s)he should consider the profit that will be sacrificed by making decision.

It is the maximum possible alternative earning that might have been earned if the productive capacity or services had been put to some alternative uses. In simple words, it is the advantage, in measurable terms, which has been foregone due to not using the facility in the manner originally planned. For example, if an owned building is proposed to be used for a project, the likely rent of the building is the opportunity cost which should be taken into consideration while evaluating the profitability of the project.

### **7.6 Types of Decision Model**

Decision making is also known as Decision Model. It is the process of evaluating two or more alternatives leading to a final choice. It is also known as alternative choice decisions. There are different types of alternative choice decisions. Some examples of alternative choice decisions are:

- i. Make or buy decision
- ii. Accept or reject a special order decision
- iii. Drop or continue decision
- iv. Sale or further processing of joint product decision
- v. Lease or purchase decision

### **7.7 Make or Buy Decision**

Management sometimes may have to face with the decision whether to make a part of product or buying them from outside. Such a decision arises when a company has idle plant capacity and technical capability of manufacturing the component.

In this decision the manufacturing company has to consider the following alternatives:

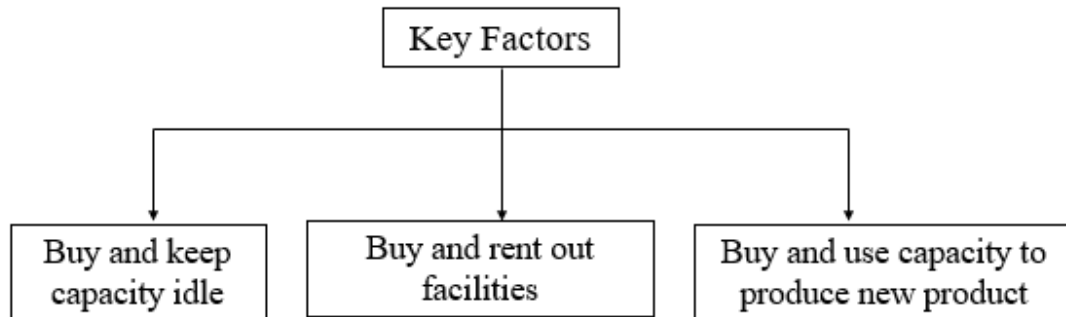
- (a) To buy certain raw materials or sub-assemblies from outside suppliers.
- (b) To produce the item within the factory.

Decision to make or buy is basically one of the determining alternatives which is economically most desirable and most effective utilization of the firm resources. Whether to make or buy a part depends upon total cost. If the cost for making is greater than buying, in that case, certainly the company should buy the part. But instead of it, if the cost for making is lower than buying, then obviously the company should make the part. Thus, the cost plays a vital role on decision making for make or buy a part. So, for making decision, a cost statement is developed which shows the total cost for making and buying.

In the make or buy decision, only relevant cost should be considered. Costs that will be incurred under both alternatives are not relevant to the analysis. Mostly, the fixed overheads are irrelevant for the decision to make or buy. The fixed cost has to be incurred under both alternatives. If the additional fixed cost has to be incurred for one alternative, that will be relevant for decision making of make or buy.

### **Solution part of make or buy decision**

- Objective
  - Cost minimization
- Decision based on cost statement
- Identify relevant and irrelevant cost
- Identify additional cost required for making
- Consider opportunity cost, if any
- Think about capacity and alternative use of capacity if buy decision
- Key considerable factors



(Source: Author)

### 7.8 Accept or Reject a Special Order Decision

The question of special order arises when a company has excess or idle production capacity. The selling price per unit of special order will be lower than normal selling price. Such a special order will not affect the regular sales of the same product.

Generally, if the company has got idle capacity, the fixed cost does not increase by accepting the special order. It will not change in total whether the order is accepted or rejected. Usually, in that case the fixed overhead is an irrelevant cost. Only the variable cost is the relevant cost. The variable cost increases by accepting the special order. But if there is no excess capacity, the special order may require some additional cost. In such a case, the additional fixed overhead has to be dealt as relevant cost.

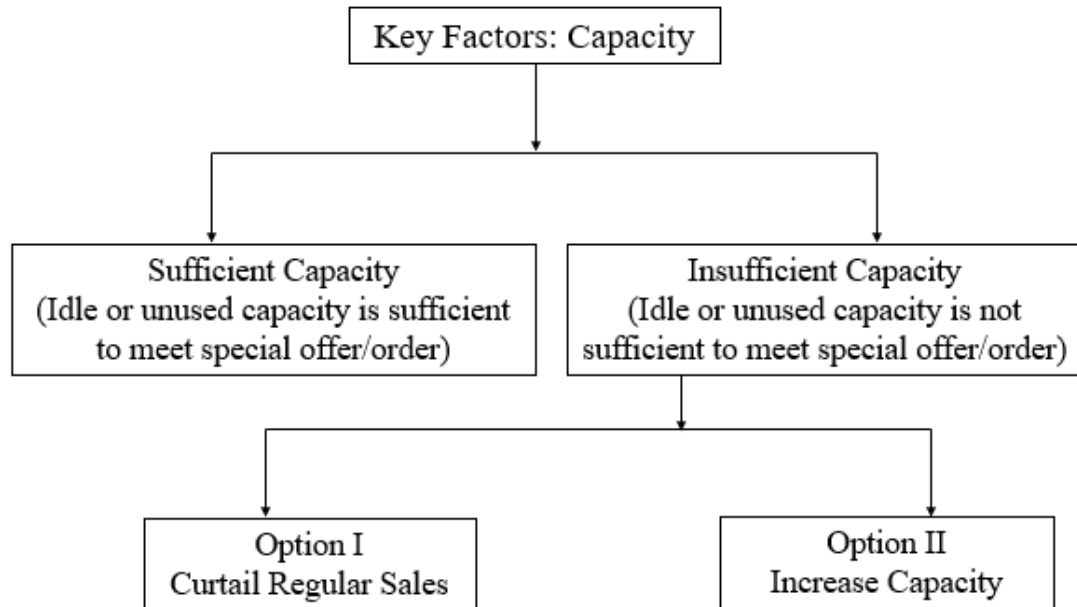
For making decision, whether to accept or reject a special order, an income statement is prepared which shows clearly the marginal cost, fixed cost and profit. If the profit increases on acceptance of the special order, that order should be accepted.

The decision can also be made on the basis of contribution margin. If the price offered is more than contribution margin, that proposal may be accepted. But when price offered is below the contribution margin, the offer is to be rejected.

### Solution part of accept or reject a special offer decision

- Objective
  - Profit maximization
  - Decision based on income statement
  - Variable costing income statement
  - Identify relevant and irrelevant cost

- Identify avoidable cost, if accept the special offer
- Identify additional cost required for special offer
- Consider opportunity cost, if any
- Key considerable factors (Think about capacity and alternative use of capacity)



(Source: Author)

#### References

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