DECISION-MAKING, INTERNATIONAL CUSTOMERS AND NON-FINANCIAL FACTORS

Southampton plc

Introduction

Southampton plc has been negotiating a contract with a potential customer in Austria. Before the negotiations started the Austrian company agreed to pay £10,000 in advance to cover the expenses of Southampton. These expenses were to cover the costs of sending out technical staff to Austria. This is the first export order the company has received since 1988. Unfortunately the previous export orders were not profitable and managers decided the best strategy was to concentrate on business in the UK.

The sales department has prepared the following statement showing that the contract will make a profit. It is normal for the sales department to prepare cost estimates as they have a lot of experience of this type of work.

Occasionally the management accountant will also be asked to comment on the estimates prepared by the sales department. As this order is different and may lead to a lot more business in the future the senior managers asked the management accountant to comment on the statement below.

Statement prepared by sales department

	£
Sales - including deposit of £20,000 (see note1)	250,000
Labour (see note 2)	85,000
Supervisor (see note 3)	15,000
Design overheads (see note 4)	2,000
Administrative charge (see note 5)	25,000
Materials (see note 6)	110,000
Depreciation on machinery (see note 7)	5,000
Profit	£8,000

After her investigation the management accountant prepared a brief report. The main points are summarised below.

Comments from management accountant

Note 1 The deposit will not have to be refunded

Note 2 The labour costs includes £15,000 of costs for work that has already been incurred. This is the cost of sending engineers to Poland to help with the negotiations.

Note 3 This is 50% of the cost of a supervisor. It is estimated that the supervisor will spend about half his time on the contract. This cost does not include a £2,000 bonus for the supervisor if the contract is completed on time.

Note 4 These costs have already been incurred.

Note 5	This charge is equal to 10% of sales. This is levied on all contracts to cover general administrative costs.
Note 6	Materials 40,000kg of material X at £1.5 per kg = £60,000 20,000kg of material Y at £2.50 per kg = £50,000 Material X is used regularly by the company. There is 20,000kg in stock but the market price has just increased to £2 per kg. Material Y is never used by the company. There is 30,000kg in stock that cost £2.50 per kg. To buy it today would cost £4 per kg. An alternative choice for the company is to sell it for scrap at £2.10 per kg.
Note 7	Depreciation has been calculated at £5,000. However the management accountant discovers that this charge is for a machine that is currently not used. The management accountant has received an offer of £100,000 for the machine now but if the project goes ahead it will only be sold for £50,000 at the end of the project.

Additional information

The statement above does not include the cost of additional training if the contract goes ahead. The cost of the training has been estimated at £10,000.

Question 1

Advise managers whether or not this contract is profitable. All assumptions must be clearly stated.

Question 2

Identify and evaluate any additional information that managers need to consider before accepting or rejecting this contract.

Reference:

McGraw-Hill Higher Education
http://highered.mcgraw-hill.com/sites/0077098595/student_view0/case_studies.html