Incremental Analysis: Definition, Types, Importance, and Example

Caroline Banton, November 29, 2020

From:https://www.investopedia.com/terms/i/incremental-analysis.asp

What Is Incremental Analysis?

Incremental analysis is a decision-making technique used in business to determine the true cost difference between alternatives. Also called the relevant cost approach, marginal analysis, or differential analysis, incremental analysis disregards any sunk cost or past cost. Incremental analysis is useful for business strategy including the decision to self-produce or outsource a function.

Incremental Analysis Explained

Incremental analysis is a problem-solving approach that applies accounting information to decision making. Incremental analysis can identify the potential outcomes of one alternative compared to another.

Relevant Versus Non-Relevant Costs

Analysis models include only relevant costs, and these costs are typically broken into variable costs and fixed costs. Incremental analysis considers opportunity costs—the missed opportunity when choosing one alternative over another—to make sure the company pursues the most favorable option.

Non-relevant sunk costs are expenses already incurred. Because the sunk costs will remain regardless of any decision, these expenses are not included in incremental analysis. Relevant costs are also called incremental costs because they are only incurred when an activity of relevance has been increased or initiated.

Types of Incremental Analysis Decisions

Incremental analysis helps companies decide whether or not to accept a special order. This special order is typically lower than its normal selling price. Incremental analysis also assists with allocating limited resources to several product lines to ensure a scarce asset is used to maximum benefit.

Decisions on whether to produce or buy goods, scrap a project, or rebuild an asset call for incremental analysis on the opportunity costs. Incremental also analysis provides insight into whether a good should continue to be produced or sold at a certain point in the manufacturing process.

Companies use incremental analysis to decide whether to accept additional business, make or buy products, sell or process products further, eliminate a product or service, and decide how to allocate resources.

Example of Incremental Analysis

As an example of incremental analysis, assume a company sells an item for $300. The company pays $125 for labor, $50 for materials, and $25 for variable overhead selling expenses.

The company also allocates $50 per item for fixed overhead costs. The company is not operating at capacity and will not be required to invest in equipment or overtime to accept a special order it receives. Then, a special order requests the purchase of 15 items for $225 each.

KEY TAKEAWAYS

- Incremental analysis helps to determine the cost implications of two alternatives.
- It is also known as the relevant cost approach, marginal analysis, or differential analysis.
- Non-relevant sunk costs, or past costs, are not included in the analysis.
- Incremental analysis also assists with allocating limited resources to product lines to ensure a scarce asset is used to maximum benefit.

The sum of all variable costs and fixed costs per item is $250. However, the $50 of allocated fixed overhead costs are a sunk cost and are already spent. The company has excess capacity and should only consider the relevant costs. Therefore, the cost to produce the special order is $200 per item ($125 + $50 + $25) and the profit per item is $25 ($225 - $200).

While the company is still able to make a profit on this special order, the company must consider the ramifications of operating at full capacity. If no excess capacity is present, additional expenses to consider include investment in new fixed assets, overtime labor costs, and the opportunity cost of lost sales.

Incremental analysis only focuses on the differences between two courses of action. These different aspects—not similarities—form the basis of the comparison.