# UNIT 3: BUSINESS ANALYSIS AND STRATEGY

## Special Orders

### Special Order Costing

Sometimes businesses receive orders which are unexpected, from a new customer or for a new product perhaps. On these occasions a business must decide whether to accept the order. The business will consider whether the order is profitable, however, even if the order is not profitable it may still be accepted. This may be because the business is considering the size of the **CONTRIBUTION** when making the decision to accept the order.

**Example:**

A business makes High Powered Speed Boats. Firstly we must work out what their profits normally are.

| Production: | 120 boats last year |
|---|---|
| Fixed Costs: | £500,000 |
| Variable Costs: | £18,000 |
| Price of the Boats: | £23,000 |

So what's its profit?

- TR = £23,000 * 120 = £2,760,000
- TC = £500,000 + (£18,000 * 120) = £2,660,000
- P = £2,760,000 - £2,660,000 = £100,000

**But what if...** they have received an order from a new business for 10 boats, and the customer was only willing to pay £19,000 each? Should the business accept the order?

**Think contribution!**

- Generated Revenue = £19,000 * 10 = £190,000
- Cost of producing the boats (variable) = £18,000 * 10 = £180,000
- Profit = £190,000 - £180,000 = £10,000

The business is likely to accept the order as it gives a positive contribution which can go towards paying the full costs of the business.

### Accepting Special Orders

Before going ahead with such special orders, **QUALITATIVE FACTORS** (non-financial factors) would also need to be carefully considered:

- **Capacity** – does the business have the space and resources to accommodate the new order 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 employees?
- **Future orders** – will completing this special order lead to future orders for the company from the customers?
- **Existing customers** – how will existing customers react if they find out that the new customer got the same product for cheaper?
- **Product adjustment** – would the special order require a product slightly different to the regular product?
- **Current utilisation** – an unprofitable order may be accepted to keep employees occupied.
- **Retaining customer loyalty** – a business may accept an unprofitable order from a regular customer as a favour to retain their loyalty.

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

### Should the Business Accept the Order?

**Reasons to accept the 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.
- Spare capacity is used, increasing return on capital invested.
- 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?
- Increasing production can have HRM benefits, such as increased wages for employees and payment of bonuses.
- Also, it can be useful to keep employees busy if the normal orders are not sufficient due to poor economic conditions. Special orders can help keep employees in their jobs.

**Arguments to decline the 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?
- 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.
- 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.
- 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.