Effective Negotiation

Preparation: Section 2

Applying Financial Tools to a Negotiation
Learning Outcomes

At the end of this session candidates will be able to:

- Undertake risk assessment to prepare for negotiations
- Produce a SWOT analysis for a negotiation
- Assess legal information and its implications for negotiations
- Evaluate and analyse supplier tenders
- Identify and calculate elements of fixed and variable costs to prepare for a negotiation
- Examine different perspectives on fixed and variable costs
- Define and undertake a break-even analysis using marginal costing
Purchasing Situations

(Diagram from workbook by Tracey G Harwood)

<table>
<thead>
<tr>
<th>HIGH</th>
<th>LOW</th>
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<tbody>
<tr>
<td>Leverage</td>
<td>Strategic</td>
</tr>
<tr>
<td>products</td>
<td>products</td>
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<table>
<thead>
<tr>
<th>LOW</th>
<th>HIGH</th>
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</thead>
<tbody>
<tr>
<td>Routine</td>
<td>Bottleneck</td>
</tr>
<tr>
<td>products</td>
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Supply risk

Source: Kraljic (1982)

Effective Negotiation
Risk Assessment
(Drummond and Ensor 2003)

- Routine products – low risk
- Procedural problem products – adoption risks
- Performance problem products – needs and compatibility risks
- Political problem products – ‘ownership’ risk
SWOT

- Strengths (internal)
- Weaknesses (internal)
- Opportunities (external)
- Threats (external)

How should a SWOT analysis be used to assist negotiation?
Legal Terms

- Express terms
- Implied terms
- Statutory terms
- Illegal terms
Legal Framework

- Sale of Goods Act 1979
- Supply of Goods and Services Act 1982
- Data protection Act 1998
- Fair Trading Act 1973
- Competition Act 1980
- Unfair Contract Terms Act 1977
- Limitation Act 1980
Supplier Tender Evaluation

- All suppliers must be treated equally
- Set clear commercial, technical and financial criteria for evaluation
- Evaluate fairly against commercial compliance
- Evaluate fairly against ability to meet specifications on a technical basis
- Evaluate fairly on the basis of costs
- Analyse all tenders against objective criteria

*The DTI provide guidelines for suppliers and purchasers regarding preparing and analysing tenders*
Post-tender Negotiation (PTN)

PTN allows flexibility in the tender process and is used when further evaluation is required providing its cost does not outweigh any resultant benefits:

- For orders over £100K
- No one clear winning tender
- Clarification of terms and conditions is required
- Quality and performance clarification is required
- Longer-term supply (12 months or more)
- Challenge prices tendered

*Lysons and Gillingham (2003)*
Costs

- Every business has set up costs
- Just being in business has a running cost.
Costs

- There are basically 2 types of cost
  1. Some cost will be there whether an organisation makes anything or not and whether they sell anything or not.
  2. Other costs come about by nature of doing business, for example research & design, manufacturing, production, services, etc.
Costs

1. **Fixed costs** – do not vary with output (rent, rates, salaries)

2. **Variable costs** – vary with output (materials, operations labour/wages, utilities)

3. **Mixed costs** – mixture of fixed and variable (utility bills – standard/usage)

**Total costs** – sum total of all costs
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Effective Negotiation

Costs

COSTS

OUTPUT

Fixed costs
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Costs

Variable costs

Fixed costs
Costs

Fixed costs + Variable costs = Total costs
Semi-variable Costs (mixed)

Semi-variable costs (mixed costs) include a fixed and a variable portion, such as a telephone bill, which includes a ‘standing charge’ and a variable charge which increases dependent on use.

**Note** the following formula to identify both costs:

*Difference in costs at two production levels*

*Difference in two production volumes*
Example

Use formula to calculate the fixed and the variable cost components of power (electricity) for the following:

Making 500 units total cost of power = £6000
Making 1500 units total cost of power = £8000
Example

Making 500 units total cost of power
= £6000

Making 1500 units total cost of power
= £8000

Variable cost =

\[ \frac{\text{Difference in costs at two production levels}}{\text{Difference in two production volumes}} = \frac{£8000 - £6000}{1500 - 500} = \frac{£2000}{1000} = £1 \]
Example

Making 500 units total cost of power = £6000
Making 1500 units total cost of power = £8000

Variable cost =

\[
\text{Difference in costs at two production levels} = \frac{\text{ Difference in two production volumes }}{\text{ Difference in two production volumes }}
\]

\[
\text{£8000} - \text{£6000} = \text{£2000} = \frac{\text{£1}}{1000}
\]

1500 – 500 = 1000

Fixed cost = total cost at 500 units =

\[
500 \times \text{Variable £1} = \text{£500}
\]

\[
\text{£6000} - \text{£500} = \text{£5500}
\]
Costs

- There is a point when production sales will have covered all it’s costs known as **Break-even Point**

\[
\text{TOTAL COSTS} = \text{SALES REVENUE}
\]

- Any further sales after this point = profit

- **Break-even point** is liquid and thus changes as costs/prices change
Break-even Point

OUTPUT

COSTS

Sales revenue

Total costs

V costs

F costs

Break-even point
Breakeven Point

COSTS  Sales revenue  OUTPUT

Break even point

Total costs

V costs

F costs

Profit

LOSS
Contribution

Contribution (C):
Is what is left over after the variable costs have been deducted from sales revenue

Contribution =
Sales Revenue - Variable Costs

C = SR - VC
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Breakeven Point

Beyond breakeven point can be calculated from the formula:

Where the number of made units required \((N)\) to cover the cost to produce them

\[= \frac{\text{Fixed Cost}}{\text{Contribution} \text{ (per unit)}}\]
Beyond Breakeven Point

\[ B \ (N) \ = \ FC \ \boxed{\_\_\_} \ C \]

This information tells an organisation at which point production becomes profitable.
Formulae

Sales revenue – variable costs = contribution

Contribution – fixed costs = profit (or loss)

Break even = fixed cost
            contribution

When is marginal costing used in your organisation in a purchasing context?
Effective Negotiation

Session 3
Analysing Financial Contribution
Understanding the Financial Context of Negotiations
Learning Outcomes

At the end of this session candidates will be able to:

- Identify total costs and its constituents
- Differentiate between capital goods, consumables and materials and their value to and impact on the business and its operations
- Identify and calculate the components of typical costing models
- Apply the concept of supply and demand on costs and pricing in an organisation
- Identify techniques for financial benchmarking
- Analyse the potential for economies of scale in a negotiation
Cost Categories

- Category 1. Direct Costs
- Category 2. Indirect Costs
Prime Costs

- Category 1. Direct Costs
- (i) Materials (engine parts, oil)
- (ii) Direct labour (production operatives)
- (iii) Direct resource expense (equipment hire)
Costs

- Category 2: **Indirect Costs**
  - cannot be directly related to a specific product/service
  - (i) administration costs
  - (ii) management salaries
Costs in Manufacturing
(Diagram from workbook by Tracey G Harwood)

direct materials + direct labour + direct expenses

prime cost + manufacturing overheads

production costs + admin, sales & distribution overheads

TOTAL COSTS
Overheads

- Production
- Sales and distribution
- Administration
Absorption Costs

A principle whereby fixed as well as variable costs are allotted to cost units and total overheads are absorbed according to activity level.

The term may be applied where
(a) production costs only or
(b) costs of all functions are allotted.

When is absorption costing used in your organisation in a purchasing context?
Absorption Costs

Production overheads usually absorbed in one of six ways:

1. Total overhead for the period
2. Total units produced in period
3. Total direct labour hours per period
4. Total direct wages
5. Total direct materials used
6. Total machine hours
Services

- Why is costing services different to costing the making of a product?

- How are services costed in your organisation – or one you know well?
Suppliers Perspective

The strategy used for costing and providing prices by suppliers depends on what they want to achieve:

- Increased volume
- Improved profitability (ROI)
- Competitive parity

Why is it important to understand the supplier’s motives in a negotiation?
Pricing Methods

- Full-cost pricing
- Contribution pricing
- Mark-up pricing

*Why is it important for purchasing negotiators to understand how prices have been calculated?*
‘Open Book’ Costing

Advantages:

- Openness reduces conflict
- Greater reliance on negotiating skills
- Focus on value for both parties
- Potential to further develop relationship
‘Open Book’ Costing

Disadvantages:

- Power of the other party
- Competition may be alerted
- Partner could become your competitor
Transfer Costs

(Lambin 2000)

- Incorporating the new product into organisation’s production or operations
- Setting up new purchasing arrangements
- Additional equipment
- Training or other support
Goods and Services
(Van Weele 2000)

- Raw materials
- Supplementary materials
- Semi-manufactured products
- Components
- Finished products
- Capital equipment
- Maintenance, repair, operations supply (MRO)
- Services

*Purchasing add value to the organisation through cost effective and efficient negotiation*
Just in Time (JIT)

- Reduces stock handling and storage costs
- Reduces risk of obsolescence and therefore reduces waste
- Reduced stock holding costs
- Lower investment required

- Reduces overall costs if product quality improves
Value Chain

(Diagram from workbook by Tracey G Harwood)

Original idea Porter 1985, from Horngreen et al 2005
Typical Cost Model

(Diagram from workbook by Tracey G Harwood)

Based on Lambin 2000

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Cost-based Pricing

- Minimum price (‘Floor price’)
- Break-even price
- Mark-up price
  - $\text{Mark-up price} = \frac{\text{Break-even price}}{1 - \text{desired Mark-up}}$

- Target price
  - $\text{Target price} = \text{Direct Cost} + \frac{(\text{Fixed Cost/Expected Sales Volume} + \text{Expected Rate of Return on Capital Invested/Cost})}{\text{Expected Sales Volume}}$
Circular Logic of Pricing

(Diagram from workbook by Tracey G Harwood)
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Cost-based Pricing

- Circular logic shows that cost-based pricing using volume of supply do not necessarily reflect accurately the price of the product because it does not take into account:
  - Economies of Scale
  - Learning curve (e.g. Hat trade)
  - Increased cost saving over time due to experience, new equipment, different materials used, etc.
  - Supply and demand will also affect price
Experience Curve

(Diagram from workbook by Tracey G Harwood)

£

price

volume

Cumulative experience

Unit cost
Price Elasticity of Demand

- Price elasticity of demand = \( \frac{\% \text{Change in quantity demanded}}{\% \text{ Change in price}} \)
- Demand is inelastic when a substantial change in price makes little difference to the amount demanded for example:
  - Few substitutes, competitors
  - Buyers slow to change buying habits
  - Unaware or fail to challenge price increase
Price Inelasticity of Demand

(Diagram from workbook by Tracey G Harwood)
Price Elasticity of Supply

- Price elasticity of supply = \( \frac{\% \text{Change in quantity supplied}}{\% \text{ Change in price}} \)
- Demand is elastic when a price change will affect the demand for the product positively or negatively, for example:
  - A slight change in price will cause a substantial change in demand
  - Seasonal sale prices
  - VAT change
Price Elasticity of Demand

(Diagram from workbook by Tracey G Harwood)
Price Equilibrium: Perfect Competition

- Price equilibrium is when supply and demand are equal.

Price elasticity is based on ‘perfect’ competition based on five conditions:

- Product is generic and non-branded
- Easily and readily transportable
- Many buyers and sellers
- No barriers of entry
- Good communication channels between buyers and sellers

One price for entire quantity available
Supply & Demand Equilibrium Curve

(Diagram from Lysons and Gillingham (2003))
Price:

Imperfect Competition

- Mostly buyers operate under imperfect competition and thus no single selling price for an item.
- Monopoly = One Supplier and no new supplier entry
- Oligopoly = A few suppliers and limited new supplier entry
- Monopolistic competition = Many suppliers and much competition

Power is likely to exist around either availability or how much the price can be controlled (e.g. Steel, Oil, Plastic, etc.)
Price Elasticity of Demand

Can be calculated from:

- Expert judgement
- Customer surveys
- Econometric studies
- Market data and studies
- Experimenting with price

Why is it important to understand price elasticity when preparing for negotiation?
Financial Benchmarking

- Performance ratios
- Financial status ratios
- Investor ratios

Why is it important to identify strengths and weaknesses of suppliers when preparing for negotiation?
Financial Benchmarking

- Performance ratios

- Key performance indicators (KPIs are a useful tool which enables comparison of performance against specified criteria for example, completion rates, budgetary conformance, customer satisfaction, etc)
Financial Benchmarking

- Financial ratios
- Identify organisation financial status, cash flow and stability as well as market position
- Performance
- Financial Status
- Investor
Financial Benchmarking

- Examples of Performance and Financial ratios

- Profit margin % = \[
\frac{\text{Profit before interest and tax}}{\text{Sales}}
\]

- Stock turnover (times) = \[
\frac{\text{Cost of goods sold}}{\text{Average stock}}
\]