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# 5

# Short-term Decision Making

## 5.1 Introduction and objectives

Previous chapters have focused on the nature of costs and how they behave in relation to changes in activity and over time. The nature of costs is an important factor to consider in decision making. Types of decisions are usually split into short and long-term. Chapter 14 (Capital Investment Appraisal) considers the longer-term decision-making process, whilst this chapter focuses on the short-term.

After studying this chapter you will be able to:

- Understand costs that are relevant to the decision-making process in different circumstances
- Demonstrate working knowledge of typical short-term decisions managers have to make and how financial data can support these decisions
- Recognise the issues of managing scarce resources in decision making; and
- Appreciate the implications of outsourcing in a business context.

## 5.2 Relevant costs in decision making

Relevant costing is a management accounting term and relates to focusing on only the costs relevant to a specific decision being made. It simplifies the decision-making process as it ignores cost data that is 'irrelevant', or will not have an impact on the specific decision being made. When making a particular decision-relevant costs are those that may change, depending on the decision taken.

Relevant costing is often used in short-term decision making and a number of specific practical examples are illustrated later in this chapter. A typical decision could involve, a venue has been hired for a commercial event to take place in two weeks' time, unfortunately ticket sales have been very slow and it looks as though the event will be run at a loss. The manager of the events company needs to make

the decision: 'Should the event be cancelled or not?' from a financial perspective he would need to look at the 'relevant' costs to see which costs would be 'relevant' to his decision (Table 5.1). What would these be?

**Table 5.1:** Example relevant costs for an event

Venue hirer costs	Irrelevant – already paid in full, with a 100% charge if cancelled
Printing tickets	Irrelevant – tickets already printed and cannot be reused
Performing artists' fees	Irrelevant – already paid in full, with a 100% charge if cancelled
Permanent event company staff salaries	Irrelevant – they have to be paid even if the event doesn't run
Casual staff employed for the event	Relevant – if the event is cancelled these won't have to be paid
Food and beverage material costs	Relevant – the food hasn't been ordered as yet, if the event is cancelled there are no F&B costs
Merchandising costs	Irrelevant – programmes and tee shirts already printed
Event publicity costs, flyers and posters	Irrelevant – already printed and distributed

For this specific decision the balance is:

- Decision A – the event goes ahead – if it does there is some income, but all the 'relevant' costs will be incurred.
- Decision B – the event is cancelled – in this situation the 'relevant' costs would not be incurred, but refunds would need to be issued (another cost) and there would be no income.

When using relevant costing in this example it is already accepted this event will not make a profit, the decision is about which option, running the event, or cancelling will make the least loss. It is a decision about mitigating losses. Irrelevant costs are still incurred by the events company, but the key point here is that they do not impact on the specific decision being made – whether it is decision A or B, all irrelevant costs will still be incurred, so they are ignored in relation to the specific decision.

## 5.3 Opportunity costs

These are decisions that are made where they are mutually exclusive alternatives. Imagine two potential customers (Jones and Smith) want to book your conference suite for a wedding at the same day and time. You only have the capacity to take one wedding on a specific day and both have confirmed dates that cannot be moved. From a financial perspective you would accept the booking that would give you the best financial return, maximises the contribution from the event, in this case accept the booking for Mr and Mrs Jones.

The opportunity cost is the value of the 'opportunity' lost for the next best alternative in making a specific decision. In this case the opportunity cost is the potential contribution from Mr and Mrs Smith's booking that has been lost

through taking Mr and Mrs Jones' booking. Opportunity costs need to be considered when making decisions, particularly where there is a 'scarce' resource (in this case physical space). Whether the 'scarce' resource is physical space/capacity, a raw material/ingredient, or staff availability it restricts a manager's ability in some way to meet all customer needs. In such situations managers have to make decisions about how best to use their scarce resources, and what they cannot do, will be an opportunity lost and therefore an opportunity cost.

## 5.4 Differences between short-term and long-term decisions

The obvious difference between short-term and long-term decision making is the timeframe involved. In reality they have different purposes in the organisation, but both are important to maximising returns for the organisation (see Table 5.2).

**Table 5.2**

Short-term decisions	Long-term decisions
Operational, tactical in nature, meeting short-term goals, or reacting to a crisis, i.e. making the best of resources in the short term	Strategic in nature, impact on corporate level objectives and goals i.e. making the best of resources in the long term
Each decision involves relatively small amounts of monetary value	Each decision can involve large sums of monetary value
Relatively easy to change decision, withdraw from activity if the business environment changes	Making wrong decisions can have a major financial impact on the firm

All decision making is concerned with making the best choices for the organisation, in financial decision making this is about the financial impact of the decisions made. Later chapters discuss the decision making process and the relationship to information needs in more detail, and Chapter 14 on capital investment appraisal focuses on the long-term decision-making process.

Decision making costs money; management time is a basic cost, but long-term decisions can be very expensive to make. Decisions with multimillion pounds being invested may take several months, feasibility studies, information costs, etc. In short-term decision making speed is of the essence, both to keep costs to a minimum and because delaying a decision (slow reaction) could have financial implications for the organisation.

## 5.5 Types of short-term decisions

Short-term decisions could include whether to resolve staff shortages by using agency staff, to make something in-house or buy it in, to offer special packages/reduce prices to boost short-term sales or to accept a booking/one-off contract.