CHAPTER LEARNING OBJECTIVES:
MAJOR:
- Distinguish between relevant and irrelevant costs.
- Use relevant information to determine the following:
  - Retain or drop a product, product line or segment.
  - Make or buy needed assets.
  - Accept or reject a special order.
  - Best utilization of scarce resources.
  - Sell or process further.

Sunk Cost - a cost that has already been incurred, or committed to, and can’t be changed by any “ethical”
decision made now or in the future. These are not limited by other cost terminology; these could be
variable or fixed, period or product, direct or indirect, etc. Cost of old equipment and any allocated cost
there from, for example, depreciation, is always a sunk cost. Any commitment for future payments under
a contract or other agreement is also sunk, in regards to not being able, ethically, to change that cost.

Relevant Cost or Revenue (a.k.a. avoidable, differential, incremental, changeable) - a cost or revenue
applicable to the particular decision being made. In effect, a cost or revenue that will be incurred or
avoided by that particular decision. Remember, the term Common Cost, also known as Allocated Cost,
refers to a cost which is incurred because of two or more cost objects and will not be eliminated because
of the removal of only one of those cost objects. Therefore, a common cost, or allocated cost, is usually
irrelevant to a decision.

Basic steps in managers approach to decision making:
1. Assemble all cost data.
2. Eliminate all sunk costs.
3. Eliminate all irrelevant costs/revenues (those which will not be different between alternatives
   being considered.)
4. Make decision based upon remaining information (which is the relevant information.)

Adding or Dropping a Product, Product Line, or Segment is usually a matter of determining the sum
(net) of the following:
- Increase or decrease in contribution margin.
- Increase or decrease in fixed costs.
- Opportunity costs, if any.

Producing a new segment margin income statement will also give you the same answer in regards
to yes or no, but would not result in the same numerical answer. Remember, an incremental versus total
approach should give you the same overall answer of yes or no, but not the same numbers, as one is
Incremental and the other is Total.

Make or Buy decisions not only include quantitative factors (as stressed in this chapter) and should
always include qualitative factors (not stressed in this course.) A quantitative approach is one of finding
the least expensive cost based upon the number of units needed/to be produced. Therefore, the number
of units needed/produced is factored-in to determine the Fixed Overhead Costs to be charged to each
unit.

Accept a Special Order can be quantitatively decided by comparing the proposed sales price (in total or
on a per unit basis) to the out of pocket costs (in total or on a per unit basis) of producing and selling that
special order. For example, direct materials and direct labor would be incurred to produce a product but
no additional fixed overhead would normally be incurred.
Utilization of Scarce Resources is easily determined by finding the contribution margin per that scarce resource for each possible use. The best use of the scarce resource is that use which maximizes the contribution margin per scarce resource. Examples of scarce resources are advertising dollars, floor space, labor hours, machine hours, and time.

The mathematical approach is:
- Calculate the contribution margin for one unit and divide by the amount of scarce resource needed to produce that unit. Do this same calculation for all possible uses of the scarce resource; then compare all possible uses of the scarce resource. The one that results in the largest UCM per scarce resource is the best possible use of that scarce resource.

Sell or Process Further is determined by a comparison of the additional revenue from processing further (new sales price minus old sales price) and subtracting the additional cost of processing (new total cost minus old total cost) and if positive process further, if negative don’t process further. Remember, all prior costs incurred to the point of the question are Sunk Costs!