Relevant Costing & Short-Term Decisions Cheat Sheet

Differential Analysis, Sunk Costs, Opportunity Costs & 4 Classic Managerial Decisions

1. RELEVANT VS. IRRELEVANT COST IDENTIFICATION CRITERIA

Cost Classification	Evaluation Test & Characteristics	Accounting Treatment in Decision Models
Relevant Costs (Differential / Incremental)	Must satisfy TWO conditions: (1) It occurs in the **future**, AND (2) It **differs** among competing alternatives.	**INCLUDE** in decision model (e.g., direct materials saved by outsourcing, extra direct labor).
Sunk Costs	Costs that have already been incurred and cannot be altered by any present or future decision.	**ALWAYS IGNORE** (e.g., historical cost or book value of existing equipment, past R&D).
Opportunity Costs	The potential economic benefit foregone by choosing one course of action over an alternative.	**INCLUDE** as a cost of the selected alternative (e.g., rental income lost from repurposed space).
Allocated Common Fixed Costs	General overhead (executive salaries, factory insurance) that continues whether a segment exists or not.	**IRRELEVANT** unless specifically avoidable upon dropping the segment.

2. THE 4 CLASSIC SHORT-TERM MANAGERIAL DECISION RULES

Decision Scenario	Key Decision Rule & Formula	Pitfalls to Avoid
1. Special Order (One-time order at discount)	**Accept if: Incremental Revenue > Incremental Variable Costs + Specific Fixed Costs** (assuming idle capacity).	Do not allocate existing fixed overhead to special order pricing. Check impact on regular customers.
2. Make or Buy (Outsourcing parts)	**Buy if: Purchase Price < Avoidable Production Costs + Opportunity Cost of Idle Space**.	Unavoidable allocated fixed overhead continues regardless of whether part is made or bought.
3. Keep or Drop Segment (Unprofitable product line)	**Drop if: Segment Contribution Margin < Avoidable Fixed Costs**. (If CM > Avoidable FC, keep segment!)	Looking at net loss after allocating common fixed costs causes managers to drop profitable lines.
4. Constrained Resource (Bottleneck machine hours)	**Produce product with HIGHEST Contribution Margin per Unit of Constrained Resource ($/Hour)**.	Ranking by absolute CM per unit gives suboptimal profit when machine capacity is limited.