From a decision making point of view, why are some costs relevant and others irre...

Finance

College: Relevant and Irrelevant Costs in Decision Making Relevant costs involve those costs that influence a specific decision in a company. Such are future costs, which will vary among alternatives. Irrelevant costs on the other hand relates to costs that do not have any effect on the cash flows. Such costs include the future and sunk costs, which do not vary between alternatives. Sunk costs and future costs are inevitable and they do not vary among alternatives. When analyzing alternatives therefore, it is important for a business organization to differentiate between relevant and irrelevant costs. This is because erroneous consideration of an irrelevant cost could result to unsound decision-making in the business. Overlooking the irrelevant data in the assessment process moreover would greatly benefit the company in saving time and effort (Averkamp 2012, p. 1).

For relevant costs, a company could for example be deciding whether to remove a product line or not. This product line could be accounting for about 4% of this firm’s activities. If the company eliminates this product line, the corporation officers will continuously receive similar salaries as before such that the expenses for the central office will not change. Product line managers plus others staffs working directly with this product line however will receive a termination thus eliminating their salaries. According to Averkamp (2012, p. 1), such eliminated salaries for individuals who worked directly with the direct line will be relevant in the decision-making process. If the salaries were $700000 when the product line was operational and $0 in its absence, the $700000 savings is therefore relevant (i. e. relevant cost). Considering this same product line scenario, salaries linked to the officers are not relevant for decision-making. This means that whether the salaries amounts to $500, 000 or $5, 000, 000, they will remain irrelevant. The salaries will be similar in the presence or absence of the product line. Averkamp (2012, p. 1) noted that a decision-maker will need not know the expenses of the central office because they will be constant in the presence or absence of the product line. Previous year's expenses will similarly remain irrelevant.

Reference

Averkamp, H 2012, " In Accounting, What is meant by Irrelevant Costs?" viewed 24 February, 2012, http://blog. accountingcoach. com/relevant-costs/.