

Differential Analysis: The Key to Decision Making

Managers must decide what products to sell, whether to make or buy component parts, what prices to charge, what channels of distribution to use, whether to accept special orders at special prices, and so forth

Every decision involves choosing from among at least two alternative—the costs and benefits of one alternative must be compared to the costs and benefits of other alternatives

Differential Cost: a difference in cost between any two alternatives

Differential Revenue: a difference in revenue between any two alternatives

- ❖ *Often referred to as “relevant costs” and “relevant benefits” because differential costs and revenues are the only inputs that are relevant to decision making*

COST CONCEPTS FOR DECISION MAKING

Only those costs that differ in total between alternatives are relevant in a decision

Avoidable Cost: a cost that can be eliminated by choosing one alternative over another

- ❖ *Avoidable costs are relevant and unavoidable costs are irrelevant*

Sunk Cost: a cost that has already been incurred and CANNOT be avoided regardless of what a manager decides to do—they are irrelevant and should be ignored when making decisions

Opportunity Cost: the potential benefit that is given up when one alternative is selected over another

THE MAKE OR BUY DECISION

Vertically Integrated: when a company is involved in more than one activity in the entire value chain

Make or Buy Decision: a decision to carry out one of the activities in the value chain internally, rather than to buy externally from a supplier

SPECIAL ORDERS

Special Orders: a one-time order that is not considered part of the company's normal ongoing business

UTILIZATION OF A CONSTRAINED RESOURCE

Constraint: anything that prevents you from getting more of what you want

Bottleneck: a machine or some other part of a process that limits the total output of the entire system

- ❖ *The constraint or bottleneck in the system is determined by the step that limits total output because it has the smallest capacity*
- ❖ *If some products must be cut back because of a constrain the key is to favor the products that provide the highest contribution margin per unit of the constrained resource*

MANAGING CONSTRAINTS

Effectively managing an organization's constraints is a key to increased profits—when a constraint exists in the production process, managers can increase profits by producing the products with the highest contribution margin per unit of the constrained resource; they can also increase profits by increasing the capacity of the bottleneck

Relaxing the Constraint: when a manager increases the capacity of the bottleneck

JOINT PRODUCT COSTS AND THE CONTRIBUTION APPROACH

Joint Products: two or more products that are produced from a common input

The Split-off Point: the point in manufacturing process at which the joint products can be recognized as separate products

Joint Cost: the costs incurred up to the split-off point—common costs that are incurred to simultaneously produce a variety of end products; they are often allocated among the different products at the split-off point