

Chapter Four: Short-term Decision Making

Accept or Reject Special Order

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What is a Special Order?

Sometime, companies decide whether to accept or reject an order that is outside the scope of normal sales. Special order are often offered at a lower price than customers pay for the product. In addition, special order occur when companies have unused capacity.

- 1- sales price for special order is $<$ sales price of the product in markets
- 2- There is unused capacity

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Differential Analysis for special order decisions

A company should not make its decision on the basis the compare between sales price of special order and the total cost of the product. A Company should compare between sales price of special order and relevant cost of that order.

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When should a special order be accepted?

- 1- Acceptance a special order should not affect normal sales of the product in markets.**
- 2- A special order can be manufactured without increasing company capacity.**
- 3- sales price of a special order should be more than relevant cost of special order.**

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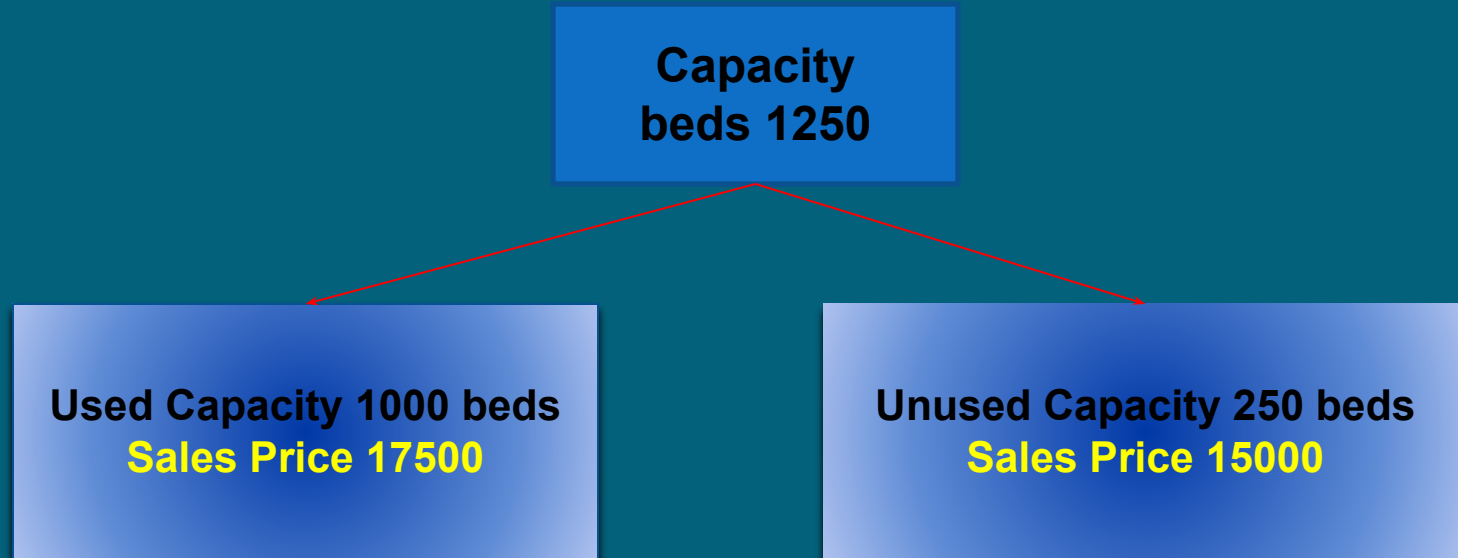
Example 1: Al-Salam company manufactures beds. The company has a capacity of 1250 beds, but the company manufactures 1000 beds which are sold through retailers at IQD 17500 per bed. The estimated cost for the bed are:

| | |
|-------|------------------------|
| 8000 | Raw material |
| 2000 | Direct labor |
| 2500 | Variable overhead |
| 1600 | Fixed overhead |
| 900 | Sales commission |
| 15000 | Total cost for the bed |

The company receives an order from a hotel to purchase 250 beds at IQD 15000 per bed. In addition, the hotel management request some modifications on design of the bed, which are estimated at IQD 1000 for each bed. Furthermore, the special order does not required any sales commission.

Required: Does Al-Salam company accept or reject the hotel order?

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Special Order

- 1- there is unused capacity
- 2- sales price of order (15000) < sales price of the product in markets (17500)
- 3- 2-sales price of order (15000) < total cost of the product 16000 (15000+1000)

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| Differential Analysis | Reject Order | Accept Order | Details |
|-----------------------|--------------|--------------|--------------------|
| 3750000 | 17500000 | 21250000 | Sales Revenue |
| 2000000 | 800000 | 10000000 | - Raw material |
| 500000 | 2000000 | 2500000 | - Direct Labor |
| 625000 | 2500000 | 3125000 | -Variable Overhead |
| 0 | 1600000 | 1600000 | - Fixed Overhead |
| 0 | 900000 | 900000 | - Sales Commission |
| 250000 | 0 | 250000 | |
| 375000 | 2500000 | 2875000 | = Net Income |

Decision is to accept the special order because it leads to net profit of IQD 375000

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Other Way

| Differential analysis for Special order decision | | |
|---|---|--|
| 15000 | | |
| | 8000 | Raw Material |
| | 2000 | Direct Labor |
| | 2500 | Variable Overhead |
| | 1000 | Cost of design Modification |
| 13500 | | Relevant Cost for each bed of special order |
| 1500 | Net Profit for each bed of special order | |

Decision: the company should accept special order because the sales price of special order (15000) would exceed the relevant cost of special order (13500) by 1500 per bed. Therefore, the company will increase its profit by 375000 (250 beds x 1500) through accepting this special order.

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Notes:

1- Direct material, direct labor, variable overhead are relevant cost because these cost will be incurred if the special order is accepted and they will not be incurred if the special order is not accepted. In contrast, fixed overhead are irrelevant cost because these cost will be incurred whether or not the special order is accepted.

2- sales commission is relevant cost and it is avoidable cost if the company accept the special order because the order does not require to pay any sales commission.

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Example 2: same information in example 1 and assume that the company can rent the unused capacity at IQD 2500 for each bed

Required: Does the company accept or reject the order that is received from the hotel?

| 15000 | | Sales price |
|--------|------|---|
| | 8000 | - Direct Material |
| | 2000 | -Direct Labor |
| | 2500 | - Variable Overhead |
| | 1000 | - Cost of design Modification |
| | 2500 | - Opportunity Cost |
| 16000 | | Relevant Cost for each bed of special order |
| (1000) | | Net Profit (Loss) |

Decision is to reject the special order