

Learning Note 9.1: Determining the relevant costs for direct labour

In Example LN9.1 the relevant labour cost is £19 per hour, consisting of the hourly wage rate of £10 plus the lost contribution of £9 per hour from component P (the contribution of component P is £36, and requires 4 direct labour hours, resulting in a contribution of £9 per hour). Hence the relevant costs for the special order are as follows:

	(£)
Variable cost (excluding direct labour)	8 000
Direct labour (1000 hours at £19 per hour)	<u>19 000</u>
	<u>27 000</u>

A selling price of £27 000 takes into account the lost contribution from component P and represents the minimum selling price that the company should accept if it wishes to ensure that future cash flows will remain unchanged. The acceptance of the special order means that production of component P must be reduced by 250 units (1000 hours/4 hours per unit). We can now check that the relevant cost calculation is correct by comparing the contribution from the special order with the contribution that would have been obtained from component P:

	Component P (250 units) (£)	Special order (£)
Sales (250 units at £88 per unit)	22 000	27 000
Less: direct labour (250 units at £40 per unit)	(10 000)	(10 000)
variable costs (250 units at £12 per unit)	<u>(3 000)</u>	<u>(8 000)</u>
Contribution to profits	<u>9 000</u>	<u>9 000</u>

This statement shows that the contribution to profits will be unchanged if the selling price of the special order is equivalent to the relevant cost of the order.

You may have noted that the hourly labour cost will continue whichever alternative is accepted, and you may therefore be concerned that the relevant cost consists of the hourly labour cost plus the lost contribution per hour. The reason for including the hourly labour cost is because a decision to create labour hours by reducing production of other work will result in a loss of sales and incremental/variable costs (excluding labour). That is, there will be a loss of contribution from component P of £76 (£88 selling price less £12 variable costs) before charging the labour costs giving a lost contribution of £19 per labour hour (£76/4 hours) in Example LN9.1. This is just another way of saying that the relevant labour cost is the hourly wage rate of £10 plus the lost contribution per hour of £9.

EXAMPLE LN9.1

A division of Rhine Autos has received an enquiry from one of its major customers for a special order for a component that will require 1000 skilled labour hours and that will incur other variable costs of £8000. Skilled labour is currently in short supply and if the company accepts the order then it will be necessary to reduce production of component P. Details of the cost per unit and the selling price of component P are as follows:

	(£)	(£)
Selling price		88
Less: Direct labour (4 hours at £10 per hour)	40	
Other variable costs	<u>12</u>	<u>52</u>
Contribution to profits		<u>36</u>

What is the minimum selling price the company should accept for the special order?