

Chapter 10

Special orders

Occasionally, businesses may receive orders for their products that differ in terms of the profile of their regular orders. This difference is often based on price paid, the quantity ordered or the lead time. These special orders can be one-off or they could be a new buyer establishing a relationship with the supplier. The decision to accept a special order depends upon the potential immediate and future quantitative and qualitative benefits that result from the order.

A special order can involve:

- Selling the same product lower than the normal sales price
- Selling a modified product at a higher price.

The first stage in examining the value and impact of a special order is to use a quantitative measure, the contribution (which is the difference between revenue per unit and variable cost per unit). This difference is known as contribution because it is the amount each item sold contributes toward paying the other costs of the business i.e. the fixed costs or to profits when fixed costs are already covered.

If a shop owner buys a tin of beans for 26p and sells it for 40p the contribution of that tin of beans is $40p - 26p = 14p$. This 14p is left over to help pay for the fixed costs such as rent, rates etc. Once fixed costs are covered (paid) then any additional contribution is profit.

Total contribution

Total contribution is contribution per item \times number of items sold

So if a clothing business receives an order for 10 000 shirts at £7.00 per shirt and variable costs per shirt are £3.00 then the total contribution is found by:

$£7.00 - £3.00 = £4$ per unit contribution. $£4 \times 10\,000 = £40\,000$ total contribution

Worked Example

R and J Ltd. is a manufacturer of headboards for beds. The business produces 3 000 headboards per month, which are sold to independent retailers for £50, who then sell these on to customers for £90.

R and J Ltd achieve revenue of £150 000 per month ($3\,000 \times £50$).

The costs include fixed costs of £70 000 per week and variable costs of £20 per headboard ($3\,000 \times £20$).

Taking all this information into account, a profit of £20 000 is achieved.

	£
Revenue	150 000
Fixed costs	70 000
Variable costs	60 000
Total costs	130 000
Profit	20 000

The business has the capacity to produce 4 000 headboards a month, but demand from its current customers is just 3 000. Therefore, a spare capacity of 1 000 headboards per month exists.

The business is now approached by a large retailer with an order for 1 000 headboards. The large retailer offers £35 per headboard, with the intention of retailing for £60.

Should R and J Ltd. accept the special order for 1 000 based on the lower offer made?

The new contribution per headboard would be £35 - £20 (variable cost) x 1 000 (the number ordered), so additional total contribution of £15 000.

This means for the month of the order; monthly profits would increase to £35 000 (£20 000 + £15 000). Therefore, on purely financial terms, the special order should be accepted because of the positive contribution and the subsequent increase in profits.

	£
Original revenue	150 000
Special order revenue	35 000
Total revenue	185 000
Fixed costs	70 000
Variable costs	
(3 000 x £20)	60 000
(1 000 x £20)	20 000
Total variable costs	80 000
Total costs	150 000
Profit	35 000

However, there are a number of other factors that have to be considered before accepting a special order; these will include qualitative (non-financial) factors:

- **Capacity** – has the business the spare capacity or is this the best way to utilise the spare capacity?
- **Labour demands** – would the special order be completed in normal hours or would extra hours have to be paid to workers?
- **Future orders** – could the special order lead to a more regular order?
- **Existing customers** – will the special order upset existing customer who pay a higher price?
- **Product adjustment** – would the special order require a product slightly different to the regular product?

This could involve changing the production process, using different materials and training workers.

Possible positives of accepting order	Possible negatives of accepting order
Further orders may follow. Some businesses will accept an unprofitable special order if there is a possibility that it will result in a profitable regular and long term order.	Working at near or at full capacity can put pressure on quality. If the business is already operating at full capacity how can it cope with existing customers in addition to the special order?
Spare capacity is used, increasing return on capital invested.	What if existing customers discover the discounted price offered to the new customer? Will they demand the same? They may become resentful and could look for a new supplier.
The new order may give access to new markets and new opportunities e.g. is it from overseas leading to new export markets or is it in a different market?	Will the new customer demand even lower prices in the future and will there be a requirement to prioritise the new order over existing customers? This could have an adverse effect on loyal and long term customers.
Increasing production can have HRM benefits, such as increased wages for workers and payment of bonuses.	The new customer may undercut existing customers when selling the finished product. This could impact on their sales, which could then impact on future orders.
Also it can be useful to keep workers busy if the normal orders are not sufficient due to poor economic conditions. Special orders can help keep workers in their jobs.	

Discussion themes

What is meant by special orders?

How is contribution used to help the decision to accept a special order?

Special orders with negative contribution should never be accepted by businesses. Discuss this statement.

What non-financial factors should be considered before accepting a special order?