

# Price and the Vendor

## CHAPTER

# 5

## Learning Objectives

After reading this chapter, you should be able to:

- understand the meaning of *price* as it relates to purchasing;
- prepare a market basket report;
- use a price index to analyze the impact of price and consumption on cost;
- distinguish between price and value;
- understand the following types of pricing in purchasing:
  - firm price
  - contract price
  - cost plus price
  - hedging
  - consignment purchasing and pricing
  - standing order contracts
- know how to select a vendor, including the following:
  - soliciting bids from prospective vendors
  - finding vendors from many sources
  - deciding to use a vendor or to buy from outside
  - making make-or-buy decisions
- award your business to a vendor by doing the following: reviewing consistency in purchasing and writing a credit memo, determining vendor reliability, determining vendor availability, reviewing vendor supplier services standards, evaluating vendor safety records and health concerns, and following through after a contract is signed.

## In Practice

*On the way back from their storeroom walk-through with Myla, the purchaser and chef began a conversation about product pricing. Chef Robert suggested to Scott, "You know, we need to do a better job with how we select vendors and establish prices."*

*(continues)*

(continued)

*Scott emphatically replied, "You're damn right about that! My gut tells me that things will be different."*

*The chef wasn't sure about Scott's commitment to do what was really necessary. He answered, "Yes, that's true. What do you think about documenting the vendor selection processes? That would go a long way toward creating transparency and inspiring confidence with Myla."*

*Scott seemed unconvinced. "Sure, sure, but I'm not sure about Myla's intentions. Seems to me she's got a chip on her shoulder."*

*Robert stopped and looked at Scott, surprised. "Her intentions are pretty clear to me. Just look at the last operational audit reports. We flunked. We provided absolutely no evidence of vendor and pricing review before awarding contracts. That's not a chip on her shoulder, that's our faulty practices."*

## INTRODUCTION

When you are shopping for yourself, price is always an important consideration, and it helps you determine where to shop. Price is no less important for a professional purchaser. Understanding the functions and recommendations detailed in this chapter will help you reach your goal of saving your company's money when selecting a vendor. In the food and beverage industry, the circumstances and methods of purchasing are unique and somewhat more complex than shopping for home use. In this chapter, you will learn about both the pricing considerations you will encounter and the tools and methods you can use to help make good buying decisions.

For the purposes of purchasing, price simply means the cost at which something is obtained. It is the monetary value set by the vendor for the products and services delivered to the point of use. In addition to the base price, price also includes applicable discounts, the terms of sale, transportation costs, taxes, and insurance.

As the purchaser, you will have to have some idea about the proposed menu prices, probable operating costs, and target customers while designing the menu. If your restaurant is a drive-through diner, caviar and filet mignon will not likely show up on the menu or purchasing specifications; the prices for these items don't match the budgets of a diner's typical customers. The objective of price evaluation, then, is to ensure that the price paid is reasonable in terms of the market, the industry, and the end use of the product to be bought. In addition, understanding of prices is necessary to isolate and eliminate items that carry an unnecessary cost. The price of an item may, at first glance, appear to be very simple to determine, but it can be rather complicated.

You will need to become familiar with how the vendor prices the needed items. Some vendors may charge you more if you order a partial case or pack size of their product because they have to spend extra money to repackage it for you. You must decide whether to buy an entire case to avoid this high cost or to carry extra inventory that you don't need. It may be cost-effective to buy a few individual cans of 46-ounce tomato juice instead of a case of 6-ounce cans. It all depends on your operation's usage and storage space. Also, you should be familiar with price history, including how and why the price of an item has fluctuated in the past. At times you will have to forecast future prices to advise managers of important changes, particularly if you have a catering department. All of this calls for maintaining a record of price history. The next section discusses **market basket analysis** and price indexing, two methods of keeping such records. Later, we will discuss the pros and cons of various pricing arrangements so that you can make good purchasing decisions.

### **market basket analysis**

compares purchase prices over time and across vendors to build reveal patterns in price fluctuations.

## MARKET BASKET ANALYSIS

Any food-service business experiences price fluctuation. It is up to management to identify the pattern of the fluctuation and act on them. First, the manager should set a particular date, preferably at the beginning of a month. This is called the “base month”. The price paid for food and beverage product in the base month can then be compared to future purchase price. The analysis of base month prices and future product prices will reveal the cost impacts of price changes by delineating the difference between vendors.

This type of analysis also provides a statistical monitor of vendors’ pricing. Seasonal patterns may reveal plainly the benefits of competitive purchases from different vendors. The chart in Figure 5-1 illustrates a sample market basket analysis of four types of berries from two vendors. We examine purchase prices over a four-month period. Note how the price changes are very different for the two vendors. Assume that the Total Purchased column actually reflects individual items purchased for the four-month period. Note the price changes in purchases from the respective vendors, here called Vendor A and Vendor B.

From Figure 5-1 it is clear that buying from Vendor B is the better choice—as long as we can presume that quality and supplier services are equal, and price is the only variable. In the example, the company has loosened its own standards of buying berries competitively: Though Vendor A’s prices have climbed steadily, the purchaser consistently has bought much more product from the vendor with the higher prices. Some purchasers make the opposite mistake—changing vendors every week to take advantage of the lowest prices. The additional costs of this approach may be more than you would save, however. Chapter 4 and 6 discuss some of the associated costs of this kind of buying.

Rebecca Charles, owner of Pearl Oyster Bar in New York, was asked, “How many seafood purveyors do you use?” She answered, “I have about four or five, three just for lobster. In a perfect world, I’d like to have one consistently, but, with the amount we use, I can’t afford to pay 50 cents more to one because he’s a good guy. I tell them, you’re not my friend, you’re my fish guy. It’s a balancing act between quality and the best price. Getting a good price is important because I price my menu as cheaply as I can to stay competitive. Providing value to the customer is important to me.”

*Source:* Caroline Perkins. “Profiles in Partnership” *National Restaurant News*. April 24, 2006, p. 18.

## Survey

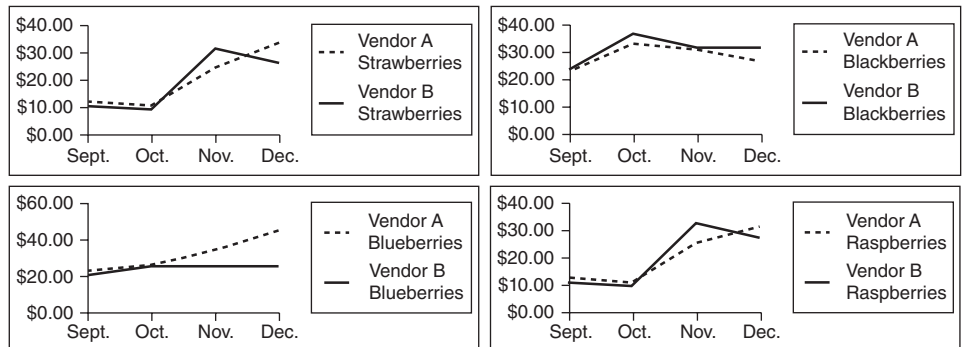
The market basket survey is not complete until the percentages of total issues are applied to the average increase of price for each category. This is what was consumed versus what was purchased. If the product has not been consumed, it is not affecting your cost because it is part of your inventory value on hand. You can learn a great deal about usage patterns in this way, and you can monitor the corresponding impact on your costs. In fact, this is a vital part of your record-keeping.

If your system is computerized, this can be simply part of the program. Furthermore, with the aid of the computer you can expand on market basket analysis by introducing an automated inventory and purchasing system that weights your results based on the percentages of total issues as mentioned above. This means the system gives more importance to items when you use more of them. If you use a great deal of an item, such as tenderloin, and the price rises even a small amount, this affects price fluctuation remarkably. On the other hand, if you use less of

Figure 5-1 Market Basket Survey

Market Basket Price Survey					
September thru December					
Prices per Flat of Berries					
Names of Items	Sept. Price per Flat	Oct. Price per Flat	Nov. Price per Flat	Dec. Price per Flat	Total Purchases from Vendors
Vendor A Strawberries	\$12.20	\$10.51	\$24.88	\$34.38	\$4,620.74
Vendor B Strawberries	\$10.48	\$9.14	\$32.09	\$26.74	\$590.98
	Sept.	Oct.	Nov.	Dec.	
Vendor A Blueberries	\$22.63	\$25.50	\$33.53	\$44.68	\$2,312.23
Vendor B Blueberries	\$19.89	\$24.88	\$24.88	\$24.88	\$169.09
	Sept.	Oct.	Nov.	Dec.	
Vendor A Blackberries	\$22.52	\$32.74	\$30.45	\$26.07	\$2,089.13
Vendor B Blackberries	\$23.33	\$36.25	\$31.33	\$31.33	\$426.32
	Sept.	Oct.	Nov.	Dec.	
Vendor A Raspberries	\$12.20	\$10.51	\$24.88	\$30.88	\$2,551.07
Vendor B Raspberries	\$10.48	\$9.14	\$32.09	\$26.74	\$346.22
Total Purchased from vendor A					\$11,573.17
Total Purchased from vendor B					\$1,532.61

Graph to illustrate the above results



another item, such as a rack of lamb, and the price changes substantially, this will not likely have such an effect on your averages because of the low amount actually purchased and used. In addition, in an automated system, these weighted base-period prices rotate each month (for example, January 2008 is compared to January 2009). Seeing this comparison assists you in making projections, since financial reporting results are most often compared to the budget and to prior-year statistics.

Unit prices are multiplied by the number of units purchased in the present period. The value of the total purchases is compared in present-year and prior-year dollars, and a percent variance is then generated. The advantage of the weighted system can be seen when we make

calculations using a traditional method and when we weight the results. Note how the following two examples (Figures 5-2 and 5-3) come out quite differently.

**Figure 5-2** Price Comparison

	2008	2009	Variance	% Variance
Tenderloin	\$8.10	\$7.40	<\$.70>	<8.64%>
Lamb Rack	\$11.00	\$12.10	\$1.10	10.00%
Total Meat	\$19.10	\$19.50	\$0.40	2.09%

It appears in Figure 5-2 that the total meat category has suffered a price increase of 2.09 percent. However on the other hand, using the weighted inventory purchasing system method, and therefore weighing the sales mix into the equation, a different conclusion is reached, as shown in Figure 5-3.

**Figure 5-3** Price Variance

	2008	2009	Variance	# Lbs. Purchased	2008 Value	2009 Value
Tenderloin	8.10	7.40	<\$.70>	1000	8100	7400
Lamb Rack	11.00	12.10	\$1.10	300	3300	3630
					\$11,400	\$11,030
Dollar variance:	Purchases in 2008 dollars		=	\$11,400		
	Purchases in 2009 dollars		=	\$11,030		
	Difference		=	-\$370		
	Percent difference		=	-3.25%		

The total meat category actually indicates a price decrease of 3.25 percent because the tenderloin activity has a much greater impact than the lamb rack activity (1,000 pounds versus 300 pounds). Menus must be reviewed to accommodate fluctuating prices, and the reviews ought to include this weighting process. This accuracy in price assessment can provide you with a competitive edge in costing and in pricing.

Weighting your averages to achieve this accuracy is a form of what is called a **price index**. This is a set of numbers generated to indicate changes in product prices. The value of the market basket analysis is in developing a price index that will measure the effects of product price changes. This index can be used to compare multiple companies that offer different presentations of the same item. The basic food price index can be calculated yearly, quarterly, or whenever a menu changes. Whatever time period you choose, fix one month as a base month or benchmark; then, when you make comparisons, you can see how the price has changed. The most productive approach is to select fast-moving or high-turnover items in each of the following categories: meat, fish, poultry, fruit, vegetables, grocery, and staples. Choose an item to represent each category; the item you choose should account for over 10 percent of that category's sales. Figure 5-4 illustrates variances in prices.

Figure 5-4 shows variance for a selection of items from October to November. Columns A, B, and C are allow you to see exactly how much has been purchased. The price in Column D is the base, or benchmark, price. Column E is the amount the price has changed from the base,

**price index** A set of numbers generated via market basket analysis to indicate changes in product prices.

Figure 5-4 Variance Example

VENDOR A Item Description	A	B	C	D	E	F	G	H
	Units per Case	Unit of Measure	Cases Purchased Nov.	Base Price Oct	Variance From Base (e-h)	Variance Percen tage (f/e)	Unit Price Nov	Total Purchased Nov
<b>Bakery Section</b>								
Dough Cookie Choc Chunk	21	lbs.	3	\$1.48	\$0.27	18%	\$1.75	\$110.25
Dough Cookie Oatmeal Raisin	21	lbs.	5	\$1.16	\$0.24	21%	\$1.40	\$147.00
Dough Cookie Sugar	21	lbs.	6	\$1.01	\$0.54	53%	\$1.55	\$195.30
<b>Dairy Section</b>								
Cheese Blue Wheel Danish	12	lbs.	1	\$1.63	\$0.27	17%	\$1.90	\$22.80
Cheese Boursin Herb	3.75	lbs.	7	\$9.14	\$1.86	20%	\$11.00	\$288.75
<b>Grocery Section</b>								
Almond Blanched Sliced	18	lbs.	2	\$3.19	\$1.06	33%	\$4.25	\$153.00
Applesauce Fancy	6	#10 cans	6	\$2.99	\$1.11	37%	\$4.10	\$147.60
<b>Meat Section</b>								
Bacon Slab 9/13Ct	30	lbs.	24	\$2.14	\$0.36	17%	\$2.50	\$1,800.00
Beef Baron	65	lbs.	6	\$1.49	\$0.16	11%	\$1.65	\$643.50
<b>Produce Section</b>								
Alfalfa Sprouts Fresh	2	lbs.	48	\$1.24	\$0.21	17%	\$1.45	\$139.20
Apple Sliced IQF Granny Smith	30	lbs.	2	\$0.67	\$0.13	19%	\$0.80	\$48.00
<b>Seafood Section</b>								
Catfish Fillets	15	lbs.	5	\$3.41	\$0.59	17%	\$4.00	\$300.00
Clam Strip Brd Bulk	6	lbs.	3	\$2.37	(\$0.21)	-9%	\$2.16	\$38.88

while Column F is the variance expressed as a percentage of the base price. Column G is the new price per unit, and Column H shows how much was actually spent in November.

Looking at the seafood section, a price increase of 17 percent occurred in catfish filets between the base month and the current month. The total in purchases of catfish filets was \$300, derived by multiplying columns A, C, and G. This simple chart can be used to differentiate between vendor bids and to record price trends. It is somewhat abbreviated, however. To make the chart reflect your variances weighted by how much you actually used the items, you will need to add some columns and data, as shown in Figure 5-5.

List the new calculations across the columns horizontally, list your items vertically along the left side, and complete the data. These in-depth calculations can help you to see how prices have changed while considering how much product was used. This is a more accurate picture of price variation. It gives you a valuable tool for setting or changing menu prices.

Figure 5-5 Menu Pricing

Column/Title	Calculate/Enter
Beginning Period. (Column E in the above example.)	The actual price at the beginning of the period. This is the base or benchmark standard.
Ending Period. (Column H in the above example.)	The actual, or new, price at end of month or period.
Actual Change. (Column F in the above example.)	The actual increase or decrease per item and category. Formula: Beginning Period – Ending Period
Percent Change. (Column G in the above example.)	The actual change as a percentage of the beginning, or base, price. Formula: Actual Change ÷ Beginning Period
Average Percent Change.	Total all Percent Changes in a category. Then, divide that total by the number of items in the category.
% of Total	This is the percentage that a certain category comprises of your total food cost. This information will be generated from the receiving and distribution module of your inventory system, if you are on a computerized purchasing and inventory system.
Average Numeric Change	Total all Actual Changes. Then, divide by the number of items in the category.
Weighted Changes	Multiply “% of total” by Average Change during the period, then divide by 100; this <i>weights</i> the variances based on how much was sold from that category.

## THE RELATIONSHIP BETWEEN PRICE AND VALUE

Price is the monetary value applied to a product by a vendor, while value is how much the product is worth to the purchaser. Value takes into consideration other things that are valuable to you as the purchaser, such as delivery and service. It is the purchaser’s responsibility to obtain the best *total* value; this means that price is only one element. Although price is often the only tangible measure of value, the purchaser must relate this price to the other elements of value. Putting a value on a vendor’s services is subjective, but it’s important to know exactly what it is about a vendor’s service that influences your decision to purchase from them. You might want to include these intangible qualities in future purchase specifications. Think about it from the perspective of your customers: If the vendor consistently delivers high-quality products on time, the customer’s experience of your establishment will be affected positively. And it is the customers who will ultimately decide whether or not they are getting value for their money.

## TYPES OF PRICING ARRANGEMENTS

To establish a written, binding contract, a definite price should be set forth in the purchase order. This may be either a specific price or a basis for determining a final price. In the case of standard items that have an established market price, such as beverages, even if you don’t put a price on the purchase order it is still a binding contract. This means you need to know what you want when you write a purchase order; you don’t want misunderstandings with your

vendors. The established practice to avoid confusion or even legal problems is to include either a specific price or a basis for determining a final price in the body of the purchase order.

There are several different kinds of price arrangements that you can make with a vendor. You might establish a firm price or a contract price; you might use hedging to establish a price for a period of time; or you may use consignment purchasing or standing order contracts to sell products as they are used. Each of these methods has its uses, as you will see below.

## Firm Price

**firm price** A price the purchaser and the vendor agree to that will not change until the material is delivered and the transaction is completed.

A **firm price** is the most commonly used pricing method in day-to-day purchasing transactions. It means that the price to which the purchaser and the vendor agree will not change until the material is delivered and the transaction is completed. This agreed-upon price may apply to a specific quantity of products, a set time schedule, or even an undetermined quantity within a given time period. Generally speaking, the establishment of a firm price should be the basic goal of the purchaser for each order, unless extenuating circumstances make it advantageous to make other promises, which could result in a lower net final cost.

## Contract Price

**contract price** A commitment to buy a group of items at a certain price.

A **contract price** is a commitment to buy a group of items—whether food and beverage products, chemicals, or office supplies—at a certain price. This type of arrangement is common in an agreement with a primary vendor which receives the bulk of your company's business. Some of your (or your vendor's) specific requirements may not be determined fully when the commitment is made; such laxity is common, if not recommended. The vendor is expected to maintain adequate quantities of these contracted items on hand in order to meet your day-to-day requirements. Vendors selected to participate in these arrangements must satisfy the company's purchase specifications.

When soliciting bids for contract pricing arrangements, you should also provide any necessary special instructions, your annual buying volumes, and the quantities you expect the vendor to have on hand. Plan to negotiate volume discounts during this process, since you are agreeing to buy greater quantities than normal and should be rewarded for it. The **cost-plus** method is one form of contract pricing.

**cost-plus** Pricing method which involves paying the vendor's actual product cost plus a certain, fixed percentage.

Cost-plus agreements are becoming popular in the food service industry. Under these agreements, your company pays the vendor's actual product cost plus a certain, fixed percentage to cover the vendor's unstable costs. Unstable costs, which should be defined in the contract, include labor, services, delivery, and other overhead items. When there is a high degree of risk involved, making costs difficult to estimate, this type of contract can be very beneficial. When vendors cannot estimate prices, they must add their own cushion (sometimes called *insurance*) to their quotes. They, too, must cover their costs. With the cost-plus contract, you will garner lower bids and pay more only when the vendor pays more.

In accepting a cost-plus contract, you are accepting the risk of price increases. You should only enter into this type of contract with a reputable, ethical vendor, so that you will pay a valid market price for your products. Furthermore, it is difficult to control your costs if prices escalate unexpectedly. Once the agreement is signed, the vendor may not have the incentive to shop cost-effectively because the conditions often stipulate that they have no competition for the duration of the contract. The vendor will be paid its cost plus the percentage, according to the terms of the contract, no matter what that cost is.

You do have one tool to be sure you are getting fair market prices, however. This form of arrangement usually offers you audit privileges of the vendor's cost files. You can check each product's prices against the prices you could get from other vendors in the same time period.



However, reviewing these records takes valuable time, and an unscrupulous vendor could easily falsify those records. If such a contract is deemed wise given your circumstances, choosing an ethical vendor is crucial.

## Hedging

**Hedging** is a contract on a future price. Purchasers use hedging to maintain a fixed price for a product or commodity they will need. The benefit of hedging is that you avoid the risk of increasing prices. Hedging is a common practice. It enables the company to pay a stable contract price for a future product irrespective of future market prices. Hedging is advantageous if you, as the purchaser, can determine how much product will be required based on the product's history, and if you can safely assume that prices will increase.

An example will illustrate the principle of hedging: Assume that a company wishes to lock in the price of a certain grade of beef tenderloin for the next 12 months. Meat prices usually change weekly and are based on supply and demand. The purchaser will review the following information before discussing the options with management:

- The establishment's past, present, and future consumption volumes
- The establishment's cash flow
- Bids from at least three vendors
- The market's price trends (as indicated in Figure 5-6)
- The amount of risk that the prices will not increase as assumed

Note: *The figures used in Figure 5-6 may not be representative of your area. They are only for illustrative purposes.*

You will have to weigh the risks and advantages of hedging before committing your company to such a contract. If the price you agree on is lower than the future market price, you will have saved money for your company. Other advantages include the following:

- Getting a better price without having to purchase a lot of inventory at once
- Protecting inventory values even if the market declines
- Guaranteeing delivery of food and beverage products without storage and other inventory control costs

On the other hand, the drawbacks of hedging include the following:

- The solidity of the commitment you must make, even if your needs change
- The risk of stocking excess product
- Any costs to resell or trade back unused product
- The large volume normally required to enter into such a contract
- The chance that prices may go down rather than up

The vendor also hedges his or her purchase prices by using what is called the *buy hedge*. The following example shows how this works. Assume that on May 1, XYZ Suppliers sells you beef prime ribs for delivery on August 1. The price they charge is the price as of May 1. XYZ Suppliers has three choices in this situation. They can buy the beef in May and hold it until they deliver it to you on August 1. This would establish the price of the beef, but it would incur storing and interest costs, possible quality problems, and an insurance cost on the beef until it is used.

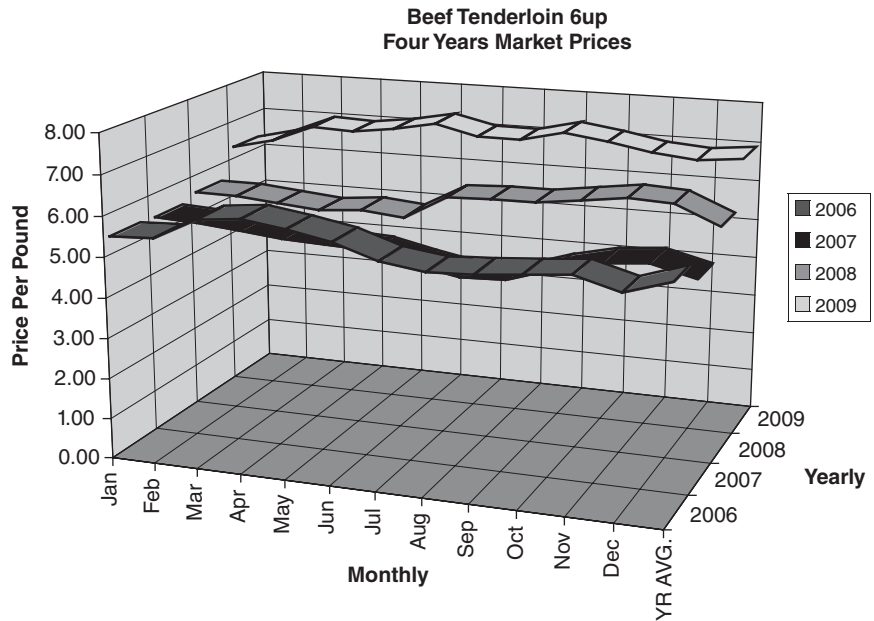
**hedging** is a contract on a future price, entered into to maintain a fixed price for a product or commodity you will need.

### ⑩ Discussion Points

Let's assume Company A entered into a cost-plus contract: In the first year there was a 9 percent markup on the product, and in the second year the markup was 8 percent. Before purchasing any product at the beginning of the second year, the manager changed the prices for on-hand products to reflect the new 8 percent contract. Now, inventory items are extended with the new markup percentage. Do you see any problem with this practice? Why or why not?

Figure 5-6 Beef Tenderloin 6 UP

Beef Tenderloin Price History Average Index - Price Per Pound													
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YR AVG.
2006	5.40	5.45	6.00	6.10	5.95	5.75	5.40	5.25	5.30	5.40	5.50	5.20	5.56
2007	5.35	5.30	5.20	5.10	5.05	5.00	4.75	4.55	4.60	4.95	5.20	5.30	5.03
2008	5.50	5.50	5.40	5.30	5.40	5.30	5.90	5.95	5.95	6.10	6.25	6.20	5.73
2009	6.25	6.50	6.95	6.90	7.05	7.25	7.00	7.00	7.25	7.10	6.90	6.80	6.91



The second alternative is to postpone the beef purchase until just before the delivery date. This involves considerable risk, however, as the price of beef may increase; this could be a considerable loss for XYZ, since they have already established the sale price.

The third alternative is to utilize the buy hedge. In essence, XYZ is doing the same thing you do when you purchase with hedged prices. This will establish the beef cost without risk of price change and without incurring the cost of carrying inventory. In the buy hedge, XYZ purchases futures contracts at the time of the sales contract (May 1), and then sells these futures contracts when they actually buy the beef. Futures prices and cash prices tend to fluctuate together: Any profit or loss due to the change in the cash price of beef between May 1 and August 1 will be offset by a profit or loss in the futures contracts. Therefore, the transaction involved in the buy hedge is a wash; it comes out even.

**Cash Market**

May 1: Sell 4,000 pounds of beef  
at \$7.05 per pound

**Futures Market**

May 1: Buy 4,000 pounds of beef  
of August future at \$7.05

Thus, XYZ Suppliers has entered into two contracts of an opposite nature, selling in cash and buying in the future at the same price to avoid the risk of price changes between the time beef is contracted to you (May 1) and the time you will pay for it (August 1).

## Consignment Purchasing and Pricing

Consignment is a merchandising technique that promotes resale. Payment for the goods is deferred until they are resold by the buyer. In this system, the vendor will inventory the product on your premises. Your company doesn't own the consigned items until they are used or withdrawn from consignment stock. This type of purchasing is carried out on a very limited scale in the food service industry. However, it is a subject that requires discussion because it can be very helpful in some cases.

The drawbacks of consignment include the difficulty of segregating the stock and the locked-in pricing structure. Storage can also be a concern. An outside or public warehouse may be used to store consigned goods, or the buyer may offer free storage on the company's premises. This may involve extra indirect warehousing and handling costs to the buyer.

However, purchasers have adopted consignment techniques successfully to reduce their companies' inventory investment and to provide immediate access to required items. Care must be taken to minimize consignment of products with high obsolescence or short shelf life.

In order to use consignment purchasing properly, the purchaser must agree to monitor and audit the consignment inventory. One of the principal reasons vendors may not wish to consign stock is their concern that the purchaser will not account for their merchandise properly. In addition to showing the vendor that it will gain more business through consignment, the purchaser must also be able to show the vendor that proper accounting controls will be used. Three principal controls on consigned inventories are identification, segregation, and monitored use. The vendor must identify on the packing list which items are consigned in order to prevent their being mixed with the regular inventory. If consigned inventories become a significant portion of the buyer's inventory, separate colored receiving reports and identification tags may make this process more clear.

The second control involves the physical segregation of consigned inventory. Since the vendor will normally maintain the insurance on consigned inventory, the purchaser must ensure that the merchandise will be stored in a protected space with safeguards against fire, theft, and other hazards.

Third, the purchaser must control the use of the consignment inventory. One of the more frequent abuses of these inventories happens like this: Someone from the kitchen realizes he or she doesn't have enough stock for the dinner period. The purchaser has left for the day, but the kitchen needs the item in a hurry. Someone from the kitchen removes the product from the consignment inventory but fails to write down what he or she took, and the purchaser doesn't even know the item was taken until the vendor checks the inventory and finds the shortage. Unfortunately, this kind of abuse can take place continually unless storeroom access is restricted or monitored. If the vendor consigns product that the buyer cannot reliably account for, the vendor will soon cancel its participation in the arrangement.

The success or failure of consignment depends largely on the accounting controls assigned to it. You must be able to indicate clearly to the vendor the releasing, receiving, disbursing, and reimbursement procedures you will use. All of these procedures should be covered in a written contract with the vendor. Consider these points in your accounting and inventory control procedures:

- Allow the vendor to inspect consigned inventory.
- Establish a schedule for disbursing the consignment inventory.
- Set minimum and maximum inventory levels for consignment items.
- Request an independent inventory-taking service for your company, as well as a periodic audit of controls, and have all findings reported to the vendor.
- Set a date for the maximum amount of time an item may be retained in consignment, keeping in mind shelf-life problems.

### **consignment purchasing**

A merchandising technique in which payment for the goods is deferred until they are resold by the buyer.

- Establish a procedure for handling discontinued or obsolete items so that they are not reordered.
- Establish a product-rotation procedure.
- Reduce vendor invoices by using a disbursement report on items taken from the consignment inventory.

As part of the regular inventory of consignment items, you'll need to prepare a report to serve several purposes. In this report, list all disbursements; this way, the report can be used to pay the vendor. Depending on the terms of the contract, more often than not you will likely also pay for missing stock items.

You can also use this report to reorder items that are falling below the minimum levels. This type of report will also give each product an individual item number. List your beginning inventory, everything you receive, everything you disburse, anything you reject, and your ending inventory. Other important data includes unit prices, par levels, and items you wish to reorder.

### Quiz

Committing to a long-term agreement on purchase quantity and a fixed price for goods regardless of market price fluctuations is called

- firm price.
- contract price.
- hedging.
- none of the above.

**standing order** An arrangement made with a vendor to deliver specific goods on a regularly scheduled basis.

**first in, first out (FIFO)** Method of inventory valuation and management in which cost of goods sold is charged with the cost of raw materials, in-process goods and finished goods purchased first and in which inventory contains the most recently purchased materials.

## Standing Order Contracts

The term **standing order** refers to an arrangement made with a vendor to deliver specific goods on a regularly scheduled basis. However, since you are not sending a specific purchase order preceding a delivery, you may easily get products you don't need. Product rotation and credits for obsolete products are normally parts of a standing order agreement; be sure that this condition is respected, so that you do not lose money on spoilage.

The person delivering such an order should deliver enough goods to reach a predetermined amount, stock the product using the **first in, first out method**, and immediately write an invoice stating the amounts delivered. Standing orders are convenient, especially if the purchaser knows how much the restaurant will use, as is often the case with daily deliveries of bread or milk. However, there are important disadvantages to standing orders, as follows:

- Storeroom access and security must be more consistently monitored.
- It may be more expensive than other purchasing methods.
- In some cases deliveries are not verified and invoices are not signed before the delivery person leaves the premises.

## VENDOR SELECTION

As a consumer, you select a grocery store based on your own needs and criteria, whatever they may be—the availability of organic produce, a convenient location, low prices, delivery service, widest selection, or other qualities. You might check weekly advertisements or visit different

stores to evaluate their offerings. You choose a store or stores, and you constantly evaluate whether you are getting the value you want for the services and products you buy. You must also decide whether to buy raw ingredients and make everything from scratch, or to purchase prepared foods that take less time at home. These questions are tied in with pricing, quality, taste, service, and other considerations. This chapter deals with these same questions at the professional level: How do you go about selecting vendors? And how do you make decisions about product choices from those vendors?

## Competitive Bids from Vendors

After you identify purchase specifications and completing product testing, competitive bids from vendors come into play. Competitive bids are the price and quantity proposals that vendors present to your company. The purchaser should solicit and select from at least three bidding vendors. There is no harm in entertaining a bid; just be sure to verify the prices periodically to ensure that quoted prices remain within your company guidelines. Use the form in Figure 5-7 to monitor competitive bids.

**WEEKLY FOOD BID FORM** Date Received: \_\_\_\_\_  
Prepared By: \_\_\_\_\_

**BID IN EFFECT FROM:** \_\_\_\_\_ (DATE) **TO:** \_\_\_\_\_ (DATE)

Product Number	Item Description	Pack Size	Brand Name	Unit of Measure	Vendor	Vendor	Vendor	Vendor

**Figure 5-7** Weekly Food Bid Form

You may need to find vendors proactively so that you can get the best price available. You can identify vendors through the following means:

- Carrying out a specific investigation involving a supplier and a trial transaction
- Choosing from an established list
- Making a routine selection based on the purchaser’s experience
- Using a well-established, well-known company
- Consulting a classified directory
- Reading manufacturers’ catalogs and sales literature
- Consulting industry sources such as professional associations
- Interviewing salespeople or other buyers
- Attending trade and product shows

Sometimes the process of selecting a vendor is subject to outside limitations. Some procurement is restricted to domestic sources by the terms of the Buy American Act. If they are legal, reciprocal agreements between countries or companies may narrow the purchaser's choices. The desire to exploit a particular technology or the resources of an affiliate may also be restrictive. Legal factors occasionally restrict the free selection of bidders as well. Warranty requirements, patent rights, license agreements, or other obligations may prevent either buyers or sellers from attempting to purchase or to market products. It is important to understand what boundaries influence the process in your geographic area and in your company.

Once the bids have been received, the purchaser and the manager should review several vendor characteristics to determine compliance with established specifications. Consider having a primary vendor in order to offer a large amount of business to one dependable company. Doing so can lower your prices dramatically. Also consider the following "vendor selection" factors to determine if the vendor is the right choice for your company:

#### Vendor Selection Criteria

- *Quality needs.* Understanding and communicating your quality needs is essential for a good vendor-purchaser relationship. It is accomplished through adequate and accurate specifications, educating the vendor, and a visit to the vendor's facility.
- *Sales support and other services.* This should be verified based on past performance and on reference checks with current business affiliates.

When Rebecca Charles, owner of Pearl Oyster Bar, was asked, "What do you look for in a distributor?" she responded, "It's all about the relationships. I've followed one saleswoman through three companies. If there is a problem with the cheese they deliver she'll come over and take care of it. She'll even go to the local retail cheese store and buy a replacement if necessary. That's the sign of someone who has been in business for a long time. That's rare in New York."

Source: Caroline Perkins. "Profiles in Partnership," *Nation's Restaurant News*. April 24, 2006. p. 18.

- *Necessary contractual obligations.* These obligations should be reviewed to ensure compliance and to prevent legal restrictions and enforcement.
- *Technical capabilities and support.* This is necessary if the product is of a technical nature.
- *Manufacturing capabilities.* The vendor should, when appropriate, be able to control its own production, thereby reducing problems with its suppliers. The vendor should also be able to provide a realistic production schedule.
- *Management capabilities.* The vendor must have the ability to provide all required supplier services, to ensure back-up inventory on hand, and to offer consistent delivery schedules.
- *Financial strength.* This is crucial in preventing interruption of supply.
- *Labor-to-management relations.* Historically poor relations between a vendor's labor and management often result in erratic delivery performance and inconsistent product quality. Strikes or labor disputes may affect the vendor's service to your company.
- *Past performance.* This provides insight into probable future performance.
- *References.* These are good indicators that establish history with other buyers, yet they are not by themselves a sufficient indicator of a reliable vendor.

- *Pricing structure and incentives.* These should be reviewed in order to ensure that you take maximum advantage of your purchasing power. Find out if the vendor offers incentives for early payment schedules. In turn, increased purchases from the vendor could help free cash-flow constraints.
- *Favorable delivery schedules.*
- *High ethics and no conflicts of interest.* See details about this issue in Chapter 3.

After receiving all bids, purchasers and other decision-makers should make a selection that best satisfies the various interests of the company at that particular time. These can change, and you may find better deals or more valuable services with other vendors. Just make sure you comply with contractual obligations with current vendors. When terms expire, you can renegotiate for better terms or find other vendors.

## The Make-or-Buy Decision

As discussed in Chapter 4, many vendors offer products already prepared into portions. You won't incur the labor cost of portioning these items, nor will you pay for waste when you prepare them. These products also cost you more, so you must evaluate whether you can prepare them in-house at a lesser cost. Your yield tests will show you the waste and labor costs of preparing the items; you should measure these costs against the cost of buying the items already prepared. This is called the make-or-buy decision, and it is something you will probably face almost every day in purchasing.

This kind of decision is usually reserved for the most expensive items and for high-volume items. As the purchaser, it is your job to see that all relevant costs are considered, so that you can make an informed decision regarding whether to make or buy the product. To do so, you must evaluate what is called the **prime cost**.

Prime cost factors in the many variable "hidden" expenses that operators incur (whether they realize it or not) when they process products on-site. The term *prime cost* refers to labor, material, and overhead costs incurred in product preparation. Figure 5-8 illustrates the difference in case cost and prime cost to convert bulk celery to diced celery. This example takes you through the stages of produce preparation, adding the costs of each stage to the original case price of the celery. The as-purchased price of \$13.50 is only a fraction of the post-preparation, end-product prime cost of \$36.22.

This example is presented to demonstrate the possible impact of a make-or-buy decision involving a food product. There are many hidden costs in preparing products, and you will need to consider which ones affect your cost in each case. Some of these costs include the following:

- *Managing the raw materials:* ordering, receiving, inspecting and storing
- *Utility costs:* water usage, refrigeration, storage, and waste disposal
- *Labor costs:* underutilization of labor capacity, delays and downtime, scheduled and non-scheduled breaks, training, taxes, FICA, insurance, and so on
- *Employee support and training, supervision, and quality control*
- *Workstation preparation, cleanup, and employee hygiene*
- *Additional square footage required for prep and equipment needs*
- *Lost time due to work-related injuries*
- *Value added:* when you purchase prepped products, you get 100 percent of what you buy; consistency and better inventory controls comprise some of the added value

Use a chart like the one in Figure 5-8 to analyze your make-or-buy decisions, and look out for these and other costs that might be specific to the item or to your company's circumstances.

**prime cost** The labor, material, and overhead costs identified in product preparation.

Figure 5-8 Prime Cost Analysis

PRIME COST ANALYSIS			
Raw material:	<b>bulk celery</b>	Finished product:	<b>Diced</b>
Raw material gross weight:	<b>55 pound</b>	Finished product specification:	<b>1/4" dice</b>

1st Prep Stage: Clean, Cut, trim leaves			
Raw material	1 (no. of case) × \$13.50/case (cost)	=	\$13.50
Direct Labor	20 (min.) × .245 (cost per min.)	=	\$4.90
Indirect Labor	4.9 (direct labor cost) × 25% (indirect %)	=	\$1.22
Waste	55# (gross wt.) – 36# (yield) = 19 × .07	=	
	(waste cost per #)	=	\$1.33
	1st prep stage prime case cost total	=	\$20.95

2nd Prep Stage: Hand Dice			
	1st prep stage prime case cost	=	\$20.95
Additional direct labor	45 (min.) × 2.45 (cost per min.)	=	\$11.02
Indirect labor	11.02 (direct labor cost) × 25% (indirect)	=	\$2.75
Waste	36 (1st prep yield) – 34 (2nd prep yield) =	=	
	2 × .07 (waste cost per pound)	=	\$0.14
	2nd prep stage prime case cost total	=	\$34.86
	34 (2nd prep yield) = 2nd prep cost per #	=	\$1.02

3rd Prep Stage: Wash and Dry			
	2nd prep stage prime case cost	=	\$34.86
Additional direct labor	4 (min.) × .245 (cost per min.)	=	\$0.98
Indirect labor	.98 (direct labor cost) × 25% (indirect %)	=	\$0.24
Waste	+34 (2nd prep yield) – 32 (3rd prep yield) =	=	
	2 × .07 (waste cost per pound)	=	\$0.14
	3rd prep stage prime case cost total	=	\$36.22
	+32 (3rd prep yield) = 3rd prep cost per #	=	1.13*

\* Not including materials, cleaning supplies, electricity, water, and overhead expense allocation.

Courtesy of Costa Fruit & Produce.



## Considerations Before Awarding Business to a Vendor

Before awarding your business to a vendor, you have a great deal to consider. The vendor must meet or exceed your needs. Remember always that the vendor has to earn your business through ethical behavior, quality products, and service. Your relationships with your vendors are critical for the success of your establishment because your customers expect a great deal from you. For you to be able to provide high-quality service to your customers, the vendor must provide you with some very important guarantees: consistency in quality, reliability of delivery, availability of the products you need, supplier services that are pertinent to your unique needs, and adequate food safety. The following segments detail each of these components, and then describes what to expect after the contract is signed.

### Consistency

Restaurant customers rank **consistency** as one of their primary concerns when choosing where to eat. Without consistent products, it is impossible to provide consistent food, and you will lose customers because of it. Consistency in purchasing means that the products purchased remain the same at all times—in line with your written, detailed purchasing specifications. For this to happen, the purchasing manager must insist on consistency in quality and pack size. Deviations should be documented by the receiving clerk and communicated to the purchaser, the chef, and the restaurant manager. Consistency is an important basis for vendor evaluation. The results of such evaluation can tell you whether or not to terminate a purchasing agreement. Figure 5-9 shows one format for judging consistency. If used consistently to evaluate your vendors, this form is a good tool for monitoring and correcting product specification problems.

The starting point for verifying and monitoring product consistency is at the receiving dock. Receiving meats, poultry, and seafood items, for example, should not be left to an inexperienced receiving clerk. The chef or the butcher should be involved in evaluating a product's quality upon arrival. The receiving clerk can certainly assist with the counting and weighing of the items, as most food products are purchased and invoiced by count or by weight. It is prudent to verify the quality and weight of the product in the presence of the delivery person before signing the delivery invoice.

Discrepancies as a result of quality or quantity (including weight) may be handled by adjusting the invoice or by writing a **credit memo**. (An example of this form, as well as instructions for its use, appears in Chapter 6.) On the other hand, if the quality is not right, the purchaser and the chef may want to send the product back with the delivery person, assuming the operation can function without the product until the next delivery. Consider also the severity of the discrepancy. For example, if you received a delivery of less-aged beef tenderloin such as 5-up instead of highly aged 6-up beef, you may just wish to inform the salesperson and adjust the price accordingly. As long as the mistake is not a habit and the vendor corrects the error quickly, accepting the lower quality may not hurt your business. In either case, when you tell the vendor that you found the error, they will know you are checking closely and are less likely to make this kind of mistake again.

Consistency will also vary with the seasons. For example, during the winter months strawberries are scarce, and taste and cost are much more variable. You may have to change brands as the seasons change. Prices of off-season strawberries may be so high that you have to raise your menu prices or do without strawberries in the winter season. This holds true for many perishable products, especially produce.

Different supplier sources also affect consistency. Often, a purchaser will buy from different vendors from one week to the next in order to get a better price. These vendors will often differ in pack sizes, brand names, and product taste. Even the same vendor may discontinue

**consistency** In purchasing, means that the products purchased remain the same at all times.

**credit memo** Used to record a credit due from a supplier when the merchandise received does not conform to what was ordered. The discrepancy could be in terms of quality, quantity, specification, and/or price.

VENDOR EVALUATION FORM												
Vendor name: _____				Address: _____				Date: _____				
Type of product/services _____												
<i>If a rating is poor in any category, document carefully in PERFORMANCE DETAILS section.</i>												
CATEGORY	Rating (zone)			CATEGORY	Rating (zone)			CATEGORY	Rating (zone)			
	Excellent	satisfactory	Poor		Excellent	satisfactory	Poor		Excellent	satisfactory	Poor	
Quality	Inspection			SERVICE	Inspection			COST	Price			
	Performance				Performance				Discout			
	Maintenance				Maintenance				Overall appraisal of vendor: After considering the performance rating			
PERFORMANCE DETAILS												
Quality	_____											
Service	_____											
Costs	_____											
General Comment	_____											
Alternate source: can you recommend a better source. If yes indicate												
Vendor name: _____				Address: _____								
Prepared by: _____												
Name: _____				Title: _____				Date: _____				

Figure 5-9 Vendor Analysis Form

a product or run out of a popular item. Because of this, the purchaser and the chef must consider substitute products from time to time, and the manager will have to respond to any guest concerns about inconsistent quality and presentation. What it all comes down to is that maintaining a consistent product involves a great deal of cost and everyone's effort. Everyone must cooperate to monitor quality while remaining flexible to deal with contingencies. The goals, as always, are to stay in business and to remain profitable.

## Reliability

Although it is difficult to gauge overall vendor reliability, this criterion is important because it affects the long-term success of doing business with a particular vendor. In the food service industry, you cannot afford to run out of a menu item on a regular basis because of supplier problems. For example, guests expect that you'll have coffee, tea, and juices at breakfast. You have to be able to depend on the vendor to maintain a steady inventory and timely delivery. On the other hand, reliability goes both ways. For example, the vendor should be able to trust that your company will pay invoices on time and that the purchaser will review their product fairly against other competitors. Vendors go to great lengths to win your business; your part of the bargain is to assure fair and timely treatment. This will go a long way toward building a good relationship with a vendor, and they should respond with equal efforts.

To measure reliability, look at the "vendor selection criteria" list above, and determine whether your vendors have those characteristics. They are excellent gauges of how to select a vendor.

## Availability

Availability should be a primary consideration in all purchases. Availability of food products depends on the season, on demand, and on supply. For example, most vegetables and fruits are seasonal, as Figure 5-10 shows.

Berries are often seasonal as well. The disproportionate demand and supply of berries during winter months is mostly to blame for their escalating prices. Without intimate knowledge of a product's history, it is difficult to say why availability fluctuates. However, monitoring availability and planning for shortages are part of the purchaser's job. When selecting a vendor, assess the vendor's history regarding product availability by asking the following questions:

- *Quantity:* Will the vendor be able to meet your company's needs sufficiently at all times? This is important for planning because you don't want supply problems at a critical period in the season.
- *Rate of usage:* At what rate does your company use the product? Use this information to coordinate deliveries. It's important to establish that you want availability but you don't want to have to buy excessive inventory.
- *Lead time:* How long will it take the vendor to get my order to you? This can easily affect your choice of supplier.
- *Long-term commitment:* How long can your company rely on the source of supply? Consideration of long-term availability is important for meeting your continuing needs. For example, you don't want to look for a new milk vendor each week to replace a short supply.
- *Transportation:* How far away is the source of the products? This characteristic can limit availability in some circumstances. If your operation is in a remote area, or if there are few delivery options, you may need to consider transportation carefully.

Figure 5-10 Availability Form

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	
<b>Fruits</b>													
Apricots	x				x	X	x	x				x	
Cherries	x	x		x	x	X	X	x				x	
Limes	X	x	x	x	x	X	X	X	X	x	X	X	
Melons	x	x	x	x	X	X	X	X	X	x	x	x	
Tangerines	x	x	x	x	x					x	x	x	
<b>Vegetables</b>													
Beets	x	x	x	x	x	x	X	X	X	x	x	x	
Cabbage	X	X	X	X	X	X	x	X	X	X	X	X	
Eggplant	X	X	X	X	X	X	X	X	X	X	x	x	
Herbs, Fresh	x	x	x	x	x	x	x	x	x	x	x	x	
Spinach	X	X	x	x	x	X	X	X	x	x	x	x	
<b>Specialties</b>													
BabySquash	x	x	x	x	x	X	X	X		x	x	x	
Jicama	X	x	x	x	X	X	X	x	x	x	X	X	
Shallots	x	x	x	x	x	x	x	x	x	x	x	x	
xRegular Availability									X Peak				
Season													
Source: Nobel/Sysco Fruit and Vegetable Availability Chart.													

## Supplier Services

Supplier services must be considered in every price evaluation. Just as the quality of a product purchased at a competitive price is a yardstick for measuring the efficiency of procurement, so too is vendor service quality an important yardstick for selecting one vendor over another. Good vendor services can be a true help during your busiest times by helping you to run smoothly, without interruptions in deliveries; by offering technical support; and by keeping good records. Then again, a vendor might not offer anything special to you, or may not even notice how busy you are. You can have either kind of vendor; which would you prefer?

Vendor services generally consist of one or more of the following:

- *Handling of complaints:* A vendor should investigate complaints promptly and thoroughly, report the facts to the purchaser, and take corrective steps. This is a valuable service to the purchaser.

- *Prompt notification:* A good vendor will notify the purchaser if anything is happening or is likely to happen that might affect the purchaser's normal flow of products. Examples include embargoes, strikes, severe weather conditions, and equipment breakdowns.
- *Prompt delivery at all costs:* At times, events beyond anyone's control delay deliveries. Vendors demonstrate good service when they rush that delivery, particularly at their company's expense.
- *Correcting misunderstandings:* A vendor should be willing to make satisfactory adjustments for misunderstandings or clerical errors.
- *Technical support:* Large vendors such as Alliant and Nobel/Sysco sometimes provide electronic purchasing software, user manuals, and even computers to qualifying purchasers. They have invested in technology to enhance the software and to make it more user-friendly. Placing orders through these systems generally averages 25 percent less time than placing orders manually.
- *Reports of purchases:* Most vendors will provide, upon your request, a detailed history of your purchases. This can be a useful planning tool.
- *Customer service:* A good vendor may have a knowledgeable, toll-free customer service line, and you should be able to contact them during your business hours. The local salesperson should be available for product or technical assistance.
- *Miscellaneous services:* Other habits by which vendors are judged include their fulfillment of promises, prompt remittance of credits, and track record backing up their bids.

## Safety

As a purchaser, you must be concerned with the suitability and safety of the consumable products offered by your vendors. U.S. Department of Agriculture (USDA) inspections and other federal regulations impose various standards with which you may have to comply. In 1990, Congress passed the Nutritional Labeling and Education Act (NLEA). This law was targeted at the packaged food industry, which was required to have food analyzed by a laboratory in order to substantiate nutritional information scientifically. In May 1994, Congress enacted a similar law to regulate food service operations that made nutrient and health claims on placards, posters, or signs. What all this means is that you must know what you are buying to serve to your customers. It is your responsibility to represent your products and nutritional claims truthfully. Both new and old products must comply with these regulations.

You must also learn about any upgrades and replacements that are needed for your existing equipment and facilities. Any establishment that knowingly or neglectfully serves bad food or beverages could be liable to fines and lawsuits. This is a moral issue as well as a legal one. One of the best ways to verify that the food you receive complies with regulations is to visit the vendor's plant, perhaps even unannounced. On visits, wear the proper attire for sanitary purposes.

Your vendor has a similar responsibility to you, and you should seek a vendor that knows the regulations, follows them to the letter, and helps to keep you informed of changes to your responsibilities and requirements. A vendor earns your business with many services and qualities, and one of these should be its knowledge and attention to the industry and its requirements.

## Awarding the Contract

When you do award a contract, tell the winner promptly so its personnel can make immediate plans to fulfill the purchase contract. Industry practices vary widely in terms of

informing losing vendors that they have not succeeded in this competitive bidding process. As a practical matter, it is neither expected nor necessary that unsuccessful vendors be informed on negotiations about minor, repetitive, or low-value purchases. On the other hand, it is good practice to advise losing bidders on major awards. The purchaser should not disclose the successful price to unsuccessful candidates, as all data should be confidential.

## After the Contract is Signed

The manager, receiving clerk, and purchaser should continue to track prices on every invoice. They should monitor that all specifications, quality, services, and prices are met. The purpose of watching these specifications is to be sure that the vendor is living up to its end of the contract. In some cases, the contract may allow for periodic review of progress by both parties. This is a good time to resolve variances from established specifications and delivery standards, if any, along with any other unforeseen issues or changes.

## SUMMARY

Pricing is a key consideration when selecting a vendor, and it informs many of the other decisions you make as you go through and repeat the ongoing vendor-selection process. To use pricing effectively, it is important to weight the prices based on your usage and to consider this factor seriously when deciding on a vendor. The bidding process helps you to see a cross-section of vendor offerings. You will also want to understand the various pricing arrangements, to be able to evaluate how each will affect your operation and to decide which structures are right for you.

However, vendors also offer other services and other qualities that are very important in your selection process. The vendor needs to work with you to offer the pricing arrangement you want. The vendors need to understand your quality needs, provide sales support and other services, and have the capabilities and financial strength to service your orders. Be sure to check references, and negotiate the best pricing incentives you can based on your business volume. The vendor you select should be of high ethical reputation and standards, so you can establish a trustworthy and dependable operation, free of questions about unethical practices.

Finally, you should evaluate potential vendors on their reliability, consistency, availability, safety, and quality of services. If a vendor fails to attend to your needs in these ways, there are many other vendors who would love to win your contract.

## CHAPTER QUESTIONS

### Discussion Questions

1. How can you improve the value of the purchase to the food service operator without altering the quality or end product price?
2. If you could buy preprocessed potatoes at \$0.75 per pound with 100 percent yield for a 50-pound bag, and you saved \$10 in labor costs, by analyzing prime cost, is it a better value to make or to buy the processed potatoes?

3. What vendor services are most valuable, and why?
4. What is the term for a commitment to a long-term agreement on purchase quantity and a fixed price for goods regardless of market price fluctuations?
5. What is the term for a method of procurement, normally used for perishable items, by which a specified amount of product is delivered on a regular basis?
6. When purchasing, what is the most important thing to consider? Please elaborate.

## CASE STUDIES

### Case Study 1: Make-or-Buy Analysis

“In my opinion, we ought to stop making our dinner rolls and accept that outside supplier’s offer,” said Mary, managing partner at Wuksachi Restaurant. “At a price of 15 cents per dinner roll, we would be paying 50 cents less than it costs us to bake the bread in-house. Since we use 150,000 rolls a year, that would be an annual cost savings of \$75,000.” Wuksachi’s actual cost to prepare these dinner rolls is shown below (based on 150,000 dinner rolls per year):

Direct material	\$20,500
Direct labor	\$36,200
Variable overhead	\$20,800
Fixed overhead (\$2.80 general company overhead, \$1.60 depreciation, and \$0.75 supervision)	\$20,000
Total cost per roll	\$0.65

A decision about whether to make or buy the bread is especially important at this time, since the oven used to make the bread is completely worn out and must be replaced. The choices facing the restaurant are as follows:

*Alternative 1:* Purchase a new baking oven and continue to make the rolls. The oven would cost \$18,000; it would have ten years of useful life and no salvage value.

*Alternative 2:* Purchase the dinner rolls from an outside supplier at 15 cents per roll under a one-year contract.

The new baking oven would be more efficient than the oven that Wuksachi Restaurant has been using and, according to the manufacturer, would reduce direct labor and variable overhead costs by 20 percent. The restaurant would use the space now being used to produce the rolls for storage and an additional refrigerator.

#### Your task:

1. To assist the director in the making a decision, prepare an analysis showing what the total cost and the cost per dinner roll would be under each of the two alternatives given above. Assume that 150,000 dinner rolls are needed each year. Which course of action would you recommend to the director?

2. Would your recommendation in (1) above be the same if the company's needs were: (a) 200,000 rolls per year or (b) 250,000 rolls per year? Show calculations to support your answer, with cost presented on both a total and a per-unit basis.
3. What other factors would you recommend that the director consider before making a decision?

### Case Study 2: Planning Future Purchases

Portobello Restaurant offers fresh orange juice in a 12-ounce glass as part of its breakfast menu. The orange juice costs the restaurant \$5 per gallon and is very popular with customers. The average order of orange juice per guest is 1.5 glasses. Below you will see the projected number of customers, by quarter, for 2005 and the first quarter of 2006.

	2005 Quarter				2006 Quarter
	First	Second	Third	Fourth	First
Projected Number of Customers	200,000	250,000	300,000	210,000	215,000

Orange juice has become so popular that even customer comments reflect its importance. It has become necessary to carry high inventories as a precaution against stock-outs. For this reason, the inventory of orange juice at the 50 gallons will be on hand to start the first quarter of 2005.

#### Your task:

Prepare a materials purchases budget for orange juice by quarter and in total for 2005. At the bottom of your budget, show the dollar amount of purchases for each quarter and for the whole year.