

What is Relevant Cost Analysis?

Worksheet

A relevant cost is a future cash cost that differs between two or more decision alternatives; sunk costs, and costs identical across all options, are irrelevant and should be excluded from the decision.

Questions

1. Which of these is always irrelevant to a decision?

- A) Future variable costs that differ by option
- B) Avoidable fixed costs
- C) Sunk costs
- D) Opportunity costs

2. A company is deciding whether to accept a special order. Which cost is relevant?

- A) Existing factory rent that continues either way
- B) Historical cost of machinery already owned
- C) The incremental variable cost to produce the special order
- D) Last year's advertising expense

3. What best defines an opportunity cost?

- A) Cash already spent
- B) The benefit given up by choosing one alternative over another
- C) A fixed cost that never changes
- D) An accounting depreciation charge

4. Why should sunk costs be excluded from decision making?

- A) They are always small amounts
- B) They cannot be recovered or changed by any future choice
- C) They are illegal to consider
- D) They always favor one option

5. A company paid \$5,000 last year for market research on a product it may now discontinue. Is this \$5,000 relevant to the discontinue-or-keep decision?

6. A firm can make a part in-house for \$12/unit variable cost, or buy it externally for \$15/unit. Fixed costs of \$20,000 continue either way. Should it make or buy 2,000 units?

7. A machine originally cost \$50,000 and has a book value of \$20,000. It can be sold now for \$8,000, or used to produce a product earning \$30,000 in future contribution margin. What is relevant?

8. Define: What is a relevant cost?

9. Define: What is a sunk cost?

10. Define: Are opportunity costs relevant?

Answer Key

1. C) Sunk costs - Sunk costs are already incurred and cannot change regardless of the decision made.
2. C) The incremental variable cost to produce the special order - Incremental variable costs change with the decision, making them relevant; the others are unavoidable or sunk.
3. B) The benefit given up by choosing one alternative over another - Opportunity cost is the value of the next-best alternative forgone, and it is relevant even without a cash outflow.
4. B) They cannot be recovered or changed by any future choice - Since sunk costs are identical under every future alternative, including them can only bias the decision.
5. The \$5,000 was already spent and cannot be recovered regardless of the decision. It is a sunk cost irrelevant. Only future costs and revenues from keeping vs. discontinuing the product matter.
6. Relevant cost to make = $\$12\,200 = \$24\,000$ (fixed costs are unavoidable either way irrelevant) Relevant cost to buy = $\$15\,200 = \$30\,000$ Making in-house saves \$6,000 Make is the better decision.
7. The \$50,000 original cost and \$20,000 book value are sunk irrelevant. The relevant comparison is: sell now for \$8,000 vs. keep and earn \$30,000 in future contribution margin. Keeping and using the machine is more valuable by \$22,000.
8. A future cost that differs between the decision alternatives being compared.
9. A cost that has already been incurred and cannot be changed by any future decision - always irrelevant.
10. Yes - the value of the best forgone alternative should be included in relevant cost analysis even though no cash changes hands.

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