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Video Transcription: Relevant Costing: The Fundamental Principle

Good day, my name is Jason. Relevant costing is an important tool used to analyse and make strategic decisions within a company. This video aims to explain the basic principle of relevant costing and illustrate its application.

The first thing to point out is that the term relevant costing can be confusing. It implies that we are only concerned with costs, in making these decisions. This is not the case at all. We are concerned with any information relevant to a decision. Both costs and revenues are relevant. Relevant information also includes factors that cannot be quantified, such as qualitative characteristics.

The foundation of relevant costing is found in how shareholder value is defined.

Shareholder value is defined as present value of the future cash flows generated by a company available to the shareholder. If these future cash flows increase, then shareholder value will increase.

So when a company makes a decision, either a short-term or long-term strategic decision, the main consideration is how future cash flows will be affected.

For me, the best way to make sense of relevant costing is by looking at a timeline.

The timeline shows the time that has passed since the company's incorporation, where we are today, and what we expect to happen in the future.

Assume a company is in the process of deciding whether to accept a special order, or not. A special order is a onetime order that is not considered to be part of the company's normal on-going business.

For example, a customer wants a discount or a modified product.

The timeline reflects that from today, the company has an option between two different alternatives. The company can decide to accept the special order, or not – in which case the status quo will prevail. If the company takes on the special project, the company's future will change.

To increase shareholder value, the rational decision is to take the course of action that will maximise future cash flows.

Therefore the company will take on the special project if the future cash flows from that special project are either the same as the status quo or higher.

The relevant cost or benefits is the extent to which our cash flows will change from the status quo, if we take on this special project. We see that the two options share the same past. Any cash flows that happen before the day of the decision, have been incurred regardless of which option we take.

This is why these cash flows can never be relevant to the decision that we make. These cash flows are not different between the two options, and they are not in the future. So they have no bearing on shareholder value.

The understanding of historical costs in the decision-making process is crucial.

Let us look at another strategic decision. So, should a component used in the production process be used in-house or outsourced, in other words purchased from a supplier?

The company has budgeted that it will need 8 000 components. The following cost information is available for 8 000 units, if produced in-house. The total cost per unit produced, assigned by the company, is R42 per unit. The fixed overheads consist of the following costs: supervisor's salary at R48 000, which is the equivalent of R6 per unit, depreciation on equipment, of R32 000, which equates to R4 per unit, and then lastly, allocated general overheads of R80 000; this amounts to R10 per unit, bringing the total fixed overhead costs of R20 per unit.

The company can purchase the component at R36 per unit. At first glance the R36 offered by the supplier seems lower than the production cost of R42, but let us do a proper analysis before we make a decision.

Let's compare the cash flows we expect to pay if we outsource the components, to the cash flows if we produce the components in-house.

Remember we are concerned with future cash flows. Are all these costs, future cash flows? What about depreciation on equipment? Depreciation itself is not a cash flow, but it is as a result of a previous cash flow. When did these cash flows occur?

Sometime in the past when that asset, to which the depreciation relates was purchased, it is a historical cost, therefore it is irrelevant to the decision at-hand. This is what we call a sunk cost; it is the cash flow that has already happened. We will eliminate non-cash flows, in other words depreciation. If the company does not produce the units it will not incur the variable costs. Therefore the direct materials, direct labour and variable overheads will not be incurred.

R176 000, in other words R22 multiplied by the 8 000, will not be incurred if the component is purchased. If the component is purchased, the purchase price will be the cash outflow; we include it in our analysis as follows:

What about the fixed costs? Remember, most fixed costs are incurred regardless of the level of activity in the company. The fixed costs, which remain, are the supervisor's salary and the general allocated overheads. Further investigation reveals that the supervisor will be discharged and their salary will no longer be paid if the units are purchased. The allocated general overheads refer to administration costs incurred by the company as a whole, which will be allocated to another segment within the company.

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The supervisor salary is an example of a fixed cost that can be relevant, even in the short term. If we produce the units in-house, we will incur the salary outflow, if we outsource production we will not incur the cash flow. The allocated overheads, however, will be incurred regardless of what we do. Thus our analysis will be as follows.

We can now calculate the total future cash flows of each option.

We see that the total relevant cash flows, if the company purchases the component, will be R368 000. If we produce the component in-house, the relevant cash outflows will be R304 000. If the status quo is maintained, the company will have future cash outflow of R304 000. If the company outsources production, it will have future cash outflows of R368 000. By making the decision to outsource production the company will be worse off, in terms of future cash flows, by R64 000.

So outsourcing the production is not the best option. This video aimed to demonstrate the fundamental principle behind relevant costing. As a company is constantly making strategic decisions, which affect the sustainable success of that company, the differential cash flows is an incredibly important tool.