# BESPLATNI GOTOVI SEMINARSKI, DIPLOMSKI I MATURSKI RAD.

**RADOVI IZ SVIH OBLASTI, POWERPOINT PREZENTACIJE I DRUGI EDUKATIVNI MATERIJALI.**

## WWW.SEMINARSKIRAD.ORG

## WWW.MATURSKIRADOVI.NET

## WWW.MATURSKI.NET

## WWW.SEMINARSKIRAD.INFO

## WWW.MATURSKI.ORG

## WWW.ESSAYSX.COM

## WWW.FACEBOOK.COM/DIPLOMSKIRADOVI

NA NAŠIM SAJTOVIMA MOŽETE PRONAĆI SVE, BILO DA JE TO SEMINARSKI, DIPLOMSKI ILI MATURSKI RAD, POWERPOINT PREZENTACIJA I DRUGI EDUKATIVNI MATERIJAL. ZA RAZLIKU OD OSTALIH MI VAM PRUŽAMO DA POGLEDATE SVAKI RAD, NjEGOV SADRŽAJ I PRVE TRI STRANE TAKO DA MOŽETE TAČNO DA ODABERETE ONO ŠTO VAM U POTPUNOSTI ODGOVARA. U BAZI SE NALAZE GOTOVI SEMINARSKI, DIPLOMSKI I MATURSKI RADOVI KOJE MOŽETE SKINUTI I UZ NJIHOVU POMOĆ NAPRAVITI JEDINSTVEN I UNIKATAN RAD. AKO U BAZI NE NAĐETE RAD KOJI VAM JE POTREBAN, U SVAKOM MOMENTU MOŽETE NARUČITI DA VAM SE IZRADI NOVI, UNIKATAN SEMINARSKI ILI NEKI DRUGI RAD RAD NA LINKU IZRADA RADOVA. PITANjA I ODGOVORE MOŽETE DOBITI NA NAŠEM FORUMU ILI NA MATURSKIRADOVI.NET@GMAIL.COM

CHAPTER 10

# The Optimal Price

## The Purpose of This Chapter

After reading this chapter, you should be able to:

- Explain how purchase prices influence buyers.
- Describe how suppliers determine their purchase prices.
- Identify methods buyers employ to reduce purchase prices.
- Calculate cost information, including edible portion cost, servable portion cost, and standard cost.
- Evaluate the advantage of an opportunity buy.

"Buying a cheap article to save money is like stopping the clock to save time."

*—Jacob M. Braude's Complete Speaker's and Toastmaster's Library*

"Some people know the price of everything, but the value of nothing."

*—Anonymous*

## INTRODUCTION

The optimal price is the price that, when combined with the optimal quality and supplier services, produces the optimal value. The optimal price represents the lowest possible edible-portion (EP) cost consistent with the optimal value of a product, service, furnishing, or piece of equipment. Remember, the best EP cost may or may not be the lowest as-purchased (AP) price. When a buyer struggles to assess the optimal AP price, therefore, he or she must be able to translate a quoted AP price into the hospitality organization's relevant EP cost. The buyer could quickly make this conversion by using the following formula:

**EP cost = AP price/edible- (or servable-, or usable-) yield percentage**

For example, if a roast beef has an AP price of $2.45 per pound and an edible-yield percentage of 75 percent, the EP cost per pound is $3.27 ($2.45/0.75 = $3.27).

After computing the EP cost, the buyer must then relate it to product quality and supplier services and conclude with the optimal value (see Figure 10.1). The buyer cannot evaluate AP price without concomitantly evaluating EP cost, product quality, and supplier services. The buyer must examine all of these components simultaneously and must seek the optimal value. We now show how the optimal price or, more appropriately, the optimal EP cost, relates to this overall value.

## HOW AP PRICES INFLUENCE BUYERS

The AP price can influence buyers in many ways. At one extreme are the buyers who shop entirely on the basis of AP price. This practice succeeds only when the buyers know exactly what they want in terms of quality and supplier services and can get two

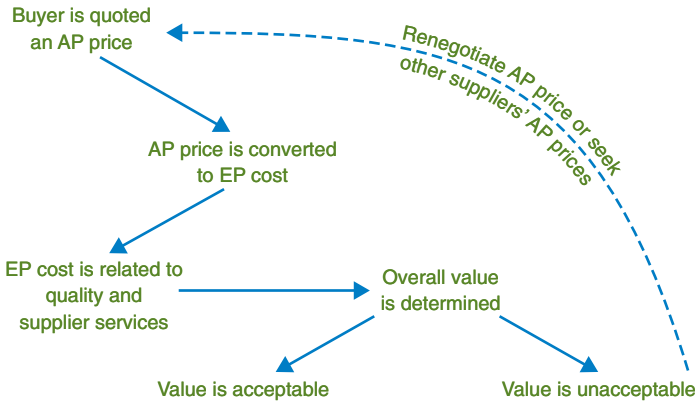


**FIGURE 10.1** The conceptual process a buyer can use to relate AP price to value.

or more relatively similar suppliers to quote AP prices that permit adequate comparisons. At the other extreme are buyers concerned almost exclusively with quality and supplier services. These buyers do not hesitate to pay a premium AP price. The majority of buyers fall somewhere between these extremes—or, more realistically, some buyers may be close to one extreme for some products and close to the other extreme for other products.

The supplier, in turn, must obtain some measure of a buyer's reaction to AP prices. In Chapter 12, we elaborate on "buyer profiles," which are sometimes referred to as "buyer fact sheets." These are diaries in which suppliers and salespersons record information on buyers' purchasing habits, as well as, invariably, reactions to AP prices.

Eventually, suppliers and salespersons can accurately gauge the influence AP prices have on various buyers. However, suppliers and salespersons use certain predictable reactions to AP prices to their advantage when selling the products and services to buyers for the first time. Some of the ways that buyers' and sellers' attitudes affect the purchasing process are discussed in the following paragraphs.

- For the most part, novice buyers, and particularly novice managers, overrate AP prices. The AP price is, after all, a number, something that can be compared and measured. Inexperienced shoppers are more apt to grasp a number until they gain sufficient practice in relating AP prices to EP costs, quality, and supplier services. Top management is usually aware of the tendency to focus on numbers, which probably explains why buyers are expected to have previous experience in other areas of the hospitality firm. This previous experience generally helps buyers relate AP prices to overall value.

- Price usually follows quality; a higher quality is normally accompanied by a higher price. To some extent, most buyers accept this reasoning. Unfortunately, at a certain point, the AP price keeps rising, but the quality fails to keep pace. Exactly when this difference between rising price and declining value occurs is not always clear, and inexperienced buyers and managers are liable to guess wrong. Even experienced purchasing personnel can be confused, especially if the products or services in question have just been introduced into the marketplace. Thus, suppliers and salespersons pushing a new item expect the AP price to receive more attention because no matter how much experience buyers have, they will have had little familiarity with new items.

  Price also may not necessarily correlate with quality if, for example, it is due primarily to the exemplary supplier services a particular supplier offers. Nor will there be a significant relationship between price and quality if a supplier encounters considerable difficulty attaining an item and, therefore, must extract a higher price to compensate for this problem.

- Generally, suppliers work under the assumption that what they sell to a hospitality firm is heavily influenced by a "derived demand." A buyer's demand for any particular item is derived from the ultimate customer's demand on the buyer's hospitality operation. As a result, an analysis by suppliers of their customers' customers can be enlightening. For example, price-conscious hospitality customers are a signal to the supplier that the buyer might be price conscious. Suppliers, then, would expect a budget-motel buyer to be price conscious and would tailor their sales presentations and offerings accordingly.

- Sometimes, price is secondary. Suppliers sense this whenever an analysis of the buyer's customers shows that the ultimate consumers are not price conscious. Salespersons react by emphasizing other factors. Prices may also be relatively unimportant to buyers when the suppliers are the exclusive distributors for one or more items. Furthermore, if suppliers feel that a buyer is in dire need of something, they may expect a corresponding decrease in concern about the AP price.

- A buyer who seeks an itemized bill is almost certainly price conscious. By "itemized," we mean a bill that notes separate charges for the item, for delivery, and for various other supplier services. In most cases, suppliers total all these charges and note only one AP price per item. But suppliers regard a buyer who asks for an itemized statement as being one step away from an attempt to provide many of his or her own economic values and supplier services.

- If the products a buyer purchases represent a huge expense to the hospitality operation, chances are the buyer will be price conscious. Similarly, the AP prices of certain items are usually scrutinized more closely than others. Meat, for example, may receive disproportionate attention from a buyer.
- Some buyers operate on a tight materials budget. If so, they are liable to become more price conscious than usual as the budget period approaches the end of its cycle. Also, some hospitality firms operate on a tight overall budget, and hard times cause them to examine AP prices more thoroughly. During difficult periods, in fact, some operators begin to assess the profit potential of providing their own economic values, such as purchasing raw food ingredients instead of a preprepared menu entrée, thereby providing their own form of value in lieu of paying suppliers for it. Suppliers recognize this thought pattern, and many of them tailor their sales efforts to meet it.

## HOW AP PRICES ARE DETERMINED

Price determination seems to be one of the last managerial "arts." It is not entirely amenable to mathematical formulas; hunches and experience come into play. Suppliers, however, normally want to maintain some perceived differences among one another's items. As long as they can do this, you will continue to see varying AP prices for the same type of product, unless these prices are controlled, either directly or indirectly, by state or product association bylaws or by legislation. Theoretically, though, the resultant values should be acceptable to all concerned because of variations in supplier services.

In Chapter 4, we considered economic forces and their probable effects on the channels of distribution. We suggested two main effects: availability of products and services, and their relevant AP prices. Availability and AP prices usually go hand in hand as one factor, particularly for perishable food products and basic commodities. But additional price-setting procedures exist. Basically, suppliers use at least four general methods for determining AP prices. These approaches are discussed in the following sections.

### AP Prices as a Function of the Supplier's Cost

Suppliers add all their operating and nonoperating costs and attempt to allocate a certain portion of these costs to each product and service they sell. Then they add predetermined profit markups to these figures. The result is AP prices based on the suppliers' costs of doing business.

This approach is quite common, if only as a starting point in AP price determination. Hospitality operators, too, typically start setting their retail prices this way. For example, menu prices usually begin with the cost of food. To this cost, management may add labor and other variable costs. A markup to cover profit and overhead is the final touch to reach an initial retail price for the menu item.

In practice, of course, each item is not always approached as a separate case. Instead, the average cost of doing business is known in relationship to sales volume, and a standard profit markup percentage may be derived.

Some products in the channel of distribution include conventional profit markups, which are sometimes referred to as "rules." A rule is a numerical factor that suppliers use to set their AP prices. For example, in the fresh-tomato market, one might find a "rule of three," which tells the supplier to take his or her cost of tomatoes, multiply this amount by three, and use the resulting figure for the AP price.

A cost-based AP price is a useful starting point. The supplier begins by applying a certain profit markup to the cost of his or her products. Then the supplier looks at his or her customers to see if they can pay, or will pay, this AP price. If they cannot, or will not, the supplier may lower the AP price, add more supplier services to justify the price, or, most typically, refuse to carry the item. The restaurant operator works much the same way: he or she will be reluctant to offer a low-profit menu item unless, of course, it is traditional and customers expect it.

It is important to keep in mind that while profit margins vary depending on the type of product, the average supplier in our industry earns an overall after-tax profit of only about 1 to 3 percent.[1] In many cases, a supplier earns only a few pennies per unit sold.[2]

## AP Prices as a Function of Supply and Demand

Supply and demand have a great effect on perishable food prices and on commodity prices. Generally, the supply-and-demand force has its biggest impact at the beginning of the channel of distribution. Bread prices, for example, do not vary as much as flour prices. Similarly, flour prices do not vary as much as wheat prices.

To a certain extent, suppliers lower some AP prices to sell a slow-moving item. Hospitality operators do this when they offer certain menu specials or special rates during the off-season.

Most of us would not prefer to participate in a market that sets prices strictly on the basis of supply and demand. Consider, after all, the yearly financial uncertainties farmers and cattle ranchers face. But supply and demand will be extremely influential as long as buyers perceive no differences among competing suppliers' offerings. Wheat is wheat, and choice steak is choice steak.

Most sellers want to reduce the supply-and-demand effect; they consider it much too risky to carry several items other suppliers can duplicate exactly. The most common way to minimize the effect is to differentiate the products somehow. How can suppliers do this? Recall that quality is just one part of value. EP costs and supplier services are important too. Suppliers know this, and, as a result, most of them try to maintain profitable AP prices by manipulating supplier services. In other words, they make one or more attempts to differentiate the overall value, not just the AP price. This differentiation comes into play whenever suppliers use the following method of determining AP prices.

## AP Prices as a Function of Competitive Pressure

Suppliers operate in a reasonably competitive market, but they have different ways to turn various sorts of competitive pressures to their advantage. By differentiating a product's overall value, or by convincing buyers that a product's overall value is unique, suppliers can minimize competition.

In Chapter 4, we suggested that hospitality-related organizations operate in a market characterized by monopolistic competition. That is, price competition is a big factor simply because many of the products such organizations sell are so similar. But each firm has some type of monopoly. A steak served in a truck stop diner might be as good as or better than the same type of steak served in a gourmet restaurant. Yet the menu prices will be different because the supplier services—in this case, certainly, service style and physical surroundings—are different, so different in fact that the overall value of each product might be quite acceptable to consumers. For the most part, many people are willing to pay more for the same item served in a gourmet restaurant than in a diner because the different supplier services justify the higher price.

Suppliers seem more willing to operate under this third method of setting AP prices. It gives them an edge since they can claim that there is no substitute for the value they provide. Moreover, it allows them numerous combinations of quality, supplier services, and AP prices sure to confuse even the most tight-fisted, objective buyer. The crucial factor, then, would seem to be supplier services. Delivery schedules, sales courtesy, general reliability—all these factors, and more, work their way into a product's overall value.

## Buyer Pricing

Without a doubt, suppliers prefer this type of price determination. Unfortunately, the buyer who practices this procedure is almost certain to overpay.

Buyer pricing comes about in one of two ways. It will occur if a buyer does not have a detailed purchase or product specification; in this situation, the supplier "assists" the

buyer in developing the spec, which, of course, will tend to place the buyer in a precarious financial position. Buyer pricing also will rear its ugly head if a buyer consistently engages in "panic buying," that is, if he or she continually runs out of products and relies on suppliers to make emergency deliveries. These emergencies will most assuredly result in significantly higher AP prices. There may also be penalties charged for unscheduled deliveries.

## WAYS TO REDUCE AP PRICE SO THAT OVERALL VALUE IS INCREASED

A quick way to increase a product's value is to pay less for that product yet keep the same quality and supplier services. This is not only a quick method, but it also leads to dramatic results: the buyer's superiors can easily see and appreciate a lower AP price, whereas a bit more quality and supplier services do not make so deep an impression, at least not immediately. Buyers in large organizations are quick to note that their superiors notice a lowered AP price. Chances are they will be asked to explain how they obtained the lower AP price, which gives them an opportunity to publicize their excellent performance. Consequently, buyers continually seek a lower AP price to increase an item's overall value.

Nevertheless, buyers should be cautious when seeking a lower AP price. The most important consideration is how well the purchased item fulfills its intended use. If a buyer pays a slightly higher AP price, all that will be lost is money. But if an item performs poorly, a buyer will waste money and time and may create some long-run employee or customer relations problems.

When seeking a lower AP price, the buyer should emphasize increasing or maintaining overall value. At no time should a buyer accept a lower AP price if the overall value of a product or service is reduced disproportionately, unless this is done with management's approval. The buyer should also fix a value on the time it takes to find or negotiate a lower AP price.

A buyer can use several methods in an attempt to decrease an AP price. A thorough value analysis of all products and services purchased will reveal the most feasible ones. Theoretically, a buyer can use some or all of the methods discussed in the following sections of this chapter.

### Make-or-Buy Analysis

Buyers should periodically perform make-or-buy analyses, at least for more expensive purchases. For example, a hospitality operation might find that it can save a great deal

of money by cutting its own steaks instead of purchasing them precut. When performing these analyses, though, buyers must be absolutely certain to consider all relevant cost data because it is very easy to overestimate these types of cost savings.

## Provide Your Own Supplier Services and/or Economic Values

Several possible cost-cutting opportunities exist. As is true with make-or-buy analysis, buyers benefit from considering the many alternatives available. For example, buyers can save money by purchasing products from a no-frills wholesale club, where customers are expected to pay with cash, credit card, or debit card, and provide their own delivery.

Buyers may also be able to select and pay for only those supplier services or economic values they desire. For example, some suppliers may offer high-priority, regular, and low-priority delivery options, with payment according to the speed of delivery. Some suppliers may offer price concessions for online orders, which are more cost-effective than orders placed during personal sales visits or over the phone. Still other suppliers may allow buyers to earn what is sometimes referred to as a "forklift discount" if they unload their own deliveries instead of requiring the drivers to do the unloading.[3]

While these and other similar options may prove tempting, unfortunately, many hospitality operations have not fared well when pursuing such cost-reduction strategies. Earlier, we discussed the potential costs and benefits of buyers providing many of their own supplier services and economic values. The conclusion seems to be that many firms attempting to do this have achieved mixed results and, in many cases, do not save nearly as much as they anticipated or have actually lost money.

## Shop Around More Frequently

Buyers who shop around frequently usually practice a technique that is sometimes referred to as "line-item purchasing." This purchasing strategy is used to obtain competitive bids for several products from two or more suppliers. Buyers then select each individual product from the supplier who has given the lowest bid for it. For example, each supplier may bid on a total list of ten products. However, the only products an individual supplier will be able to sell will be the ones he or she has priced lower than those the competing bidders have priced.

Suppliers do not like buyers to "cherry pick" their bids in this manner. They prefer buyers who use a purchasing technique that is sometimes referred to as "bottom-line, firm-price purchasing." Using this buying procedure, buyers agree to purchase a group of products from the supplier who bids the lowest total price for the group. In this case,

the successful bidder comes away with the complete order, while the unsuccessful ones leave empty-handed.

Although it takes considerable time, money, and effort to shop around, the potential rewards may make this strategy very profitable. If buyers have the time to develop specs and seek bids and do not mind dealing with several potential suppliers, generally they will obtain lower AP prices. As always, though, it is not quite clear whether the lower AP prices translate into increased values.

## Lower the Quality Standard

Although it is possible to lower the quality one notch while lowering the AP price two notches, it is unlikely that this tactic will be successful. We have suggested elsewhere that buyers seldom have the authority to reduce the quality standard unilaterally. Management input is normally required. Also, a few suppliers are unwilling to stock a product line of more than two or three qualities, thereby minimizing the opportunity to purchase lower-quality items. Therefore, even if you decide to accept a lower quality, you may be unable to purchase it, though it is possible some suppliers might carry those qualities you desire.

Lowering the quality standard for all items purchased is unusual, but it is not uncommon to do this for a few items. Whenever you do this, though, you risk confusing or alienating your steady customers. A hospitality operation's image and reputation are very fragile and could easily be tarnished irreparably if quality standards are altered.

## Blanket Orders

A blanket order is a form of volume discount. It usually includes quite a few miscellaneous items, no one of which is particularly expensive. However, the sum of the large number of low-cost items included in the blanket order makes it worth the supplier's time and effort, and some AP price concessions may be granted.

The basic question with blanket orders seems to be whether you should try to order on an optimal-size basis or to order these items only a few times a year. In most cases, such as for personalized matchbooks, it would probably benefit you to place a large order once in a while because any optimal order size you might calculate would almost certainly be impractical. In fact, most buyers opt for a reasonably large par stock for these miscellaneous items and order up to par only once every three or four months.

When you place a blanket order for miscellaneous items, their AP prices may or may not decrease. Even without a reduction in AP prices, you can expect some savings if you use blanket orders because you significantly reduce your annual ordering costs while experiencing only a slight increase in annual storage costs.

## Improved Negotiations

It is possible to lower the AP price by adopting a strict negotiating posture. For many products, AP prices are pretty well set and are not normally subject to negotiation. But supplier services and economic values can be manipulated, which might result in a higher overall value. Also, it is sometimes possible to negotiate more favorable credit terms or payment schedules. Although this does not lower the AP price, it does increase overall value since you can delay paying your bills and can use that money elsewhere, if only for a little while.

AP prices are generally a little more flexible for long-term contracts and certain types of services. The AP price of a product purchased on a six-month contract basis is usually lower than the AP price for the same item purchased on a day-to-day basis. Also, strict AP prices do not always accompany such services as contract cleaning and consulting.

## Substitutions

Whenever AP prices become too onerous, or appear to be heading that way, management can take at least one of four actions: (1) pay the price and pass it on to the consumer, (2) lower the quality and/or reduce the supplier services and economic values provided to the hospitality operation's customers, (3) drop the item, or (4) stop offering the item but carry a substitute.

The fourth alternative is often used in the restaurant business and to some extent in the lodging industry. This strategy does not necessarily lower the AP price of any item, but it can lower the total cost of operating the business. Buyers and suppliers should be encouraged to offer substitute possibilities to management since they are the first to notice price trends, availability trends, and increased costs of preparation or service. They also are the first to evaluate new items on the market. Furthermore, in some situations, these substitute items save money.

The big disadvantage with substitutes is that not all firms can use them. For instance, a family restaurant can manipulate menu offerings quite easily, but a steak house finds this substitution road a little rougher. Nevertheless, substituting products is a useful alternative that hospitality organizations often employ effectively.

## Cash Discounts

A supplier may be willing to accept a lower AP price, provided he or she receives cash in advance, at the time of delivery, or shortly thereafter. This is particularly true if the supplier is cash-starved. This practice is referred to as a "cash discount."

The cash discount is a viable alternative only when the buyer has the authority to promise a quick payment and only when enough cash is available. In large firms, the

accounting department or financial officer decides the payment schedule (in small operations, it is the owner-manager's decision) unless, of course, suppliers have strict payment demands or buyers have the authority to negotiate payment schedules that do not require a quick cash outlay. The accounting department usually does this as a part of its own cash management program, and because it may be more efficient to pay bills on a periodic basis. In addition, companies rarely have large amounts of cash available on a moment's notice. Nevertheless, paying cash up front can be extremely economical. The immediate cash payment, sometimes coupled with the proviso that you are buying an item "as is," can be such an attractive money-saving opportunity that sometimes it might even pay to borrow the funds to complete such a transaction.

A concept related to the cash discount is the "cash rebate," which is sometimes also referred to as a "rebate" or a "coupon refund." Essentially, the supplier will charge you the full AP price, but later on, after you send him or her some proof of purchase, you will receive a bit of money back—a cash rebate. It does not appear to us that this activity saves as much money as it might seem to initially. Generally, you have to pay postage, absorb the costs of reproducing bills or other proof-of-purchase records, and endure the long wait for your money. Most large hospitality organizations do not like this procedure because of the extra work involved; they prefer bargaining for lower AP prices up front. Nevertheless, these types of rebates are quite common for many items, and, if economical, they should be pursued as much as possible.

## Hedging

The idea behind hedging is to maintain a specific AP price, not to reduce it. For example, assume that you wish to maintain the AP price of chicken for the next month. To do this, you would determine how much product you need for one month and enter into an agreement, usually a "futures contract," to purchase this amount one month from now at a specific price. During the month, you would purchase product as needed on the open market at the current AP price. If the AP price is higher than it was at the beginning of the month, you would be paying more for the product. However, your agreement, or futures contract, theoretically would be worth more. That is, the value of your agreement, which can be sold on the futures market, would increase. This increase would offset the higher, open-market AP price for the commodities. Consequently, you offset your high purchase price by selling your futures contract at a profit that you would then use to subsidize your "loss" on the open market. Where hedging is successful, the tendency is to maintain a stable AP price for the month.

But buyers should consider several problems associated with hedging: (1) a lot of cash may be necessary to buy futures contracts because the minimum amount of product

involved in each agreement is relatively large; (2) hedging can be done for only a few items, though these items may account for the bulk of your purchasing dollar; (3) transactions costs are involved—you must pay people to trade the contracts for you, as you cannot do this yourself unless you own a seat on a commodity exchange; (4) few small hospitality operations can muster the time necessary to engage in this activity; (5) the transactions costs might easily overpower the benefits you could derive from this type of protection against AP price fluctuations; and (6) it is possible, though unlikely, that no one would want to purchase your contract when you need to sell it to break even.

At one time, the hospitality industry appeared to be well on its way toward making the hedging procedure a common component of the overall procurement strategy. However, the industry has had second thoughts about this procedure. While some large hospitality organizations maintain at least a modicum of hedging as part of their overall purchasing arsenal, few companies currently seem to follow this pattern. Examples of this practice, such as fuel hedging, are common in the airline industry.[4]

## Economical Packaging

Every now and then, interest reemerges in changing some of the packaging methods manufacturers use. Some of the containers in use force an operator to waste storage space. For example, cylindrical cans and slope-necked bottles require more shelf space than cube-shaped boxes. In addition, a lot of packaging contains such cosmetic touches as pictures and suggested recipes, which tend to increase the overall cost.

Since you buy products for production and not, like supermarkets, for immediate resale, you gain no benefit from attractive but inefficient packaging. Theoretically, more standardized packaging should reduce the AP price. Furthermore, efficient packaging reduces your storage capacity needs, thereby providing another saving. Nevertheless, manufacturers do not like to abandon this type of advertising and promotional appeal.

The buyer should consider purchasing products that are packed in adequate, not luxurious, packaging materials, if at all possible. In addition, large volume packs are normally cheaper per unit of weight than their smaller counterparts. For instance, a 1-gallon container of sliced peaches usually costs less than four 1-quart containers.

Another advantage to large containers is that they tend to lessen the possibility of petty pilferage.

## Odd-Hours Deliveries

If suppliers deliver at night or very early in the morning, they should be able to handle more delivery stops because of the decrease in road traffic and other distractions. To some extent, these types of deliveries are done predominately in large, downtown urban

areas that have particularly troublesome traffic jams during the day. It is not clear just what type of AP price reduction you could expect with these deliveries. Theoretically, you should gain some monetary benefit by increasing delivery efficiency.

Night deliveries might produce other cost savings, notably reductions in receiving costs. However, these savings would be possible only if all receiving was done at night, since night deliveries by just one supplier probably would increase costs; this is because the receiving and storage areas would need to be open for an extended period of time. These savings can materialize, though, if you trust the driver with a key to your premises.

A concept related to night deliveries is the possibility of receiving monetary considerations from a supplier if you agree to receive deliveries during the "sacred hours." The sacred hours are those surrounding the lunch period, typically from 11:30 A.M. to 1:30 P.M. In some cases, the foodservice buyer who agrees to receive deliveries during this time period may earn some price concessions.

## Co-op Purchasing

Recall that a purchasing co-op is a group of buyers, each representing a different hospitality operation, who pool their individual small orders. The resulting single large order more than likely qualifies the group for a lower AP price.

Several advantages and disadvantages are associated with co-op purchasing, and some of these are addressed in Chapter 12. It does seem clear that AP prices decrease whenever you purchase a large amount of a product or service. However, what is not clear is the effect on EP costs.

## Cost-Plus Purchasing

Under the cost-plus purchasing procedure, the AP price is equal to the supplier's cost of the product, which is sometimes referred to as the "landed cost," plus an agreed-upon profit markup. The markup can be a set dollar amount or a percentage of the supplier's cost. Either way, if the supplier's cost decreases, the buyer will enjoy a price reduction. However, if the supplier's cost increases, so will the AP price.

Buyers must be willing to incur a bit of risk if they participate in this type of buying process. A sudden price increase is the most obvious risk. However, buyers must also be careful to monitor suppliers so that they do not subcontract products to their friends several times, thereby creating an artificial "daisy-chain" type of distribution channel, whereby the suppliers' costs are illegally inflated. In addition, if the profit markup is a percentage, suppliers have no incentive to control their costs. (Note that government buyers usually are not allowed to enter into a cost-plus purchase agreement if the profit markup is a percentage of cost; however, they can usually agree to a set dollar

amount.) Wise buyers normally have, and exercise, the right to audit the supplier's records to determine whether the correct AP price has, in fact, been charged.

Large hospitality operations generally prefer a long-term arrangement in which both the availability of a product and its AP price are predictable. While suppliers usually do not mind agreeing to provide a certain amount of product to a hospitality company, they do not like to enter into a long-term, fixed-price contract. So, the use of a cost-plus arrangement seems to be the logical compromise. Negotiations center on the agreed-upon profit markup, not on the actual AP price itself. It appears that a hospitality corporation must follow this strategy if it wants to develop long-term contractual arrangements with its suppliers.

## Promotional Discounts

A promotional discount is a rebate from the supplier that the buyer's company must use to promote the retail sale of the product. For example, a cheesecake manufacturer might grant a 2 percent rebate if you agree to promote his or her product in your foodservice operation.

Today, the traditional promotional discount is not so common. More often, suppliers provide free promotional materials now and then (see Figure 10.2 and Figure 10.3). Many suppliers also like to do joint promotions with hospitality operations.[5] For example, a liquor distributor may split the cost of a special event with a local nightclub operator. In this case, although the nightclub operator does not receive a lower AP price, he or she does enjoy an increased promotional budget.

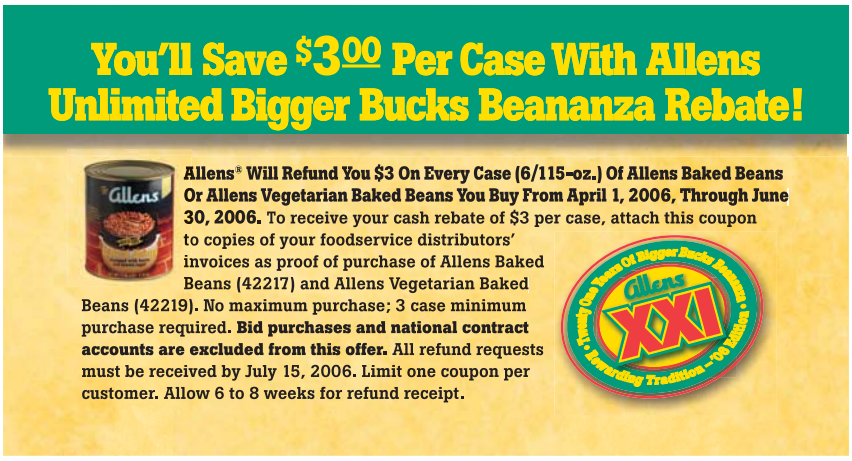


**FIGURE 10.2** Promotional offer.

*Courtesy of Allen Canning Company ©2006.*


**FIGURE 10.3** Promotional offer/discount.
*Courtesy of Dole Food Company, Inc.*

If the option to gain a promotional discount arises, management should not jump too quickly. The extra money is, of course, tempting, but you need to do some serious thinking about how such a promotion will affect your operation's reputation. This decision can have several ramifications, and some of them may prove troublesome in the long run.

## Exchange Bartering

Exchange bartering is simply the practice of trading your products or services for something you need. This is a relatively common practice in the hospitality industry (see Figure 10.4).[6] For instance, it is not unusual for a hotel company to exchange room nights, restaurant meals, and beverages for radio and billboard advertising. Industry experts think that as long as bartering represents no more than approximately 10 to 15 percent of a hospitality operation's total sales revenue, it can be a very profitable arrangement.

Bartering does, however, have its costs. For instance, you may have to join a barter group. More than 500 such barter groups exist in the United States. A few charge a fee to join (around $400) but most typically charge a 10 to 12 percent commission for each transaction.[7]

You may be able to avoid these costs if you engage in what is sometimes referred to as "direct bartering," whereby you personally make a deal with another business to swap goods and/or services.[8]

Bartering presents other potential difficulties. For example, you may have image problems to contend with. At times, you may have to deal with price gouging and poor selection availability. Furthermore, the Internal Revenue Service (IRS) may be more apt to audit your income and expense records if you engage in a significant amount of bartering because the agency suspects bartering might become the prelude to unreported income. In 1982, the IRS recognized bartering as a legitimate purchase strategy so long as "trade" dollars are reported correctly for tax purposes.

The savings associated with bartering can be significant. For example, when you pay a bill of $100 with $100 worth of menu items, you have been able to discharge the obligation for much less out-of-pocket cost to you. Furthermore, if you restrict your trading partners' ability to exchange their meal credits—say, allowing them to eat during only the slow periods—you may gain even more financial benefit.

## Introductory Offers

New products continually come on the market. Some suppliers move these items by selling them for an inexpensive AP price, at least for the first one or two orders. Alternately, you might buy one and get one free. The obvious problem, of course, is that these offers are temporary. You can hardly make a career of moving from one introductory offer to the other. This strategy is inconvenient, and suppliers do not like it. However, you could take advantage of an offer and stock up on the merchandise in anticipation that you can use it later, for example, for special parties.


**FIGURE 10.4** An announcement by an organization that matches individual businesses that want to trade.

*Courtesy of ITEX.*

## Reevaluate EP Costs

You should get into the habit of revising the portion divider (PD) and portion factor (PF), if necessary, of currently used ingredients and ingredients that you expect to use at some later time. You should do this for all of the ingredients that you are procuring from current suppliers and for all of the ingredients that you might consider buying from other suppliers from whom you are not currently purchasing. Furthermore, you should occasionally consider purchasing an ingredient in some other form, such as a form that provides less edible yield, because it just might turn out that the ingredient purchased in that form offers the lowest EP cost.

You can never ignore an ingredient's overall value, of which the EP cost is only one factor. But, assuming that the quality and the supplier services are the same across the board, and also assuming that your other expenses will not increase if you purchase different types of ingredients, you owe it to yourself to examine the potential of purchasing another product that can be cheaper for you in the long run.[9]

You need to have a storehouse of data to perform this type of analysis. Each ingredient that you currently purchase, as well as each ingredient that you could conceivably purchase, must be listed, along with its PF and PD. As such, as we discussed in Chapter 9, food services that have sophisticated computer technology would more likely do this type of analysis.

If you have these data, you can proceed to evaluate the EP costs of each ingredient. Simply divide the AP price per pound for any ingredient by its PD, and, instantly, you have the EP cost for one serving of that ingredient.

### Example I

Given the following data, determine the EP cost for one serving of each ingredient.

| INGREDIENT | EDIBLE YIELD (%) | SERVING SIZE (OZ.) | AP PRICE PER POUND |
|---|---|---|---|
| (a) Raw corned beef brisket | 50 | 4 | $1.38 |
| (b) Raw corned beef round | 75 | 4 | $1.45 |
| (c) Cooked corned beef brisket | 90 | 4 | $2.98 |
| (d) Cooked corned beef round | 95 | 4 | $2.45 |

**Solution:**

Compute each ingredient's PF:

(a) PF = 16 / 4 = 4

## Example I (continued)

(b) PF = 16 / 4 = 4

(c) PF = 16 / 4 = 4

(d) PF = 16 / 4 = 4

Compute each ingredient's PD:

(a) PD = 4 × 0.50 = 2.00

(b) PD = 4 × 0.75 = 3.00

(c) PD = 4 × 0.90 = 3.60

(d) PD = 4 × 0.95 = 3.80

Compute each ingredient's EP cost:

(a) EP cost = $1.38 / 2.00 = $0.69

(b) EP cost = $1.45 / 3.00 = $0.48

(c) EP cost = $2.98 / 3.60 = $0.83

(d) EP cost = $2.45 / 3.80 = $0.64

## Example II

Given the following data, determine the EP cost for one serving of each ingredient.

| INGREDIENT | EDIBLE YIELD (%) | SERVING SIZE (G) | AP PRICE PER KILOGRAM |
|---|---|---|---|
| (a) Fresh raw spinach | 60 | 90 | $1.75 |
| (b) Frozen leaf spinach | 100 | 90 | $2.95 |
| (c) Frozen chopped spinach | 100 | 90 | $3.25 |

**Solution:**

Compute each ingredient's PF:

(a) PF = 1000 / 90 = 11.11

(b) PF = 1000 / 90 = 11.11

(c) PF = 1000 / 90 = 11.11

Compute each ingredient's PD:

(a) PD = 11.11 × 0.60 = 6.67

(b) PD = 11.11 × 1.00 = 11.11

## Example II (continued)

(c) PD = 11.11 × 1.00 = 11.11

Compute each ingredient's EP cost:

(a) EP cost = $1.75 / 6.67 = $0.26

(b) EP cost = $2.95 / 11.11 = $0.27

(c) EP cost = $3.25 / 11.11 = $0.29

## Example III

Given the following data, compute the servable portion cost for one serving of each ingredient.

| INGREDIENT | SERVABLE YIELD (%) | SERVING SIZE (ML) | AP PRICE PER LITER |
|---|---|---|---|
| (a) Scotch (750 ml bottle) | 95 | 50 | $8.25 |
| (b) Scotch (1 liter bottle) | 95 | 50 | $7.95 |
| (c) Scotch (1.75 liter bottle) | 100 | 50 | $7.25 |

**Solution:**

Compute each ingredient's PF:

(a) PF = 1000 / 50 = 20

(b) PF = 1000 / 50 = 20

(c) PF = 1000 / 50 = 20

Compute each ingredient's PD:

(a) PD = 20 × 0.95 = 19

(b) PD = 20 × 0.95 = 19

(c) PD = 20 × 1.00 = 20

Compute each ingredient's servable portion cost:

(a) Servable portion cost = $8.25 / 19 = $0.43

(b) Servable portion cost = $7.95 / 19 = $0.42

(c) Servable portion cost = $7.25 / 20 = $0.36

As mentioned earlier, unless you have access to specific computer technology, it is very difficult to maintain current EP costs per serving for all food and beverage ingredients. However, you could develop some useful cost data in a relatively short amount

of time if you knew each ingredient's: (1) AP price per unit, and (2) its edible- (or servable-, or usable-) yield percentage. For instance, if you know that raw corned beef brisket carries an AP price of $1.38 per pound and that its edible-yield percentage is 50 percent, you can determine very quickly the EP cost per pound for this item by using the formula mentioned by Dr. Jean Hertzman in Chapter 9 and noted at the beginning of this chapter, which is repeated here:

**EP cost = AP price / edible- (servable-, or usable-) yield percentage**

**EP cost per pound of raw corned beef brisket = $1.38 / 0.50 = $2.76**

This type of cost information is very useful to buyers because it provides a solid base upon which they can make sound purchasing decisions. But buyers are not the only ones who will find this information useful; so will other managers and supervisors, who rely on product cost data to perform their jobs. Production managers, for instance, also use these data when performing their menu-planning duties. Specifically, product cost data are needed whenever a supervisor or manager has to "precost" the menu and calculate suggested menu prices.

Precosting a menu involves costing out each menu offering. This is done by first calculating the EP cost of each ingredient included in a menu offering and then obtaining a total EP cost per serving. The result of this work is the calculation of each menu item's "standard cost," that is, the expected (or theoretical) cost of the menu item.

To see how a standard cost is calculated, consider the following example:

## Example

Menu item: Steak Dinner

| INGREDIENT | SERVING SIZE (OZ.) | EDIBLE YIELD (%) | AP PRICE PER POUND |
|---|---|---|---|
| Steak | 12 | 80 | $4.75 |
| Beans | 4 | 90 | $0.65 |
| Potatoes | 4 | 75 | $0.90 |

**Solution:**

Compute each ingredient's PF:

$PF_{(steak)} = 16 / 12 = 1.33$

## Example (continued)

$PF_{(beans)} = 16 / 4 = 4.00$

$PF_{(potatoes)} = 16 / 4 = 4.00$

Compute each ingredient's PD:

$PD_{(steak)} = 1.33 \times 0.80 = 1.06$

$PD_{(beans)} = 4.00 \times 0.90 = 3.60$

$PD_{(potatoes)} = 4.00 \times 0.75 = 3.00$

Compute each ingredient's EP cost:

$EP\ cost_{(steak)} = \$4.75 / 1.06 = \$4.48$

$EP\ cost_{(beans)} = \$0.65 / 3.60 = \$0.18$

$EP\ cost_{(potatoes)}$ $0.90 / 3.00 = $0.30

Compute the standard cost:

$4.48
0.18
+0.30
$4.96

Once a standard cost is computed, a manager can calculate a suggested menu price by dividing the standard cost by the target (i.e., desired) product cost percentage. For example, if the manager wanted the food cost of the steak dinner menu item to be 30 percent of its menu price, the suggested menu price would be $16.53 ($4.96/0.30 = $16.53).

Note that if $4.96 = 0.30 × menu price, then

**Menu price = $4.96 / 0.30 = $16.53**

The $16.53 figure is only a suggested menu price. The wise hospitality operator will usually begin with this price, but he or she typically will adjust it somewhat so that it is consistent with local market conditions. Furthermore, the manager would not normally adopt a menu price of $16.53; more than likely, he or she would use a price of $16.50 or $16.95, figures that are more recognizable to the typical customer.

The standard cost can also be used in a hospitality operation's overall cost control system. For instance, if you find that at the end of the month you sold 500 steak dinners, the total standard food cost for the ingredients needed to prepare and serve these

meals would be $2,480 (500 × $4.96 = $2,480). This total standard cost can then be compared with the total actual cost, which may be calculated in the following way:

**Inventory value (in dollars) at beginning of month for the items in the dinner**
**+ Purchases for the month (in dollars)**
**= Inventory available for the month (in dollars)**
**× Inventory value (in dollars) at end of month**
**= Actual cost (in dollars)**

The actual cost should be close to the total standard cost. If a significant "variance" exists between them, the hospitality operator will need to diagnose the situation, uncover the problem(s), and take corrective action.

## OPPORTUNITY BUYS

One general category of purchases that can reduce AP prices dramatically deserves a separate discussion. Some single event may occur that causes a supplier to offer a bargain. A number of examples of the kind of opportunity we refer to appear in the discussion that follows.

Suppliers offer opportunity buys for several reasons: (1) Sometimes they give a normal quantity discount for large purchases of one item. When you buy larger and larger amounts at one time of a particular item, the per-unit AP price decreases. For example, when you buy 50 cases at one time, the AP price per case might be $8. But if you increase your order size to 100 cases, the AP price per case might be $7.95. (The figures 50 and 100 cases are sometimes referred to as "break points.") (2) Many suppliers offer volume discounts for large purchases that include several items. (In our experience, quantity discounts and volume discounts are the most common types of opportunity buys.) (3) Suppliers may have a "blowout sale," "buyout sale," or "closeout sale." These "sales" generally refer to merchandise that may be unsalable for one reason or another, or merchandise that must be sold at a loss. In most instances, the buyer of these "sales" is in a position to take advantage of someone else's misfortune. (4) Some suppliers have move lists, or "muzz-go" lists, which include items that are on the verge of spoiling or, for one reason or another, are of poorer quality. These items, though, are wholesome and some hospitality operations can use them. (5) Suppliers might have received an excellent buy and want to pass some of the savings on to their good customers. (6) Suppliers may be cash-starved and willing to offer cash discounts on large purchases. (7) New suppliers may be trying to break into the market and will sell items at a loss in order to introduce their company. (8) Established suppliers may be introducing a new

product line and, while so doing, may reduce their AP price. (This is referred to as an "introductory offer" when the amount you can purchase is relatively small.)

To take advantage of an opportunity buy, a buyer usually must agree to purchase in very large amounts. The buyer may have to purchase the item when he or she already has a complete stock. In addition, the buyer usually has to produce the cash in advance or on delivery.

Buyers must, of course, evaluate both the quantitative and the qualitative factors when exploring the attractiveness of an opportunity buy. On the quantitative side, buyers first must consider the numbers: they must determine the potential savings. If the savings are insufficient, buyers do not need to evaluate any qualitative factors.

For example, assume that you normally purchase 600 cases of canned peaches once a month. The AP price is $5 per case, for a total of $3,000. You have an opportunity to purchase a two-month supply, or 1,200 cases, for $4.95 per case, for a total of $5940. Your ordering cost for each order is $25. Storage costs are 24 percent per year, or 2 percent per month. What should you do?

Figure 10.5 depicts a quantitative analysis of this opportunity buy. In the usual situation, you would spend $6,050. In the proposed situation, you would spend only $6023.80. You would save $0.05 per case and $25 with one less order. By deciding to take the option of buying 1,200 cases, you make two savings, but you also incur an additional cost. You must buy next month's supply right now and store these 600 cases for an extra month, incurring a 2 percent storage charge on $2,940, which comes to $58.80. You would not have to do this if you continued your monthly ordering schedule—that is, your normal storage costs would prevail. The upshot of this quantitative analysis, assuming that your ordering and storage cost estimates are reasonably correct, is a savings of $26.20. So, based on the numbers, which reveal a very small savings, management could either take this opportunity or leave it.

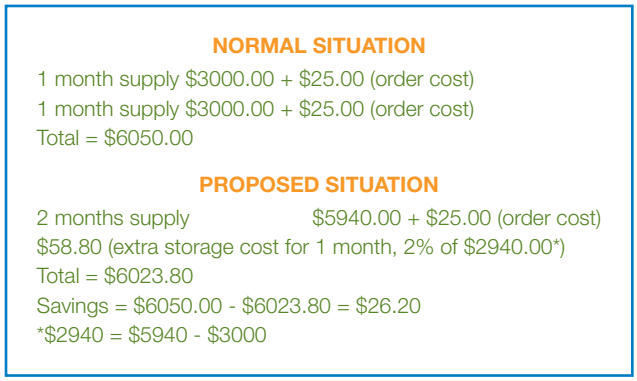


**FIGURE 10.5** A quantitative analysis of an opportunity buy.

There is a simpler way to evaluate the quantitative aspects of this opportunity. In the first place, many buyers do not consider the ordering cost, mostly because of confusion about the makeup and magnitude of this cost. Basically, these buyers look at the opportunity buy as an investment. In the peach example, you must buy an additional 600 cases for $2,940 and store these cases for one month. In short, you have been asked to invest $2,940 in inventory for one month. If you do, you save $60. The return on this investment, then, is 2.04 percent ($60/$2,940) per month, or 24.48 percent per year. This percentage is normally compared with some cutoff percentage rate, usually a rate that represents the storage cost.

Regardless of which quantitative method the buyer uses, the emphasis should not be on a formula but on the estimates used in the calculations. Management must spend its time determining the relevant storage cost. (Recall that varying opinions exist surrounding the makeup of this cost.) Management must also determine what percentage rate of return it requires to take advantage of an opportunity buy. (In our experience, a buyer may be willing to purchase an additional one-month's supply of a product if the supplier discounts the AP price by at least 2 to 3 percent.)

Normally, management takes a conservative approach when setting this percentage rate and sets a relatively high rate. That way, if the savings of an opportunity buy exceed this high rate, the buy is, indeed, an excellent opportunity. But if management sets an unreasonably high rate, it may needlessly reject opportunity buys that, in reality, it should accept.

We think that the percentage rate should differ according to the storage requirements of the product. Dry storage products would have a low annual rate, perhaps 12 percent, whereas refrigerated and frozen products would require a higher rate, perhaps 18 percent or more, to offset the higher costs of refrigerated storage.

These quantitative analyses can be more complex than our discussion so far has indicated. For instance, you may have to consider the probabilities of large AP price increases or decreases during the next month, as well as the possibility that you may suddenly start using less of the product. If management sets a reasonable cutoff percentage rate, however, you usually will not need to examine these additional possibilities. As noted, the conservative approach seems popular and is, in itself, normally sufficient to cover most of these extra potential costs.

A buyer satisfied with the numbers can evaluate several qualitative aspects of the opportunity buy before making a purchasing decision, including:

1. Is the quality the same? Does it compare favorably with the normal purchase?
2. What is the probability of a large decrease in the item's AP price after the opportunity buy?

3. Are cash reserves available? How will the purchase affect the overall cash position of the company?
4. Are storage facilities available? Will this buy pose an excessive burden on these storage facilities?
5. What is the storage life of the product?
6. Will insurance premiums, security risks, and the like increase dramatically, or will the current annual storage cost (in the peach example, 2 percent per month) remain pretty much the same?
7. Will personal property taxes increase now that the overall inventory level is higher?
8. Will the usage rate of the item remain the same over the next few weeks or months? Is it possible that management will discontinue the item? Technically, you do not save money when you buy the product; you save money only when you use it.
9. Does the opportunity buy require a change of suppliers? If so, your current supplier may become disgruntled. Also, what happens if the new supplier cannot maintain the overall value?
10. Are the supplier services the same? If not, how do they differ? Are these differences being considered when the numbers are being evaluated?
11. Is the opportunity a legitimate one? Are you buying legitimate merchandise from licensed suppliers? You should never purchase anything if you doubt the legal status of the item.
12. Furthermore, a buyer should not engage in any illegal activity when trying to save money. For example, you may save sales taxes on a piece of equipment if you buy it in another state and arrange to have it delivered to you. Alternately, you may accomplish the same objective by purchasing equipment through an out-of-state Internet supplier. However, even though you do not pay sales taxes to the supplier's state, you are required to pay them in your state (usually in the form of "use taxes").
13. Another problem is purchasing from unlicensed independent food distributors. You never know where they get their merchandise or whether they are under government inspection. Local producers often are not required to undergo federal inspection. Most states have laws preventing the purchase of home-canned and other home-prepared products. But local egg farmers and fishermen, who sell only in their local area market, usually require no inspection. Furthermore, they are not likely to obtain the necessary business license. Hence, you incur a risk by purchasing these products.

14. Sometimes a hospitality operation that is going out of business attempts to sell its inventories and equipment. Perhaps the operation is selling items that actually belong to its creditors.
15. Another example is the salvage opportunity. For instance, a refrigerated railroad car overturns. Someone tries to sell the frozen-food merchandise for 20 cents on the dollar. Should you take such a deal? No, since buying food salvage or food from unlicensed purveyors is a violation of local health codes. The violation is referred to as "purchasing food from an unapproved source." It is permissible, however, to purchase nonfood and nonbeverage salvage items. For example, you could purchase a freight-damaged table if the damage will not interfere with the hospitality operation's production and service or tarnish the company's image. A buyer must realize, though, that he or she could be purchasing an item that suffers more than cosmetic bruises. Indeed, a freight-damaged item might be unusable and might not be a bargain at any price. Since products of this type generally are sold with no guarantee, the buyer must be willing to gamble that such a purchase will enhance the company's profits.
16. You may be able to save a great deal of money if you purchase used merchandise. Unfortunately, these items normally are sold or auctioned off in an "as-is, where-is" condition (i.e., there is no guarantee, and you would need to provide your own transportation). The high probability of a much shorter useful life for these types of items makes their purchase a risky endeavor. However, you may come out ahead if you are the lucky one who can spot a good opportunity. This is especially true if you can purchase a little-used demonstration model or a new one displayed only at a trade show exhibit.

Opportunity buys are clearly challenging. The quantitative aspects are relatively simple when the ordering and storage costs used are reasonably accurate. But the qualitative aspects are much more difficult to assess. This probably explains why most managements usually take a cautious approach when evaluating opportunity buys.

## HEDGING YOUR BUDGET—A MINI ECONOMICS LESSON

It comes around every year like clockwork—budgeting time. This is when every purchasing director wishes for a crystal ball for peering into the future. What will be the price of prime rib in six months? Will the cost of paper products go up because of a new clean air act that affects paper mills? Will there be a drought that will raise the price of feed and therefore the cost of poultry?

## HEDGING YOUR BUDGET—A MINI ECONOMICS LESSON
**(continued)**


Glenn Millar

The goal is to develop as accurate a budget as possible, neither too high nor too low. Hedging is one way to balance a budget's estimates. According to Glenn Millar, a consultant with eDairy, Inc., "People don't hedge enough. Hedging is an appropriate way to mitigate risk when making financial plans for the future."

What is hedging and how does it work? Using butter as an example, we'll explore the hedging process. Let's say that in the next year you know your hotel restaurants will use 40,000 pounds of butter. You look at the Daily Dairy Report (www.dailydairyreport.com), which provides a good summary of future dairy prices. You discover that the average price for butter futures in the coming year is $1.35 per pound, with prices as high as $1.40 per pound for some months and as low as $1.30 per pound for others. Your estimate for budgeting purposes will be that you will buy 40,000 pounds of butter at $1.35 per pound in the coming year for a budget line item of $54,000. You could stop right there. This is a good estimate, based on reliable information and it will probably satisfy your chief financial officer.

What if the price of butter goes up dramatically, costing more than was budgeted? You might find yourself having to cut back on the purchase of less critical items to stay within your overall budget.

There is a way to make sure that even if the price of butter rises, your budget won't be affected. Hedging involves a separate transaction where one purchases futures contracts on

*continues*

## HEDGING YOUR BUDGET—A MINI ECONOMICS LESSON
**(continued)**

the exchange market. A "futures contract" is an agreement to purchase or sell a commodity (in our case butter) at a certain agreed-upon price, in a specific timeframe.

As an astute purchasing director, you buy two futures contracts for butter at $1.35 per pound, each to expire during the coming year. Butter futures are sold in 20,000-pound lots so this will cover your 40,000-pound requirement. Futures brokers generally charge a $25 fee per transaction or $50 for the two purchases. In addition, when you purchase a future, there is a margin amount or good faith deposit that is required to be in an account with your broker. For butter, that amount is $1,000 and since you are buying two futures, you will be required to have $2,000 in your account.

It is important to remember that with futures contracts you never actually take possession of the butter, you are simply buying the "right" to that amount of butter at a given price. An individual could buy two futures contracts for butter as a short-term investment just as easily. He or she will never take possession of the butter; the investor will simply sell the right to that butter at some point in the future.

Now let's say that in three months you sell the first contract at the current market price of $1.50 per pound. Your gain on the sale of the future is $0.15 per pound, but the butter you are actually buying from your supplier is also costing you $1.50 per pound. The net gain on the future offsets the "loss" you would show on your budget. The sale of the contract will net $3,000 which can be moved from your brokerage account to general funds to purchase butter at the higher rate.

Six months later you sell the other future at $1.20 per pound, which results in a loss of $0.15 per pound. However, the price you pay to your supplier is also $0.15 lower than your budgeted amount. Your net cost of $1.35 equals your magical budget number. At this time you will need to put $3,000 back in your brokerage account to offset the loss on the sale, but at the same time you are paying $3,000 less for butter than you had budgeted.

"Remember, when you are hedging, you are not hoping to make money by speculating in the market, you are trying to mitigate the impact of market fluctuations on your budget," says Millar. "It is important to keep in mind the reasons you are purchasing the futures contracts and focus on the budgeted amount as the goal," he adds.

Once you have convinced your chief executive officer of the value of hedging, you can buy futures for a number of other big-ticket items such as beef, poultry, pork, and dairy products besides butter. You can also buy futures for energy including gas, electricity, and gasoline for fleet vehicles.

"Hedging is a powerful tool for purchasing agents who want to make accurate budget decisions in our world of uncertainty and risk," concludes Millar.

## HEDGING YOUR BUDGET—A MINI ECONOMICS LESSON (continued)

Glenn Millar is a former partner at Kellers Creamery LLC, a $500 million butter dairy company located on the east coast. He is currently the managing partner of Modern Dairy Markets, market maker for the Chicago Mercantile Exchange's numerous dairy contracts. He also consults with food companies on risk management through eDairy, Inc.

**Resources**
www.dailydairyreport.com
www.investordictionary.com

# Key Words and Concepts

"As-is, where-is" condition
Actual cost
AP price and its influence on buyers
As-purchased price (AP price)
Barter group
Beginning inventory
Blanket orders
Blowout sale
Bottom-line, firm-price purchasing
Break point
Buyer fact sheets
Buyer pricing
Buyer profiles
Buyout sale
Cash discount
Cash rebate
Cherry picking
Closeout sale
Commodity
Commodity exchange
Competitive pressure
Conventional profit markup
Co-op purchasing
Cost-plus purchasing
Coupon refund
Credit terms
Daisy chain
Demonstration model
Derived demand
Direct bartering
Economic values
Economical packaging
Edible yield
Edible-portion cost (EP cost)
Ending inventory
Exchange bartering
Fixed-price contract
Forklift discount
Freight-damaged item
Futures contract
Hedging
How the AP price is determined
Introductory offer
Inventory available for the month

## Key Words and Concepts (continued)

Itemized bill
Landed cost
Line-item purchasing
Long-term contract
Make-or-buy analysis
Menu price calculation
Monopolistic competition
Muzz-go list
Negotiations
Odd-hours delivery
Opportunity buy
Ordering cost
Panic buying
Portion divider (PD)
Portion factor (PF)
Precosting the menu
Product cost percentage
Product substitution
Profit markup
Promotional discount
Qualitative aspects of opportunity buys
Quality standard
Quantity discount
Sacred hours
Sales taxes
Salvage opportunity
Servable portion cost
Servable yield
Shopping around
Standard cost
Storage cost
Supplier services
Supplier's costs
Supply and demand
Target product cost percentage
Usable yield
Use taxes
Used merchandise
Variance
Volume discount
Wholesale club

## Questions and Problems

**1.** Assume that your economic order quantity (EOQ) is 500 cans. If you purchase 500 cans, you pay $343.50. If you buy 1,000 cans, you pay $650; 500 cans represent a three-month supply, and 1,000 cans represent a six-month supply. Storage charges are 12 percent of inventory value per year. The cost of preparing one purchase order is $25.

(a) Should you purchase 500 or 1,000 cans? Why?

(b) Even if it is cheaper to purchase 1,000 cans, why might you reject such a huge order?

## Questions and Problems (continued)

2. Consider the following problem data:

   EOQ = 500 pounds (one-month supply)
   Normal price = $1 per pound
   Storage cost = 24% per year, or 2% per month

   The product is ordered monthly. The cost of one purchase order = $20. You have an opportunity to purchase 1,000 pounds of this product this month at $0.95 per pound. How much will you save if you purchase 1,000 pounds?

3. Assume that you normally purchase 60 cases of Canadian whiskey once every three months. The cost of the whiskey is $3,600. The distributor wants to sell you a six-month supply, 120 cases, for $6,768. What do you suggest?

4. Explain how a buyer relates AP price to EP cost.

5. What are the four methods that suppliers use to determine their AP prices? As a buyer, which method would you prefer? Why? Which method would the supplier prefer? Why?

6. Review the various ways of reducing AP prices. Which method do you think is best? Why? Which is worst? Why?

7. What is the major objective of hedging?

8. Assume that you normally purchase 100 cases of Scotch per month at an AP price of $32.50 per case. You could purchase a two-month supply at an AP price of $30 per case. Your ordering cost is $25 per order, and your storage cost is 24 percent per year. How much would you save if you purchased a two-month supply?

9. Briefly describe the concept of "derived demand."

10. What are some major disadvantages of lowering your quality standard to reduce your costs?

11. What is the primary difference between a quantity discount and a volume discount?

12. List some advantages and disadvantages of exchange bartering.

## Questions and Problems (continued)

**13.** Given the following data, determine the EP cost of each ingredient.

| INGREDIENT | EDIBLE YIELD (%) | SERVING SIZE (OZ) | AP PRICE PER POUND |
|---|---|---|---|
| Lettuce A | 70 | 3 | $0.22 |
| Lettuce B | 80 | 3 | $0.29 |
| Lettuce C | 90 | 3 | $0.32 |

**14.** What are some advantages and disadvantages of purchasing used merchandise?

**15.** Define or briefly explain the following terms:

(a) Blanket order
(b) Cash discount
(c) Introductory offer
(d) Quantity discount
(e) Break point
(f) Move list
(g) Promotional discount
(h) Coupon refund
(i) Sacred hours
(j) Salvage buying
(k) Buyer profile
(l) Buyer pricing
(m) PD
(n) PF
(o) Make-or-buy analysis
(p) Direct bartering

**16.** Under what conditions would salvage buying be illegal?

**17.** Given the following data, compute the EP cost for a 6-ounce portion:

Item: Prime rib
AP price: $2.85 per pound
Edible yield: 12 ounces per pound
(One pound = 16 ounces)

**18.** What are the advantages and disadvantages of purchasing merchandise from a no-frills wholesale club?

**19.** Under what conditions would management consider a product substitution strategy in order to reduce costs?

**20.** What are the major problems associated with the hedging strategy?

## Questions and Problems (continued)

**21.** Given the following data, compute the standard cost for one seafood dinner:

| INGREDIENT | SERVING SIZE (OZ) | EDIBLE YIELD (%) | AP PRICE PER POUND |
|---|---|---|---|
| Fish | 12 | 75 | $8.98 |
| Rice | 4 | 100 | $0.22 |
| Beans | 4 | 90 | $0.65 |

**22.** What is the name of the difference between the standard cost and the actual cost?

**23.** How can the actual cost be computed?

**24.** Given the data in Question 21, compute the suggested menu price for a seafood dinner, assuming that the target food cost percentage is 40 percent.

**25.** What could cause the actual cost to be greater than the standard cost? What could cause the standard cost to be greater than the actual cost?

## Experiential Exercise

**1.** How can you reduce the overall AP price and increase overall value?

a. Interview a restautant or hotel manager involved in purchasing for his or her operation. Ask the manager to comment on specific methods he or she employs to reduce the overall AP prices of products.

b. Compare the manager's methods with the following ones described in this chapter:

Make-or-buy analysis

Provide your own supplier services and/or economic values

Shop around

Lower the quality standard

Blanket orders

Improved negotiations

Substitutions

Cash discounts

## Experiential Exercise (continued)

Hedging
Economical packaging
Odd-hours deliveries
Co-op purchasing
Cost-plus purchasing
Promotional discounts
Exchange bartering
Introductory offers
Reevaluate EP costs
Opportunity buys

c. Identify any reduction methods that the operation is not employing and ask if they have been considered. If a particular method has been considered but not implemented, ask for an explanation. If it has not been considered, ask if the operation might benefit from this type of reduction method. Provide a report to include:
   i. The identification of AP price reduction methods used by your selected hospitality operation.
   ii. A discussion of why particular reduction methods are not currently being used.
   iii. A discussion of the possible benefits of implementing new reduction methods.

## References

1. Patt Patterson, "Finding 'Bargains'—and Knowing How to Police Them," *Nation's Restaurant News*, April 5, 1993, p. 37.
2. Michael L. Facciola, "Supply & Dementia," *Food Arts*, May 1992, p. 112.
3. Marj Charlier, "Existing Distributors Are Being Squeezed by Brewers, Retailers," *The Wall Street Journal*, November 22, 1993, p. A6.
4. Warren Getler and Scott Kilman, "Cheddar Lovers May Take a Slice of These Futures," *The Wall Street Journal*, January 14, 1993, p. C1. See also Scott Kilman,

## References (continued)

"Broilers May Return to Roost at Merc," *The Wall Street Journal*, November 19, 1990, p. C1; Leslie Scism, "Derivatives May Deliver Postal Savings," *The Wall Street Journal*, November 11, 1993, p. C1; "Business Brief—AirTran Holdings Inc.: Subsidiary Enters Program to Hedge on Fuel Costs," *The Wall Street Journal*, January 5, 2001, Eastern edition, p. 1. More examples of hedging can be found by searching "hedging" at www.google.com.

5. Patt Patterson, "Suppliers Offer Free Promo Help for the Asking," *Nation's Restaurant News*, March 2, 1992, p. 39. See also Paul Moomaw, "Two Heads (and Two Pocketbooks) Are Better Than One," *Restaurants USA*, January 1991, p. 12; Katie Fairbank, "TV Advertisers Seek to Cash in on Movie Characters' Cachet," *Dallas Morning News*, June 11, 2003, p. 1A.

6. James W. Damitio and Raymond S. Schmidgall, "Bartering Practices in the Lodging Industry," *Hospitality Research Journal*, 1994, 17(3), p. 101. See also Mark Robichaux and Michael Selz, "Small Firms, Short on Cash, Turn to Barter," *The Wall Street Journal*, November 26, 1990, p. B1; Peter D. Meltzer, "Bartered Bucks," Food Arts, July/August 1993, p. 41; Michael Selz, "Health-Care Bartering Seen as a Money-Saver," *The Wall Street Journal*, December 23, 1993, p. B1; Sarah Hart Winchester, "Cutting Costs Without Cutting Quality," *Restaurants USA*, March 1995, p. 13; M. Franner, "Creative Financing," *Foodservice and Hospitality*, July 1995, pp. 15–16; Leon Stafford, "Tourism Officials Barter to Stretch Tight Advertising Budgets," *Atlanta Journal-Constitution*, May 15, 2003, p. D1. See also Robert Selwitz, "Increased Exposure, Cash Savings Are Benefits of Bartering," *Hotel & Motel Management*, Aug. 2005, Vol. 220, Issue 14, p. 101–125.

7. Ira Apfel, "Trading Places," *Restaurants USA*, May 2001 (available at http://www.restaurant.org/rusa). See also Bob Ortega, "Swap the Sweat of Your Brow for a Suite Right on the Beach," *The Wall Street Journal*, June 16, 1995, p. B1; J. Damitio, M. Malk, and R. Schmidgall, "Smarter Barter," *Lodging*, July/August 1993, pp. 45–48.

8. Robert Liparulo, "Food as Currency," *Restaurants USA*, September 1993, p. 20. See also James W. Damitio and Raymond S. Schmidgall, "Bartering Activities of the Fortune 500 and Hospitality Lodging Firms," *International Journal of Hospitality Management*, March 1995, pp. 3–9.

## References (continued)

9. Jacquelyn Lynn, "Profiting from Smart Purchasing," *Restaurants USA*, April 1996 (available at http://www.restaurant.org/rusa). See also Patt Patterson, "Review Purchasing List with Your DSR to Cut Costs," *Nation's Restaurant News*, October 11, 1993, p. 18. See also Marilyn Tseng, "Food Purchasing Patterns in Purchase-driven Societies," *Public Health Nutrition*, May 2006, Vol. 9, Issue 3, p. 277–278.