UNIT 5 DOMESTIC vs INTERNATIONAL PURCHASE

Objectives

After reading this unit, you will be able to:

- discuss “make or buy” decisions;
- disecribe the needs, procedure, problems & main documents in International purchase;
- discuss cultural aspects in International purchasing; and
- discribe approches for negotiating with foreign suppliers.

Structure

5.1 INTRODUCTION

Once the role and organization of a purchasing department are known, the most basic and important job is to find suppliers that are capable and willing to provide quality, service, and competitive price for the items to be purchased. To get the best sources of supply to meet various kinds of organizational buyers may make choices from among a number of equally eligible sources. Also there can be cases when an extensive search may be required to find a supplier, or to even develop a new source of supply in case of complete unavailability of a supplier. A number of principles and methods are required to be applied more intensely today than ever before by any organization. As companies are forced by competition to improve the performance of their products, they, in turn, press the suppliers to upgrade their performance on quality, service, and price. The purchasing managers must apply basic methods of selection analytically and aggressively.

5.2 DECISION ON MANUFACTURE OR PURCHASE

Normally, industrial requirements are satisfied by purchase of the needed product or materials from some outside source. However, there is usually the alternative possibility of producing a needed part or product within the buyer’s own organization, sometimes with potential advantages in cost, convenience, or control. This is not always feasible, but it should be considered. In a broad sense, the question “Make or Buy?” must be answered in advance of every purchase, in the form of company policy it not by special analysis. This question may refer to a particular fabricated part for regular product use, or, on a broader scale, it may involve the decision of whether the company shall operate its own foundry department instead of purchasing castings, or shall have its own printing department or undertake similar operations. It may likewise concern the making of special equipment, such as warehouse shelving, or major construction projects.

5.3 MAKE OR BUY: A POLICY DECISION

Whether to make an item within the user's plant or to buy it from outside sources is a major policy decision. Normally decisions in this aspect are taken at the top level. The role of materials management depends upon the position of the head of the materials management division in the organization. If he is a member of the top management team, a key role is played by him as he is best equipped to deal with the problem. Otherwise he has to play a supporting role by providing relevant data so that the top management can take a scientific decision. A great deal of coordination is required between materials management and production departments in collection, collation and analysis of data, such as quality requirements, quantity requirements, existing production facilities, balance equipment requirements, and so on. An organization may form a committee to analyze and recommend proposals. Make or buy decisions arise due to either of the following two reasons: (i) consistent failures on the part of suppliers in the supply of items, and (ii) availability of items from outside suppliers may not be adequate owing to stiff competition from many end-users.

5.4 "MAKE OR BUY" DECISION MAKING PROCEDURE

The decision to make or buy an item is presumably made before the requirement ever gets to the stage of a purchase requisition, and it is frequently outside the scope of purchasing department responsibility to find the answer. On the other hand, it is an ever-present consideration in determining the best method of procurement, even after a requisition has been received and regardless of previous practice. Therefore, a purchasing department is responsible for analyzing the relative merits and advantages of both procurement methods and of making policy recommendations if a change is indicated. Costs and conditions in the supplier industry may be such as to suggest very strongly the advisability of self-manufacture products, formerly purchased. It may also work in the other direction, when the possibility of advantageous purchase arrangements suggest the adoption of this method, even though such action may mean retirement of equipment and facilities formerly used in production. The whole program of subcontracting, is an example of procuring by purchase a wide variety of components, many of which would normally be produced in the purchaser's own plant.

The significance of the question "Make or Buy?" and the amount of study justified in arriving at a decision depend largely on the volume of business involved in monetary terms. If it concerns a product representing only a few thousands rupees of annual expenditure, it will not make much difference either way. If the amount reaches hundreds of thousands of rupees, it is frequently a matter of utilizing existing equipment balanced against the convenience and cost of procurement from outside sources. If the amount of money involved is really substantial, involving investment in new equipment, a full-scale analysis is essential, going beyond direct cost considerations into matters of company policy, personnel, labor relations, plant layout, scheduling, and the numerous other details incident to any kind of new project or manufacturing programme.

The procedure of arriving at either of the two decisions must be comprehensive one, considering a number of important factors and aspects related to manufacture and purchase. These factors are briefly explained below.

Cost Comparison

The decision of "make or buy" must be approached analytically and objectively. The company's own facilities must be considered as an alternative source of supply in competition with outside suppliers. A change in policy is not so simple as merely changing from one supply to another. When it is concerned only with manufacture of a particular part, utilizing surplus capacity or facilities already on hand, it may not be too serious a matter, and the policy could easily be revoked in case the results proved less advantageous than expected. But in respect to larger and more significant items of supply, and particularly when new facilities are to be added or a new line of operation undertaken, it is likely to involve significant tooling costs, investment in space and equipment and enlargement of the organization, all of which represent a continuing problem of cost and efficient operation. There may be different kinds of analysis worksheets discussed under different situations. A typical, analysis worksheet for cost comparison is presented in Figure 5.1.

In this analysis, first the total cost of purchase is determined for the given item. Cost of purchased goods is accurately determinable. Complete cost up to the time of use is the significant figure: price, plus transportation charges, plus costs of handling and storage. This cost should be calculated on an annual basis.

Against the estimated total cost of purchase as determined, the total estimated cost of production should be compared. The production cost should include the cost of materials and direct labour, the investment and carrying charges, including depreciation on equipment, and overhead expenses, with due allowance for the possibility of idle time and production at less than capacity, normal waste and spoilage, and the other usual risks of management that are assumed by the supplier when goods are purchased. These costs should be calculated on the standard basis used throughout the company, because the new manufacturing operation may become a part of the company's general activities and must assume its share of the burden. The factor of profit, which is necessarily a part of the supplier's price, is not a proper consideration for the buyer, because the buyer is concerned with costs, and the profit to his or her company accrues only in the sale of the finished product; however, efficient self-manufacture, elimination of sales expense, and consequent lower cost of components do enhance the profit potential in the eventual sales.

	Purchased Cost (Rs.)	Manufactured Cost (Rs.)
A. **Direct Variable Costs – Note A:**		
1. Material – Include Variations for Major Products	Rs.________	Rs.________
2. Labour – Include Variations for Major Products		________
Reroute		________
Shift Premium		________
Incentive Pay		________
Etc.	________	________
3. Subcontract	________	________
B. **Overhead:**		
1. Material Handling		________
2. Indirect Labor	________	________
3. Hourly Supervision		________
4. Training – Include Special Skills	________	________
5. Set up		________
6. Overtime Premium		________
7. Vacation and Holiday Pay	________	________
8. Fringe Costs	________	________
9. Other Variable Costs:	________	________
C. **Semi-Variable and Fixed Costs:**	________	________

D. **Other Costs and Expenses – Note C:**

1. Purchasing, Shipping, Storage, Testing, etc.	______	______
2. Administration Cost	______	______
3. Tooling charges, if any	______	______
4. Excess capacity charge, if any	______	______
TOTAL	______	______

NOTES

A. Separate departmental labour hour and overhead rates may be preferable to the use of composite rates.

The divisional rate for overhead applied should be predetermined as substantial amounts of direct labour hours are absorbed in the make or buy products.

B. Semi-variable and fixed costs may be included for specific items.

C. These incremental and out-of-pocket costs are included only when quantities being considered are substantial in amount.

D. Includes vendor's invoice price and adjustments for out-of-pocket non-compensating costs included in the manufactured cost column.

Figure 5.1: A Typical Analysis Worksheet for Cost Comparison.

The results of a full-scale cost comparison may seriously modify estimates of cost and other advantages based on casual judgment. Almost certainly, it will indicate the prudence of a highly selective approach to the question of "make or buy" based on detailed analysis of the individual case.

Quantity Factor

Unit cost is not the only factor to be considered. The quantity of a requirement is important for several reasons. In the first place, it will help to determine whether or not the potential cost saving is sufficient to warrant the undertaking of a special manufacturing project or process. Second, it has an important bearing on actual costs through the economies of mass manufacture and the possibilities of absorbing initial costs. Third, it should be sufficiently large to ensure that any facilities that may be established or installed for the purpose are kept reasonably fully occupied so that overhead costs for idle time do not offset the unit-cost advantage.

The solution lies in setting a basic production capacity that is large enough for economical production yet within the limit of minimum expected requirements. This is calculated to keep the facility running at capacity, any deficiencies being supplied by purchases from the outside. The advantages include the convenience of having such facilities conveniently available, the possibility of producing rush jobs without waiting for an outside supplier to fit them into his or her schedule or paying premium prices for extra service, and the possibility of handling short runs and other special and commercially uneconomical requirements on a cost basis.

Quality Control

In many cases, cost comparison and quantity factor may not necessarily be the determining factor in reaching a decision. It may be desirable to undertake, or to retain the manufacture of an item in the buyer's own plant when costs under this method are demonstrably and substantially higher than prices obtainable from outside sources.

Such high-cost procurement by manufacture is justified on the basis of quantity of the item obtainable through self-manufacture. It is possible to have the assurance of strict quality control when the processing and fabrication of components are performed and supervised by the organization. Close coordination and a single responsibility are frequently better than divided responsibility, and the manufacturer's assurance of guaranty of the item may become the sole determining factor in making the decision.

Furthermore, greater interest and effectiveness in quality development and improvement can be expected on the part of a producer who is following through from raw material to end product than from a supplier who is producing to strict specifications furnished by a customer.

Make-or-Buy Checklist

It is better if the company is able to prepare a checklist for each of the factors to be considered. Answers to the select questions in each factor will help an analyst make decision on the basis of scientific and logical reasoning. A typical checklist may consists of the following questions:

i) **Quantity Factors:** Adherence to specifications? Quality control setup? Is proper equipment available? Experience in this type of work? Who pays for bad parts?

ii) **Capacity Factors:** Is space available? Is available space obtainable? Is machine time available? Must machinery be bought? Are outside finishing operations required? Is sales relationship a factor? Is stability or supplier relationships a factor? How much working capital is needed for inventory? Is new capital investment needed? How much use have we for the new equipment? What return can we expect?

iii) **Labour Factors:** Would layoffs be created? Would it help us hold the organization together? Must staff be increased? Is special training necessary? Are there union pressures? Is the labour rate competitive?

iv) **Scheduling Factors:** Can we get all necessary components on time? Have we the capacity to adjust to peaks or slowdowns? Would timing be surer with added sources? Are engineering changes frequent?

v) **Skill Factors:** Is the best design experience available? Is the part natural to us? Is this the most profitable use of our executive' time? Is design-assistance relationship a factor? Do we have adequate measures of inside efficiency?

vi) **Cost Comparison** (on the basis of 100 pieces): Material cost, operations cost (direct labour, overhead, and profit), setup cost, tools repair allowance and spoilage, packing and shipping costs from outside supplier, tool charge (cost of tools per 100 pieces).

This is a very complete and scientific evaluation of the problem, dealing principally with the internal company factors involved. However, it should be pointed out that make-or-buy decisions also have external effects and that there are some long-range considerations of this nature that should also have serious attention. The checklist section on capacity factors recognizes this by querying the effect on sales relationships and the stability of supply relationships.

It is not uncommon, in times of business decline, for manufacturers to switch from buying to making certain parts when excess capacity shows up in their own plants. Even if this is done as a temporary measure, rather than as a considered policy based on economy of manufacture, the immediate effect is to leave the suppliers of these parts stranded and to intensify for them the hardships of the business decline, The purchasing manager may well question the wisdom of such use of the make-or-buy alternative, especially if the decision is of a temporary nature. For, when business picks up and the buyer once again seeks parts and service from that vendor, the buyer will almost certainly find that the supplier relationship has deteriorated. In extreme cases, he or she may actually have lost that source of supply.

It is apparent, from the many internal elements affected by the make-or-buy policy, that the decision is not one to be made by the purchasing executive alone, even though it is primarily a question of procurement method. It is within his or her province to make a recommendation for or against the method in respect to certain requirements of the materials program, and his or her recommendation should be supported with a detailed analysis of available outside sources, comparative costs, and other factors. His or her company, as is true for any other supplier, has the privilege of judging the profit potential and other advantages and disadvantages of the proposal that will determine whether it is advisable to undertake the production or to relinquish it in favor of outside purchase.

Production executives will naturally be in the best position to pass judgment on the equipment and facilities available or needed and on the practicability of the plan. Production and cost departments will check the purchasing manager's cost estimates. Financial officers will check the advisability of the capital investment involved. Technical and engineering advice will be sought on the advantages of quality control within the organization. Marketing executives are concerned with anything that will enhance the salability of the product and possibly with finding an outlet for surplus production from the new department. The final decision, after all these viewpoints have been presented, is a matter for top management.

Conditions for Make-or-Buy

i) During the period of business decline or recession, the equipment may be idle, and the manufacturer may undertake to make rather than buy some parts or components to spread the overhead costs and keep employees working, happy, and loyal for the future.

ii) When an item is purchased, the purchasing agent can negotiate with several suppliers, and the keener the competition, the more favourable the terms that can be gained. When a firm makes an item, flexibility is lost, for there is no competition.

iii) When there is a monopoly or suspicion of collusion among the suppliers to maintain high prices, the manufacturer may lean toward making the item.

iv) When top management decides to buy something it formerly made, it obviously incurs all risks associated with the selection of an outside supplier. Less obviously, risk is also taken when management decides to make an item it formerly bought.

v) Subcontracting is the result of a make-or-buy decision to purchase the item or component instead of making it.

When a manufacturer is operating at full capacity and still cannot meet his customer's delivery dates, he will subcontract some part or component to enable him to increase his output of the finished product and thus remain competitive. In this case, the subcontractor can be viewed as an extension of the manufacturer's production process.

Activity 1

Write an interactive computer program for 'make or buy' decision

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5.5 NEED FOR INTERNATIONAL PURCHASE

For a growing economy like India's, achieving self-sufficiency should be the goal but not at the cost of imports. Importing is an essential economic function which cannot be completely eliminated. Ricardo's principle of comparative advantage states that it would be beneficial for an economy to concentrate on the production of items in which it specialises, to export these items, and to import its requirements of other items. The principle, though not totally practical, cannot be dismissed. International trade is undoubtedly governed by political motives and, as such, a country cannot totally rely on another country for its requirements of specific items. It would be equally fruitless to undertake import substitution at any cost. The Government of India from time to time reviews the import policies considering various aspects such as trade balance, and raw materials stock. Import policies of any state as such are not static and changes in policies and procedures are very important to industries which depend on imports for their production.

The relatively sudden development of a one-world market has important implications for purchasing managers. They now have greater availability of supply, but also a great need for careful selection of sources, some of which may be located thousands of kilometers away. This situation calls for involvement of purchasing department of a company in international purchase.

There are several reasons for international purchase. Some of these reasons are described below.

i) **Cost Benefits:** Generally, offshore sources have been able to offer buyers lower prices, particularly on manufactured goods, because of lower labour, material, and overhead costs. Total landed costs, including the cost of transportation for thousands of kilometers in some cases, are often lower than are those of domestic suppliers of a wide range of industrial suppliers and equipment.

ii) **Continuity of Supply:** Increased worldwide demand of goods made it imperative that new sources of supply be developed. Most industries have become aware since they experienced the kind of shortages during Yom Kippar Arab-Isreal war of 1973.

iii) **High-quality Technological Know-how:** Foreign suppliers have displayed great flexibility in adapting their manufacturing methods to special requirements. Their products, particularly the process equipment and machineries, are often far advanced over Indian counterparts and the quality of many products (e.g., stainless steel, high-tolerance forgings, precision ball bearings) is often superior to that of higher-priced domestic items.

iv) **Greater Competition:** The growth of commerce and industry in economically underdeveloped nations has opened up new sources and new productive capacity. Increased competition and availability in international market have a powerful attraction for professional buyers.

v) **Relative Ease of Communication:** The development of almost instantaneous communication and rapid transportation between any points in the world has helped promote international trade. A telephone call from New Delhi to New York, for example, may take almost same time that a call between far cities in India takes. Air shipments from Europe and North America have become very fast.

vi) **Suppliers may be Customers:** Virtually the whole world may be a potential market for goods produced by a company, so it makes a good economic and political sense to buy in that market when it offers the competitive advantages.

It may be the policy of most multinational corporations to accept some responsibility for the economic development of the nations in which they operate. Moreover, a country may resort to countertrade to generate hard currency to finance new industrial projects. Countertrade is generally a transaction in which a seller agrees to purchase goods from buyers, equal to an agreed-upon percentage of the original sales contract value. It can take a number of forms. In *counter-purchase* transactions, suppliers receive certain goods as partial payment from the buyers. One western tool manufacturer, for example, received products in good supply in the buying country¾salt, silverware, and shoes. In any case, the recipient of those goods has to dispose of them. In a *compensation* transaction, the supplier agrees to buy a certain amount of "resultant products" (i.e., those derived from the equipment or technology sold to the buyer). The builder of a chemical plant, for example, would agree to buy a certain amount of the product produced by that plant. In both cases, the counter-deliveries do not represent 100 per cent of the value of the sales contract. Each side pays some cash for the products it receives. *Barter* is the direct exchange of goods having offsetting values, an even swap, without any flow of money taking place. Generally, purchasing and marketing share responsibility for counter-trade programmes.

5.6 PROCEDURE FOR INTERNATIONAL PURCHASE

If a company is importing for the first time, the first and foremost step for it is to check whether the item is allowed to be imported. If the item is banned for imports (on the ground that it is indigenously available), the starting point is to get a list of all local manufacturers and ask for quotations. If the manufacturers are not in a position to supply, a written statement to that effect should be obtained from them. These statements should be presented to the government to get the clearance for imports. The government, on its part, might give names of some more possible suppliers, or may write to the suppliers themselves and then possibly clear the import of the items. Companies can get import entitlements on the exports even if they are indirect.

In case the import clearance is obtained or the item is not banned for import, a company has to go through the following stages to accomplish the purchase:

i) **Locating the Foreign Source of Supply:** This has to be done by contacting the Ministry of Trade, Foreign Consulates and Embassies, Indian Consulates in foreign countries and other sources. A foreign consulate or embassy has a commercial attaché who is well versed with the list of suppliers in his or her country.

ii) **Procurement of the Item:** At this stage the importer will be involved with foreign source of supply, manufacturing unit of his company, engineering department and governmental institutions, such as DGTD, MMTC and STC.

iii) **Documentation:** Special documents, not used for indigenous purchases, are required in foreign purchase: The Bill of lading, Invoices, Certificate of origin, Weight certificate, Insurance policy, and Markings of Packages are the commonly used documents.

5.7 PROBLEMS IN INTERNATIONAL PURCHASE

Issuing a purchase order to a foreign supplier does not, however, automatically guarantee acceptable prices, better service, high quality for the product to be purchased. Suppliers must be as carefully researched as domestic vendors are. Dealing with unknown companies in foreign markets may present a number of difficulties and obstacles. In order to overcome them, the purchasing people get many opportunities for improving their skills in negotiation, research, and finance. A number of large companies with overseas purchasing operations have, as a matter of policy, used such operations as training grounds for younger personnel marked for advancement to high managerial positions.

There are some problems in overseas buying that require close attention and control. Unless total costs are carefully considered and monitored, the economic advantage that seems to exist in a low initial price may quickly evaporate. Rising freight costs, a high rate of reject in items purchased, labour troubles at supplier plants, delayed deliveries, the need for carrying heavier inventories to protect against such delays, and the possibility of having capital tied up in letters of credit are just some of the elements that may affect the final cost of a product purchased from a foreign supplier.

5.8 SELECTION OF FOREIGN SUPPLIERS

Locating a supplier may involve something as simple as a telephone call or as extensive as a small research project. The buyers may get relevant information on foreign products and producers from a number of sources. However, evaluation of the supplier is somewhat more difficult and time consuming as it may require consultation with other customers of a distant supplier, obtaining and testing samples, or preferably, visiting overseas plants if the producer's reputation is unknown.

Information sources include a variety of publications, from trade journals and newspapers to directories of manufacturers and distributors, to trade lists, directory reports, and surveys from the Department of Commerce. One guide to international purchasing procedures lists twenty major directories on international trade. They include such volumes as *The American Register of Exporters and Importers*, published in New York; *Jane's Major Companies of Europe*, published in London; *Dun & Bradstreet's World Marketing directory*, published in New York; *Directory of Swiss Manufactueres and Products*, published in Zurich; and the *Bottin International Business Register*, published in France, which contains information on companies throughout the world.

The Department of Commerce maintains up-to-date lists of names and addresses of foreign companies dealing in specific products in more than a hundred countries. The lists also identify importers and dealers, along with other pertinent information. The department also maintains trade centers in leading foreign cities such as Warsaw, Seoul, Milan, Paris, and Sydney. There are also American Chambers of Commerce in fifty leading cities throughout the world, all prepared to help U.S. buyers and sellers. Embassies and consulates, both of foreign countries and the United States, are similarly equipped to aid businessmen seeking to trade in their respective countries. Banks, airlines, and shipping companies have significant collections of data on businesses in the countries that they serve, as well information on local customs and procedures. The International Federation of Purchasing and Materials Management (IFPMM) has drawn up a list of member correspondents in twenty or more nations who have agreed to provide overseas buyers with data on suppliers in their respective countries.

When there is no competitive advantage involved, purchasing managers of other companies experienced in overseas buying are usually willing to help newcomers to the field.

5.9 DIRECT AND INDIRECT BUYING

Whether to buy directly from overseas suppliers or indirectly through intermediaries depends to a large extent on the volume and frequency of purchases, the anticipated length of a relationship with a supplier, and the availability of qualified buying personnel.

Small volume or occasional purchasers most often use a variety of middlemen (wholesalers, brokers, selling agents) for overseas transactions. For a fee (which in the case of selling agents or representatives is paid by the supplier), they will handle the basic details of a purchase, including choice of a supplier when necessary. The breadth of services varies widely among these intermediaries, so it is important to know in advance whether or not their fees (which can run up to 25 per cent of the value of the purchase) cover such important elements as research on vendors, shipping costs, insurance, customs, administrative expenses, and degree of financial responsibility, among others. Prudent buyers will also make an effort to determine, preferably from their other customers, the broker's or agent's performance record.

Among the advantages cited for buying through trading companies are greater efficiency and convenience, lower costs, shorter lead times, and assurance of quality inasmuch as inspection is made before shipment and the trading company remains responsible for unacceptable shipments. One criticism is that the prices the companies obtain are seldom established on the basis of costs. Instead, they are based on market levels at the time of purchase and hence the buyer may be deprived of the benefits of direct negotiation.

As transportation and communication improvements make the world market even more compact and accessible, middlemen will undoubtedly be relegated to a minor or highly specialized role in international trade. A separate foreign purchasing office or cell in an organization may be set up because of the following reasons:

i) **Lower Operating Costs:** Foreign purchasing overhead is generally lower than the brokers' fees. Communication is more effective and less costly.

ii) **Better Control:** On-site administration provides better control over price, quality, and delivery schedules. The foreign office is also better equipped to handle the intricacies of foreign exchange.

iii) **Up-to-date Information:** The rules and regulations that govern foreign transactions in overseas countries often change, and an on-site office has access to the most current legal and economic information.

iv) **Better Understanding:** Foreign nationals in such offices can often negotiate better agreements because of their familiarity with the territory, local business conditions, local customs, and, of course, language.

5.10 MAIN DOCUMENTS IN INTERNATIONAL PURCHASE

There are many types of documents prepared and used for international purchase. The main documents are discussed below:

i) **Bill of Lading:** The bill of lading is the most important document which accompanies bills of exchange drawn under letters of credit. It is an evidence of the fact that goods have been despatched by the exporter and gives the importer title to the goods and enables him to claim them on arrival at the destination.

   A bill of lading is a document signed by the master of a ship or by the ship-owners or their agents acknowledging the receipt or certain specified goods for carriage and embodying an undertaking that the goods will be delivered to the consignee, or to his order or assignee, or merely to order. The bill specifies the port of shipment, the destination and the condition under which the goods are received for carriage. It is at the same time: (i) a receipt for goods delivered to carrier for transporti1tion, (ii) a contract between the shipper and the carrier for transportation of the goods and then delivery to the consignee or his order, and (iii) a document of title to the goods, giving the holder title to the goods mentioned.

Bills of lading are prepared by the shipper on forms supplied by the shipping company. Normally, a bill of lading shows the date and place of shipment, the name of the carrying vessel, the name of the consigner and the consignee, the post of destination, the number, contents, and identification mark of the goods shipped, and the amount of freight 'paid' or to pay. The detailed particulars of the number of packages, the mark they bear, their contents and the amount of the freight on them are entered in the space provided for them.

Bills of lading are usually made out in sets of four, three copies signed and one left unsigned; the last being retained by the ship's master for his own use. In the commercial contracts, a set usually means a set of three signed copies, though there may be more or fewer copies according to the requirement laid down in a particular contract. Goods are released at destination only against surrender of the bill, and when one copy has been surrendered the other copies become void.

The bill of lading possesses some characteristic of a negotiable instrument. It can be transferred by endorsement to another person. Goods shipped under a bill of lading are often deliverable to a person named or to his order, or just to order, in which case the title to the goods can be transferred by endorsement and delivery of the bill of lading.

While it is not a carrier's responsibility to examine and verify the contents of the packages consigned for shipment, he verifies that the packing is good enough for the requirements of the contents and to stand the handling the goods will receive before they are delivered. A bill of lading which indicates that the goods are in apparent good condition without any qualification is known as a "c1ean" bill of lading. If, on the other hand, the bill bears some remark relating to a defect in packing, such as 'three bags torn', 'some cases broken', 'received in damped condition', 'goods not sufficiently packed', etc., it is known as a foul or dirty bill of lading. A 'foul' bill of lading is not an acceptable document, unless specifically provided for in the foreign trade contract. Such remarks protect the carrier against any claim for losses attributable to bad packing. They also protect everyone else who comes in possession of the bill of lading for value. Moreover, an insurance company also does not provide any cover for the part of the cargo which is poorly packed.

ii) **Invoices and Certificates:** Among the documents that accompany bills of exchange drawn under letters of credit in foreign trade transactions are the commercial invoice, the consular invoice, the certificate of origin, and the packing list. There are in effect detailed descriptions of the goods shipped, their prices and other charges, the country of origin of the goods, and other particulars of the transaction. Which of these documents are included and in what form is a matter of contract between the buyer and the seller.

a) **Commercial Invoice:** This document describes the merchandise, and indicates the price and other details of the transaction. The name and address of the buyer and the seller, the vessel of shipment, the port of discharge, the shipment, export and import permit numbers, the number of contract and invoice, and the other essential details of the transaction are recorded on the invoice. The financial terms of the sale, such as whether under letter of credit, and sight drafts are given. The number of packages and the identifying marks and numbers on them are clearly indicated. The goods contained in the packages are detailed and prices are given item by item, the trade discount is deducted from the gross aggregate price of the goods, and a total net value is shown. Any other charges to be included under the contract such as for packing, freight, insurance, and the cost of preparing a consular invoice are added to the total.

The commercial invoice is neither a document of title, nor is it negotiable. Its main utility is as a book-keeping device for both the seller and the buyer.

It is a double check on accuracy, a check of actual goods against the invoice, and the invoice against the copy of the order. It also indicates whether the agreed price has been charged, and enables costs of any damage to merchandise to be calculated. The banks check the amount of the invoice against the letter of credit, if a letter of credit is used in financing the transaction. Normally, the amount of the invoice must be within the limit set by the letter of credit, and any excess may indicate inaccuracy in the invoice, a misunderstanding or deliberate overcharging the invoice by the seller. The banker then warns the buyer accordingly and the buyer may take steps to get the discrepancy rectified.

b) **Certificate of Origin:** The laws of some countries require a certificate of origin of imported goods to be produced before clearance of goods by customs and assessment of duty. An importer, therefore, may request the exporter to send a certificate of this kind along with other documents. The certificate is usually required where goods from certain countries receive preferential treatment or the import of goods from some countries is partially or wholly prohibited. The country where the goods are produced should, therefore, be known to the customs authorities. Sometimes, the certificate of origin is endorsed on the back of the relative invoice, in which case the whole document is known as a "Certified Invoice".

c) **Packing List:** A packing list serves to indicate the exact nature, quantity, and quality of the contents of each package in a shipment. The list helps the importer to identify the goods and check them against his own order. Banks may require such a list when they have financial interest in the merchandise. Clearance of goods through customs is also facilitated by packing lists.

iii) **Nature of Insurance Policy:** Marine Insurance Policy is a contract between the insurer and the insured whereby the former, in consideration of the payment of a premium by the latter, agrees to indemnify the latter against loss incurred by him in respect of goods exposed to "perils of the sea" or to the particular perils insured against. For a policy to be valid, the insured must have an insurable interest in the goods subject to insurance, i.e., he benefits from the existence of the goods and suffers a loss if the goods are damaged or lost. The insured need not have this interest at the time of insuring, but must have acquired it at the time of putting a claim under the policy for damage or loss of the goods.

The insurer, known in marine insurance parlance as the underwriter, is the party providing insurance cover, and it may be an insurance company transacting marine business or some firm of underwriters. A proposal for marine insurance is made through a marine insurance broker, who writes the particulars of the proposed insurance on a ship, which he submits to some underwriter. If the latter accepts the risk he signs the slip, and the insurance is in force from that time though the actual policy is delivered later.

iv) **Markings of Packages:** A packing list serves to indicate the exact nature, quantity, and quality of the contents of each package in a shipment. The list helps the importer to identify the goods and check them against his own order. The banks may require such a list when they have a financial interest in the merchandise. Clearance of goods through customs is also facilitated by packing lists. The packages should be suitably marked with address, dimensions, weight, and other particulars.

v) **Payments:** The importer is involved with banks, the Ministry of Finance, and the Reserve Bank. The documents involved are: (i) letter of credit/drafts, (ii) terms of payment, (iii) rate of exchange, (iv) payments under various credits and trade agreements.

vi) **Letter of Credit:** A letter of credit is an arrangement whereby the obligation to pay an exporter is undertaken by a bank. The bank's credit is available to an importer who is not known outside and who otherwise would not be trusted with goods by a trader in another country. If a letter of credit is received from a bank, the credit standing of the importer is of little consequence. What becomes important to the exporter is the credit standing of the bank issuing the letter of credit.

The importer requests a bank in his country to issue a letter of credit in favour of the exporter. The bank writes to a correspondent or some other bank in the exporter's country that a credit has been opened in favour of the exporter, and the latter bank informs the exporter about it. The advising bank informs the exporter that it will honour drafts drawn by the latter under terms and conditions laid down in the letter of credit. The liability for payment is really that of the bank issuing the letter of credit and the bank that honours the drafts drawn by the exporter, gets reimbursed by the issuing bank.

The essential elements of a letter of credit are as follows:

i) The name of the bank issuing the letter of credit is stated on the top of the instrument. The exporter receiving the letter should see whether the bank is acceptable to him or not.

ii) The instrument mentions the name and full address of the beneficiary, i.e., the seller in whose favour it is issued.

iii) The amount for which the credit is issued is clearly stated. This amount is sometimes calculated exactly on the basis of the quantity of merchandise to be shipped. Banks are then not willing to accept and honour drafts for a smaller or larger amount. To avoid this difficulty some flexibility mentioned in the amount is introduced by using the word "about" with the sum.

iv) The name of the importer for whose account the credit is opened is mentioned in the letter of credit. The credit standing of the importer is of little consequence to the seller if he is satisfied with the issuing bank. In fact, the importer may not be known to the exporter at all.

v) The letter of credit lists the documents to be attached to the draft drawn under it. The list is made out by the importer and given to the bank of issue. The documents are such as clearly indicate the discharge of contractual obligation by the exporter. Any discrepancy between the documents that accompany the draft and as those specified in the letters may result in a refusal by the advising bank to honour the draft.

vi) The letter of credit has an expiry date, i.e., a date up to which the instrument is valid. A time or an exact date is mentioned by which the whole operation should be completed. The date given is normally one which will allow the exporter to conveniently ship the merchandise under the contract and to get all the required documents within the period. Again, if the time given is not enough for the exporter he may communicate with the issuing bank or the importer and get the date changed.

vii) The type of credit opened, whether revocable or irrevocable, confirmed or unconfirmed, is stated on the instrument.

Activity 2

Suppose you are a purchase manager of a company. Prepare a report for your boss on the rules and guidelines to be followed for foreign-made products for your company

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5.11 CONSIDERATION OF CULTURAL ASPECTS IN INTERNATIONAL PURCHASING

Regardless of the type of purchasing organization or methods that a company establishes overseas one cardinal rule must be observed: "Know and respect the culture and customs of the nationals with whom you wish to deal." A corollary to the rule is: "Know how to communicate with foreign counterparts, preferably in their own language, but at least through skilled interpreters." Ignorance or disregard of these matters may lead to embarrassment at best and harm the interests of an importer at worst.

The following set of "rules" for negotiating in a foreign market may be considered as a guide:

i) Have high-level introductions,

ii) Avoid embarrassments,

iii) Understand the importance of appearance,

iv) Be patient even it progress is slow,

v) Speak their language, if only a little.

vi) Have plenty of business cards.

vii) Give a few mementos.

viii) Be generous with visitors.

Any analysis prior to the establishment of a long-range overseas procurement program should also include some consideration of politico-economic conditions in the country or area involved. There is obvious risk in doing business in national economies that are strike-prone, plagued by civil disorder, ruled by unstable governments, and subject to manipulation for domestic and international political purposes. Anyone of these conditions, if extended for any length of time, can result in delayed or canceled shipments, revocation of price agreements, and destruction of property. Even the problems of delayed shipments may require heavy investment in inventory building to guard against plant shutdowns, thereby adding to the total cost of a purchase. Under these conditions, overseas buyers may resort to double sourcing, that is, they place part of their business with one or more domestic suppliers to assure themselves some supply in the event of trouble overseas. This, however, dilutes the benefits that they would otherwise get from a foreign supplier's lower price.

5.12 NEGOTIATING WITH FOREIGN SUPPLIERS

Negotiations with foreign suppliers call for a good deal of understanding and insight in addition to the normal planning required for such sessions. Formal plans are needed, but they are not enough; negotiators must have more than ordinary skills to deal productively with people of different commercial and cultural backgrounds from theirs.

Preparation for negotiation in a foreign country (or anywhere for that matter) begins with the designation of skilled negotiators who have sound judgment and can adapt readily to new or difficult situations. As a backup to basic negotiating techniques, experienced international traders suggest these approaches:

i) Observe local custom in business relationships. Customers and suppliers customarily should know each other on a personal basis before getting down to business.

ii) Because negotiations in direct overseas purchasing are generally conducted on the supplier's home ground, at least one member of the negotiating team should be fluent in the language and thoroughly conversant with normal business practices of the country.

iii) Serious negotiations should be conducted whenever possible only with persons who have the authority to commit their companies. Anyone without that authority may simply drag out the negotiation, wasting valuable time, and ultimately leading the buyer to reveal his or her bargaining strengths (and weaknesses) prematurely.

iv) Some foreign negotiators measure their success in negotiation by the number rather than the substance of the concessions they win. If they win on more than half the issues, they may consider the negotiation a success. In such a situation, good strategy on the part of the buyer would be to develop as many negotiation points as possible in the advance planning. This would give the negotiator flexibility in making minor concessions without endangering major objectives.

v) Business managers in many foreign countries are extremely status conscious and consider it undignified to deal with lower-level personnel. Negotiating teams, therefore, should whenever possible be composed of, or at least led by, persons whose titles correspond with those of the supplier representatives.

vi) Negotiators should avoid peremptory or abrupt actions and decisions that could alienate suppliers (who may also be customers of one or more divisions of the buying company).

vii) No negotiation should be concluded without mutual understanding and firm agreement on product specifications, delivery schedules, prices, packaging and shipping methods, insurance, and terms of payment. This seems an elementary precaution, but, because of language and other differences, carelessness in ironing out details could lead to costly mistakes for both sides.

5.13 SUMMARY

In today's business conditions, international purchase has become imperative for most organizations willing to be able to offer competitive products and service globally. There are many advantages of purchasing requirements from foreign suppliers. However, a number of problems need to be overcome in order to have a best-possible procedure for international purchasing. The importers in this context have to prepare and use a number of documents for this purpose. While negotiating with foreign suppliers and their representatives, a number of cultural and socio-technical issues need to be considered.

5.14 SELF ASSESSMENT QUESTIONS

1) List the advantages of purchasing requirements from foreign suppliers.

2) Mention and briefly discuss the problems that a buyer may encounter while entering the international market in the first time.

3) Discuss, with suitable examples, how socioeconomic and cultural aspects may become the determining factor in the success of international purchasing.

4) List the important documents that are required for purchasing products from foreign suppliers. What are the essential elements of each of these documents?

5) How are the foreign suppliers selected? What precautions must be taken while negotiating a contract with a foreign supplier?

5.15 REFERENCES AND SUGGESTED FURTHER READINGS

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UNIT 6 VENDOR NETWORK

Objectives

After reading this unit, you would be able to:

- discuss selection of suppliers for developing a supply chain network;
- describe decisions & define problems in supply chain Network;
- discuss supplier development models;
- discuss supllier networking; and
- highligh the importance of business network.

Structure

6.1 INTRODUCTION

The search for competitive differentiation has led firms to move from their predominantly cost-based focus of the 1950-1970s to the one based on both quality and cost during the 1990s. This change has created a paradigm shift in business practice from the "producer-driven orientation" of the past to today's "customer-driven orientation". The competitive environment of the present is characterized by continual and unpredictable changes in market demand, in terms of both product specifications and quantity. This has also led to the need for manufacturers to have enough capacity to produce a broad range of high-quality products at low cost with short lead times, and to build these products in an efficient way to suit the specifications of individual customer.

It may often be the case that no single organization can respond quickly enough to the changing markets in a competitive environment of this type. Furthermore, large organizations are often very complex and slow to move, while smaller organizations suffer from a scarcity of resources. These conditions favour the emergence of new forms of dynamic network to connect manufacturers. Such a network develops on the basis of temporary alliances with other parties. These alliances are based on the core competencies of the various suppliers to create a supply chain that is highly responsive and flexible at responding to customer orders. To ensure such flexibility, the supply chain is considered to be temporary and its precise form is dependent on the demands of the market. By developing collaborations of this kind, manufacturers can increase their level of expertise and minimize the risk of investment.

6.2 SELECTION OF SUPPLIERS: A KEY ISSUE

One of the key issues in developing such a supply chain network is the selection of the suppliers. Sound selection is crucial since the performance of the chain depends on every single organization involved. Many factors are usually taken into account in the supplier selection process. Samadhi and Hoang (1998) have suggested a three-stage procedure for evaluating supplier compatibility, starting with abstract and strategic factors, moving through their attributes in terms of manufacturing, and ending with logistical factors. Talluri et al. (1999) have given a framework for the design of a design value chain network with a two-stage procedure that combines data envelopment analysis (DEA) and goal-programming techniques. In other work, De Boer et al.(1998) have proposed the outranking methods to support the selection of suppliers. These methods are based on multi-criteria factors. In all of this research, by De Boer et al. (1998), Samadhi and Hoang (1998), and Talluri et al. (1999), the strongest emphasis is placed on the strategic factors that need to be considered in selecting suppliers.

On the other hand, some efforts have been made to address operational factors. D'Amours et al. (1996) have developed a model for the price-based planning and scheduling of actions to do with multiple products to create a symbiotic manufacturing network. In that research, they have assumed a set of bids from potential suppliers as given. The impact of information sharing on the development of networked manufacturing has been considered in subsequent work by D'Amours et al. (1999). Li and O'Brien (1999) have developed a two-stage model for the design of an efficient supply chain. It focuses on analyzing the impact of three possible manufacturing strategies, the make-to-order (MTO), make-from-stock (MFS), and make-to-stock (MTS) strategies.

6.3 OVERVIEW OF DECISIONS AND PROBLEM DEFINITION IN SUPPLY CHAIN NETWORK

The objective of the supply chain network is to minimize the end customer's total level of dissatisfaction, composed of price and delivery lead time.

As Samadhi and Hoang (1998) have explained, there will be no collaboration if there is no one to initiate it. The suppliers to be selected to participate in the collaboration must also be compatible with the initiator(s). In this research, a set of manufacturers is given. The manufacturing company that receives the prospective order directly from the ends customer acts as the initiator. This manufacturer is then at the chain level decision of this supply chain network. The other manufacturers respond to the initiator's lower-level product-procurement requests. In this research we use the term "supplier" to describe any manufacturer playing a lower-level supporting role. After receiving a prospective order, the initiating manufacturing company sets the goals for the potential suppliers at each stage of the supply chain. These goals are: due date for delivery (d), quantity required (q), and required unit price (r).

The potential suppliers then play their part in achieving these goals by applying the operational-level model to optimize their manufacturing and logistical activities to determine the order quantity(Q_o^{min}). After receiving responses from all potential suppliers at each lower stage of the chain, the initiating manufacturing company uses the chain-level model in the final stage to determine the order quantity for each selected supplier (partner), and estimates the performance of the supply chain. Fig.6.1 gives an overview of the problem situation.

Decisions at the operational level are thus concerned with the optimizing the manufacturing and logistical activities of each potential supplier to meet the customer's requirements. Chain-level decisions then deal with evaluating each bid from the potential suppliers and determining the final configuration of the supply chain.

Figure 6.1: Overview of the problem situation

Table 6.1: Different flows and decision variables in supply chain network

Flow 1: Invitation to bid	**Flow 2: Suppliers bid**
Delivery due-data(d) Order quantity (q) Target of unit price (r)	Order quantity supplier i has offered to provide at stage n (q_{oin}) Minimum order quantity required of supplier i at stage Delivery lead time at order quantity supplier i has offered to provide at stage Delivery lead time at minimum order quantity required of supplier i at stage Price for order quantity supplier i has offered to provide at stage Price for minimum order quantity required by supplier I at stage
Flow 3: Results of bid Order quantity allocated for production by supplier i at stage n for delivery to supplier j at stage $n-1$ ($Q_{ain,jn-1}$)	
Flow 4: Physical flow	

Activity 1

Make an internet search on the state-of-the-art supply chain network. Make also a list of available analytical models of the supplier selection process in this context.

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6.4 PURCHASING PERFORMANCE AND SUPPLIER DEVELOPMENT

Facing increasingly competitive challenges, many organizations view supplier performance as an important contributor to their competitive advantage. They work closely with suppliers and expect to improve performance and capabilities by engaging supplier development programs.

It has been reported that such programs have been extensively implemented in western countries. However, developing the supplier has also provided quite challenging. A conceptual model for guiding the implementation of supplier development program was proposed by Hahn et al. However, it was not empirically tested. Some perceived critical elements of supplier development were explored by Krause and Ellram, and some “antecedents” of involvement in supplier development program were also identified by Krause. But these factors were not linked with purchasing performance. In this body of literature, few empirical research studies have been conducted to examine the factors which are critical to the success of the approach.

6.5 SUPPLIER DEVELOPMENT MODELS: A REVIEW OF LITERATURE

Hahn et al. developed a conceptual model that described the organizational decision process associated with a supplier development program. This model was established just on the basis of experience of several companies actively engaged in such a program. Krause and Ellram conducted a survey of 96 US purchasing firms and found that the majority of buying firms involved in supplier development perceived their suppliers as partners and placed a greater emphasis on some critical elements than those not involved in such programs. These critical factors included two-way communication, top management involvement, cross-functional teams and larger purchasing power.

Krause developed reliable and valid measures of the factors influencing supplier development and tested a structural model that postulated the interrelationship among these factors. The buying firm’s propensity to engage in supplier development may be affected by its perception of supplier commitment, its expectation of relationship continuity, and effective buyer-supplier communication.

The studies in this field provide some useful insights for managers who wish to invest their time and resources to improve supplier’s performance. Supplier development stresses that direct supplier development plays a critical role in driving performance improvement in purchasing and contributes strategically to overall organizational effectiveness.

6.6 INFLUENCING FACTORS OF SUPPLIER DEVELOPMENT

The important elements of supplier development may be identified from the buying firm’s perspective. The following factors are worth mentioning:

i) **Long-term Strategic Gal:** Supplier development efforts should focus on developing supplier future capabilities in technology and product development rather than focusing only on current quality and cost. The clarity of long-term strategic goals is the key to the success of supplier development programme.

ii) **Effective Communication:** Open and frequent communication between buying firm personnel and their suppliers is identified as a key approach in motivating suppliers. Early involvement and open channels of communication increase both parties' understanding and encourage problem solving between both parties.

iii) **Partnership Strategy:** The majority of buying firms involved in supplier development may perceive their suppliers as partners. Adopting a partnership strategy means that a buying firm pursues a long-term relationship with suppliers and they would like to show their commitment. Without buyer's commitment, the suppliers may be unwilling to make changes in their operation to accommodate and desires of that.

iv) **Top Management Support:** It is top management who recognizes the need to initiate a supplier development programme based on the firm's competitive strategy. Purchasing management needs the encouragement and support from top management to expend their resources within a supplier's operation.

v) **Supplier Evaluation:** Not all selected suppliers qualify for development assistance and a buying firm must carefully identify where to focus its supplier development efforts. Supplier evaluation results can provide valuable information about general areas of weakness where performance improvements are required.

vi) **Direct Supplier Development:** In order to pursue excellence and develop best practices, the suppliers need the encouragement or expertise of their buyers. Direct supplier development activities include providing support personnel, capital, equipment, technology, or direct involvement with suppliers in identifying and eliminating non-value or duplicate costs, processes and time. These assistances from the buyers can accelerate supplier capability improvement greatly.

vii) **Perception on Supplier's Strategic Objective:** Supplier development requires a mutual recognition by the buyer and supplier of the need for continuous performance improvement. Supplier development would not work if the supplier does not have a compatible strategic objective with that of customer.

Activity 2

Based on your library search, make a comprehensive write up on different types of vendor development practices.

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6.7 SUPPLIER NETWORKING

In many business environments, networking is almost an inevitable solution to help companies respond fast to market changes. Though networking companies may deepen their relationship with partners and thus become more dependent on each other. The key success factors in networking, and the motives for entering into a partnership or alliance form the basis for the development of network arrangements. Opportunities like reduced transactions costs, ability to concentrate on core skills, access to key technologies, and risk sharing among partners give direction for the development process.

6.8 IMPORTANCE OF BUSINESS NETWORKS

Business networks are defined as a long-term, purposeful arrangements among organizations that allow the operating organizations to get long-term sustainable competitive advantage. In strategic networks a lot of weight is put on the reciprocity of the relations. The individual companies operating in the network are dependent on the resources of the other network companies, and the possibilities of the individual organization to utilize these resources are determined by their place in the network. Network arrangements result from strategic collaboration between more than two independent companies with the aim of pursuing economic advantages. A network can be defined as a specific type of relation linking a defined set of persons, objects or events. Japanese companies have organized their suppliers into hierarchies: first-tier or primary suppliers provide systems rather than components. This trend reduces the number of first-tier suppliers and also makes the buying company more dependent on the suppliers. The primary tool employed by the Japanese to implement closer supplier co-ordination and individual supplier development is cross-exchange of staff between buyers and suppliers. The integrated procurement strategy should include such issues as: value chain positioning, environmental analysis, objective setting, organization structuring, strategic make or outsource decisions (which should include the strategic assessment of what is a firm's core competency), choice of different strategies (when to use competitive, partnership or network strategy) and the links between company level strategy and other functional strategies.

In general, through networking, companies aim at reducing financial and technological risks and improving their competitive advantage through deeper specialization. Further challenges are caused by such factors as shortening turnaround times, fast developing technologies, and the globalization trend.

6.9 PROBLEMS AND RISKS IN VENDOR NETWORKING

The network-related problems and risk are connected mainly to the network's resistance towards changes, new technologies, practices and members, as well as to problems and risks that may arise in network management or the setting up of appropriate development activities. Increasing requirements for communication and co-operation activities also add claims for more efficient information systems, openness, trust, and production systems. There may also arise problems with information transfer.

A business network is comprised of several tiers of suppliers. The first tier suppliers, which work for the OEM company, have again their suppliers. Thus, like the buying companies, they need to take the responsibility of the work of the suppliers against that of their customer, the OEM. The difference is the scale of deliveries. The relationship between the primary suppliers and the OEM has with its customers. As the suppliers make investments to satisfy the main contractor's anticipated demand they also carry part of the demand risk of the main contractor. The main factor affecting the risks of the supplier is being strongly dependable on one customer or operating in many networks. The types of problems and risks usually encountered are as follows:

i) **Too Low or Inappropriate Demand:** The demand problems may be caused by a decreased demand of end products due to economical trends or change of product generation. It is also possible that the universal demand does not decrease but the OEM loses its position in the market. Furthermore, the success of the OEM does not guarantee the success of the supplier; it may become replaced by competitors in their market place if the competitors can offer better services to the OEM.

ii) **Problem in Fulfilling Customer Deliveries:** In hierarchic network delivery, each acting company is responsible of its deliveries to the customer at the next hierarchy level. Thus, each company must control not only their own work but also the work of their subcontractors. As the price is most often fixed before the delivery, the main items to be managed are quality and the time. As the development of networking has led to an increase in the size of the responsibilities of the primary suppliers, they quite often have to face new management challenges as well. These challenges are mainly related to the demand fluctuations and flexibility of supply. Too high demand may also be risky, if companies are not able to adapt their operations to the growth.

iii) **Cost Management and Pricing:** Having demand and fulfilling deliveries is not enough for a company to be profitable. It must also be able to manage its costs, both fixed and variable. The increasing responsibilities in many cases also require growing investments; thus risks of investments often increase. In high demand business cycles, companies may endanger their ability to control their cost structures and investments.

iv) **Weaknesses in Resources, Development and Flexibility:** The products and markets are changing and new competitors appear all the time. If a company wants to remain in the network, it must follow the trends, developing and creating new knowledge if needed. Many OEMs consider the ability to development as one important criterion when prioritizing suppliers. It must, however, be remembered that the company will itself carry the risk of investing in changes or development. Thus the investments should be based on careful reasoning of the company's own future vision and objectives.

6.10 SUMMARY

As has been emphasized by many companies, the development of vendors becomes one of the prime responsibilities of the corporate management of any organization. A company through this development process gains on several aspects, mainly to be able to do business with competitive advantages. In this context, the networking of vendors, under different tiers, is the key action-based programme an organization will definitely opt for. There are several advantages of this approach. However, the risks involved also should not be undermined. A set of preventive measures is what is required to make vendor networking an improved way of doing business.

6.11 SELF ASSESSMENT QUESTIONS

1) Why has management of supplier network become a contemporary and critical issue? Explain with reference to the present industrial situations.

2) Draw the supply chain network indicating different kinds of flows and decision variables. What is the basic objective of such a network?

3) What are the issues critical for supplier development? Discuss each.

4) How is the performance of purchasing function dependent on supplier development? Illustrate with suitable cases and examples.

5) List the problems and risks in supplier networking. What are the preventive measures that may be suggested in this context?

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UNIT 7 BUYERS-SELLERS RELATIONSHIP

Objectives

After reading this unit, you would be able to:

- describe the obligations of the purchasing manager to the company;
- discuss supplier relations with purchasing manager;
- describe the policies & important issues for relationships;
- discuss improvement aspects in relationship of buyer & supplier; and
- discuss negotiation and its rules & guidelines.

Structure

7.1 INTRODUCTION

Purchasing decisions remain largely a matter of personal judgment and it is necessarily carried on, to a great extent, through personal contacts and relationships. The purchasing manager is the custodian of company funds, responsible for their conservation and wise expenditure. He or she also is a custodian of the company's reputation for courtesy and fair dealing. The ultimate act of selecting a vendor and awarding the order is essentially a matter of patronage. For all these reasons, a high ethical standard of conduct is essential. The purchasing manager not only must act ethically but should be above the suspicion of unethical behavior. A code of conduct in this context may be a prerequisite and should be formulated. A few principles that are required to be followed by the purchasing function are as follows:

i) To consider, first, the interests of his company in all transactions and to carry out and believe in its established policies.

ii) To be receptive to competent counsel from his colleagues and to be guided by such counsel without impairing the dignity and responsibility to his office.

iii) To buy without prejudice, seeking to obtain the maximum ultimate value against each rupee of expenditure.

iv) To subscribe to and work for honesty and truth in buying and selling and to denounce all forms and manifestations of commercial bribery.

v) To accord a prompt and courteous reception, so far as conditions will permit, to all who call on a legitimate business mission.

vi) To respect his obligations and to require that obligations to him and to his concern be respected, consistent with good business practice.

vii) To cooperate with all organizations and individuals engaged in activities designed to enhance the development and standing of purchasing.

In fact, establishing a long-standing relationship with the supplier base becomes the ultimate objective of any purchasing function.

7.2 OBLIGATIONS TO THE COMPANY

The purchasing manager's obligations to his or her own company essentially consist of the responsibility for doing a complete and conscientious job in the function to which he or she has been assigned. The code wisely goes beyond this, however, in emphasizing the obligation to buy without prejudice. That implies the obligation to maintain an open mind on purchasing matters. Prejudice is usually interpreted as discrimination against particular suppliers, their representatives, or their product, usually on personal or irrelevant grounds. Basically, however, prejudice concerns an attitude of mind on the purchasing manager's part that has implications far beyond this relatively simple and elementary example. Prejudice is not altogether a negative concept. A good part of all sales effort consists of the attempt to prejudice a buyer in favor of a product or supplier. There is nothing remotely unethical about this. Often it succeeds only too well. There are probably more orders placed because of the inertia that comes from habit, reinforced by relatively trouble-free experience with an established source of supply, than are withheld because of annoyance with a salesperson's mannerisms or dislike for his or her taste in shoes.

The purchasing manager has an ethical responsibility to the company not to be put under special obligation to any supplier by the acceptance of excessive entertainment or by permitting sales representatives consistently to buy his or her lunches, even though this may be done in the spirit of ordinary business courtesy. Such relationships should be kept on a thoroughly equitable basis. For this reason, progressive companies provide their purchasing executives and buyers with expense accounts. A few important aspects in this regard are as follows:

7.2.1 Ethical Obligations

The code of conduct as mentioned is necessarily of a general and practical nature. It is certainly true in purchasing that courtesy and fair dealing beget confidence and cooperation on the part of the supplier, assets that frequently spell the difference between a merely adequate purchasing performance and a major contribution to operating efficiency and sound profits. Without these, ordinary purchasing problems can readily become serious supply emergencies, particularly in times of economic change or stress. There are opportunists and "sharpshooters" in purchasing as in every other field, but they are rarely successful over any extended period of time. A growing company that expects to be in business a year or ten years hence will do well to insist upon and to support high ethical standards in its procurement policies and practices.

7.2.2 The Problem of Gifts

It is a fairly common practice for a company to distribute some sort of gift to its customers during festival seasons. It is natural for sales representatives to direct some of these gifts to the purchasing department. In the great majority of cases, such gifts are relatively inexpensive and represent a genuine expression of appreciation and goodwill.

Many purchasing departments, however, have established a definite policy against the acceptance of such favours: First, because of the possible suggestion of commercial bribery; and second, because the cost of such gifts is a "sales expense" that eventually must be reflected in the price of the goods sold and purchased. Some weeks before the holiday season, suppliers are notified of this policy by letter. Any gifts received contrary to the policy are returned with an explanation or donated to a charity. Items of small value, usually of an advertising nature, may be exceptions to such a rule. But there is danger in the haphazard interpretation that "two cigars are acceptable, but a box of cigars must be returned."

7.2.3 The Effects of Example

The head of the purchasing function is usually concerned with prestige and efficiency in the buying operation, and will avoids placing him or her under any obligation to a supplier, as a matter of ordinary business sense. Buyers can be similarly motivated if they are convinced that the company policy is firm and is enforced and observed at every level of the company, starting at the top. Various forms of commercial bribery have taken place in many company departments, even in top management-more than most people realize. That is why the head of the department must not only establish a strong policy but set a good example.

Activity 1

Ethical conduct in purchasing depends, to a large extent, on the local culture to which the purchasing agents and suppliers belong. Get the information related to this aspect in India.

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7.3 SUPPLIER RELATIONS

All department heads, but particularly purchasing managers, have an ethical responsibility to see that their companies enjoy a reputation for scrupulously fair dealing. As the point of contact in dealing with suppliers, they have a special responsibility in this respect. Their actions and conduct are critically judged, and this judgment is quickly and widely disseminated among salespeople at large. Whether or not the criticism is justified, purchasing managers cannot afford to ignore it.

It should be clear that purchasing managers are under no moral obligation to see every salesperson. Sales interviews are but one of the many activities that occupy them. This does not contradict the policy of receptiveness and openness. Some matters are not appropriate to the company's needs; others are not timely at the moment the salesperson chooses to call. Some salespersons are inconsiderate in making frequent calls when they have nothing new to contribute. Purchasing managers and not sales representatives are the proper judges of when calls become too frequent. But this does not relieve buyers of the obligation of courtesy, a prompt acknowledgment of the call and a reason for not granting an interview. Every salesperson should be seen on the first call and be given an opportunity to tell his or her story; subsequent policy will depend on the particular circumstances. There is no justification for keeping any caller waiting for a protracted period if the interview is to be denied. And in any event, waiting time should be kept at a minimum.

Accomplishing this may be primarily a matter of organizing the reception procedure. Callers should be announced to the buyer on arrival. If there is an immediate answer, it can be given at that time. If there is to be any appreciable delay before the interview can be granted, for any reason, the sales representative should be apprised of the approximate waiting time that will be necessary.

Similar courtesy should prompt the purchasing manager to inform unsuccessful bidders when a proposition has been closed, as well as to inform the one who receives the order. Small companies, particularly, cannot afford to have a large number of proposals outstanding. This would overtax their capacity should all bids be successful. They should therefore be relieved of these tentative commitments of capacity promptly. Furthermore, if the notification indicates in what respect the proposal fell short of the buyer's requirements, it will help the vendor in future negotiations and may lead to the development of a useful source of supply for the buyer. At the same time, it will temper the disappointment of an unsuccessful bidder to know that there was a real reason for the adverse decision.

When a sample is accepted for test, it entails an obligation on the buyer's part to make a fair trial, and it is a courteous gesture to inform the vendor of the outcome of that test, at least in general terms. Some buyers find it easy to terminate an interview by accepting a sample, even if they have no serious intention of giving it a trial. Such practice verges on misrepresentation and in the long run undermine the confidence that is essential to sound business relationships. It is avoided in many companies by a policy requiring that all sample lots for trial be bought and paid for by the buyer's company. This procedure works both ways: it incurs no obligation to the vendor, express or implied, beyond the transaction itself, and it gives the company a definite interest in completing the trial and making a fair evaluation of the product or material thus acquired.

Well-considered policies of this nature build confidence and respect and strengthen the personal relationships between the buyer and the vendor. Relations with supplier are affected by a number of factors, which are briefly discussed below.

7.3.1 Obligations to Suppliers

If business is to be awarded on the basis of bids, the buyer should insist on receiving firm bids within a stated time. If the buyer permits or encourages revisions, particularly at the last moment, the way is opened for sharp dealing on the part of vendors, and the buyer is not free from suspicion of the same fault on his or her own side. *If revisions are to be permitted*, the same opportunity should be frankly offered to all bidders, and, if the specifications are changed because of an alternative product offered by one of the bidders, all should be invited to bid on the new specification.

The purchasing manager is *not responsible for a vendor's error in calculating a bid*. But, if one of the proposals seems excessively low, indicating that an error may be responsible for the discrepancy, it is good practice to ask for a recalculation. If it happens that some item has been omitted from the estimate or that a mathematical error has been made, the purchasing manager is not in the position of taking advantage of such an inadvertent slip to the detriment of the seller. On the other hand, it frequently happens that such a recalculation results in an even lower bid, although this possibility may have been far from the buyer's mind. Naturally, if the bid is accompanied by a detailed breakdown of costs and the error is patent, it would be unethical to hold the vendor to such a proposal, which obviously does not represent the vendor's real intention.

Once an order or contract has been placed on the basis of a legitimate bid, the buyer is not responsible for assuring the bidder a profit on the transaction. Sellers occasionally appeal for relief from a contract that turns out contrary to their expectations, but the buyer is under no obligation to surrender or modify his or her own contractual rights if the agreement has been made in good faith. The buyer has an ethical responsibility to his or her own company and to competitive bidders in cases of this sort. If an adjustment can be made, or an alternative source found, without sacrifice of the buyer's position, it may be wise to take such action on the grounds that service and satisfaction will be greater under the new arrangement. But the whole purpose of the contractual agreement is to provide for carrying out the transaction as planned, with a definite allocation of responsibility to both parties, including the risk of unforeseen developments. As a general rule, sellers respect the buyer who stands firmly on his or her rights and prefer to do business on this basis, having the corresponding assurance that the buyer will observe his or her responsibilities under the contract just as conscientiously.

7.3.2 Confidential Information

The buyer is under no ethical compulsion to answer questions other than those that relate directly to the proposal. Competitive price information is regarded as confidential and should not be disclosed under any circumstances. And, although it is generally true that full and frank discussion leads to a better mutual understanding and perhaps to a better purchase, there are circumstances in which factors other than price are also of a confidential nature.

Although trade secrets are much less a factor in industry today than they were a generation ago, there are still a number of things that a company may wish to keep strictly within themselves. All buyers are well aware that suppliers rarely know the full extent of the uses that their product serves, the buyer may need to waive the benefits of any implied warranty on the seller's part and has no basis for later expressing dissatisfaction or pressing a claim for unsuitability in his or her purchase. The seller who is not informed as to the intended use is bound only to the extent of conformance with any specifications that may be set forth in the order.

7.3.3 Sharp Practice

The term "sharp practice" is best defined by some typical illustrations of evasion and indirect misrepresentation just short of actual fraud. They belong to the old school of unscrupulous shrewdness, when buying was concerned with the immediate transaction rather than the long-range programme. These examples would have been commonplace among an older generation of buyers, and sellers in that period were habitually on their guard against such possibilities. In modern procurement and marketing, which are based on mutual confidence and integrity, such practices are frowned upon just as severely by the buyers themselves as by the sales organizations with which they deal.

It is sharp practice for a buyer to talk in terms of large quantities, encouraging the seller to expect a large volume of business and to quote on a quantity basis, when in fact the actual requirement and order are to be in relatively small volume that would not legitimately earn the quantity consideration.

It is sharp practice to call for a large number of bids merely in the hope that some supplier will make an error in his or her estimate, of which the buyer can take advantage.

It is sharp practice to invite bids from suppliers whom the buyer will not patronize in any case, using these quotations only for the purpose of playing them against the proposals of those who are really acceptable sources of supply. It costs money, time, and effort to prepare estimates and bids. Sellers are glad to undertake the expense in the hope of securing a contract, but the buyer has no right to impose these costs on a seller when the buyer has no intention of giving the seller an opportunity to get the business. .

It is sharp practice to leave copies of competitors' bids or other confidential correspondence in open view on the desk while negotiating with a seller, in the knowledge that the latter can scarcely fail to notice them.

It is sharp practice to deal only with "hungry" suppliers and to try and keep them hungry so as to force concessions. More generally stated, this applies to any abuse of purchasing power to the detriment of the seller. Although it is legitimately expected of a purchasing manager to make full use of his or her company's purchasing power, this factor should normally operate to mutual benefit, with the buyer's position strengthened by virtue of being a more desirable customer, offering greater volume, steadier flow of orders, more prompt payment, or similar considerations of value to the seller.

7.3.4 Combating Unethical Practices

The subject of business ethics is not one-sided. Purchasing managers and buyers are faced from time to time with unethical sales practices. There is sharp practice in selling, collusive bidding, restrictive conditions in specifications, artificial stimulation of demand and prejudice among shop operatives, sabotage of competitive products, padding of orders and shipments, use of unfamiliar trade terms and measurements, supposedly sample orders that are magnified into excessive quantities, obscure contract clauses buried in small type, and many others. In most cases these can be avoided by proper selection of vendors, but perhaps only after unfortunate experience has indicated the disreputable sources of supply. In dealing with some of the practices, such as collusive bidding, more direct and aggressive action is called for as a corrective measure.

What is needed to restrict such unethical practices is competent, objective buying, supported by the necessary follow-through with insistence on contract performance, acceptance testing, and the like. The purchase order or contract in itself constitutes a legally enforceable document. All supplementary agreements, specifications, and special terms should likewise be reduced to writing, using care to see that no ambiguity exists in respect to what is expected of the seller.

Confidence in a supplier is an essential of any sound purchasing department, but confidence need not be blind. It must be earned and the reputable supplier welcomes the opportunity to show that he or she is worthy of confidence.

7.4 POLICIES FOR RELATIONSHIPS

Every purchasing department has policies, whether or not they are put into writing. They are one of the administrative tools of departmental management. There are three specific advantages of establishing these policies:

i) an established policy eliminates the necessity for making a new decision every time a comparable situation arises,

ii) a written policy assures understanding and ensures that decisions and actions are consistent and in accordance with the judgment of the responsible department head, and

iii) an approved policy gives authority to the indicated course of action.

The policies may be described under the following categories.

7.4.1 Internal Relationships

The establishment of a purchasing department is in itself a policy or company management. It immediately entails a whole series of internal and interdepartmental policies relating to lines of authority, channels of procedure, and departmental relationships in general. These policies should be promptly clarified and made a matter of record, for they define the scope and responsibilities of the purchasing function in any particular organization and determine to a considerable extent the effectiveness of the purchasing operation. Neither can they be set by the purchasing manager alone, because they affect the responsibilities and actions of other departments as well.

Policies in this category include such matters as the authorizations required on requisitions to purchase, permissions for vendors' sales representatives to contact plant personnel, the final responsibility for specifications, the procedures to be followed in standardization and value analysis recommendations involving engineering changes.

To be effective, a policy must be clear and definitive, but it need not be arbitrary. Consequently, many policies set up criteria for decisions, or methods of handling situations, or conditions of action. For example, it is obviously undesirable to grant free access to plant personnel for all vendors' sales personnel, either at their own initiative or at the request of plant managers, for such a policy would negate the principles of centralized purchasing. Yet there are many situations in which such a contact is mutually desirable and is, in fact, an aid to intelligent procurement. A sensible and commonly accepted policy on this point is to require that such contacts be made through the purchasing department and that in such interviews no commitments are to be made by plant personnel as to preference for products or sources, which might weaken the position of the purchasing department in subsequent negotiations.

7.4.2 Vendor Relationships

Relationships with vendors and their representatives, too, are subjected to policy control. It is for the buyer to decide whether a particular proposal from a supplier is pertinent and timely from the viewpoint of the company's needs and whether the interview time is warranted. The purchasing department may suggest fixed calling hours, and, make provision for exceptions in the case of the out-of-town caller and special appointments. The policy guidelines may dictate that

i) price information is kept confidential for industrial purchasing,

ii) vendors are permitted to revise their bids only in case of obvious error, or in a subsequent negotiating stage if terms, quantities, or specifications are modified so as to warrant a price adjustment,

iii) if it becomes a new proposal on the buyer's part, a new request for bids may be in order,

iv) if the vendor is selected on merit, on the basis of the original proposal, and the terms are altered in negotiation, he or she will probably stand on the original choice,

v) unsuccessful bidders are required to be with the reasons for the adverse decision, if feasible.

Ordinarily, purchasing policy favours the use of the buyer's standard order form and terms in all cases. But sometimes, when Installations and special warranties are involved, the vendor's form that is specifically designed for these situations is more appropriate and obviates the need for writing in a lot of special clauses and conditions on the buyer's form. For such cases, purchasing policy can set up certain criteria for the acceptability of a seller's form. These criteria safeguard the rights of the buyer and avoid conflict with other basic company and purchasing policies. The policy may include getting approval of the contract by the company's legal department.

It may be good policy to use personal contacts on a systematic basis and to extend it with a policy of inviting vendors periodically, individually or as a group, to acquire a personal knowledge of the buyer's plant operations.

7.4.3 Policies On Supply Source

Another group of purchasing decisions that lend themselves to the guidance of a consistent and considered policy concerns the selection of supply sources. The policy of maintaining multiple or alternative sources is almost universal. But this does not answer the question of what kind of sources should be chosen.

The local supplier usually offers natural advantages of convenience, faster deliveries, and lower transportation cost. There are factors that weigh in his or her favour in any source consideration. However, the objective appraisal of supply sources may show others to be equally or more desirable, and a more distant competitor may underbid the local bidder sufficiently to offset his or her initial advantage. To foster good community relations local sources sometimes, are given business thereby helping maintain local prosperity by keeping business in the local area. These factors have enough validity and importance to make some companies go so far as to establish a small percentage cost differential that is considered acceptable in dealing with local sources, all other things being equal. Such a policy is usually permissive, rather than mandatory.

Assuming that facilities are adequate and that prices are competitive, the policy should be made known regarding preference of small or large companies as suppliers. The case for the small company as a supplier usually hinges upon the fact that an order or account of given size looms proportionately larger in the operations of a small supplier, and it is logical to expect that he or she will give it closer individual attention and service than it might receive in the larger organization, where it is of relatively minor importance. Another argument cited in favor of the small company is the rather paradoxical one that the buyer's patronage helps the small company to grow larger and hence the buyer will get greater loyalty and cooperation from the small supplier. Both arguments are probably unfair to the many efficient and conscientious large supplier companies that have attained their present stature through high standards of service.

Should an effort be made, as a matter of policy, to deal, so far as possible, directly with primary manufacturing sources rather than through distributors and other middlemen? If quantity warrants, there may be some price advantage on direct shipments. If the distribution system and price structure are such that there is no saving on direct purchases, as is often the case, there may be advantages in the distributor's services. A reputable manufacturer supports his or her products and warranties, and usually provides essential technical services in either case.

7.4.4 Reciprocal Purchasing Policy

One of the most troublesome and controversial policy questions that purchasing executives have faced is that of reciprocity. The urge to select suppliers on the basis of how much they may buy from one's company is both common and understandable. But it generally does not come from those purchasing managers who take scientific purchasing seriously. Most of the effort to promote reciprocal buying comes either from suppliers or from within the buyer's own organization, usually from top management or the sales department.

Under any form of reciprocal buying policy, purchasing becomes less selective because freedom of choice from among several suppliers is limited. It negates the critical criteria that scientific purchasing calls for in the selection of sources, and it discourages competition among other suppliers, who quickly become aware of its existence. In short, the purchasing manager may lose of negotiating and buying power.

7.5 IMPORTANT ISSUES IN RELATIONSHIPS

Let us discuss some important issues in relationships.

7.5.1 Cordial Relations between Buyers and Sellers

The buyer as well as the seller know very well that good relations are essential for the smooth running of a business. Yet there are many suppliers who frequently fail to meet the delivery schedules and fail in quality standards. The suppliers on the other hand complain about delayed payment, cancellation of orders, and increased rejection due to rigid inspection. In any organization, it is the prime responsibility of the materials manager to keep relations smooth.

The buyer and seller must recognize that they are partners in a work that requires joint responsibility, and as such, good relationships between them can go a long way in adding to the vitality of on-going professional relationships as well as in increasing the effectiveness. The underlying philosophy should be based on mutual confidence and should be one of inter-dependence. The primary objective of the relationship is to buy and sell for a profit. The supplier can assist the buyer through ideas for cost reduction, new products and, service even during a crisis. Such healthy relationships are possible only when both the parties are competent in their profession and respect the principles of human relations. For example, if the supplier lacks the know-how and facilities to meet the specifications sought by the buyer, he will be of little help. Similarly, if the buyer lacks techniques of negotiating with the suppliers, he can never hope to develop a meaningful relationship with the supplier. The buyer should consider a good vendor as an intangible asset of his organization.

7.5.2 Control In Practicing Reciprocity

Reciprocity is the practice of selecting one's own customers as suppliers. In fact, under reciprocity, the materials manager may even accept slightly higher prices from a supplier because he is also a customer. Sometimes this practice may result in strained relations between other suppliers and the buyer. Whereas reciprocal buying is advantageous in boosting the sales and fosters goodwill with the suppliers in question, it is not a desirable practice as in many cases such suppliers are very small in number. This is especially so in the case of companies which have only one product to offer when many of the suppliers will find no use for the product.

7.5.3 Backdoor Selling

Suppliers' salesmen form an excellent source to developing healthy and effective relations. Many companies provide information to the salesmen as the names and locations of the buyers responsible for different commodity classifications, a physical locations of purchase departments, norms of the company with regard to suppliers' salesmen etc. This may imply that they need to have dealings only with the concerned buyer. On no occasion, except with the buyer's explicit approval, should they meet the operating personnel. Several arguments can be put forward to justify this. Firstly, it is the buyer's responsibility to meet the seller's salesmen for which he gets paid. Secondly, salesmen may unnecessarily waste the time of operating personnel in discussing problems which are better sorted out by the buyer. Further, the user should not be directly approached by the vendor for ethical considerations.

7.6 IMPROVEMENT IN RELATIONSHIPS

Buyers should make it a point to look upon their relationship with suppliers as one of inter-dependence. It is essential that buyers should understand the needs of suppliers. Suppliers expect fair and honest dealings, ethical practices and a minimum amount of rush orders. During negotiations they prefer to deal with buyers who have sufficient authority, and who are reasonable and well informed. The materials manager must ensure that personal contacts are encouraged. In this context, the buyer should periodically visit the suppliers' plant and assess the suppliers' strengths and weaknesses.

Many buyers have found it useful to organize meetings of their suppliers periodically, to develop personal contacts and to acknowledge inter-dependence. Some buyers believe in organizing 'informal meetings' with major suppliers to explore possibilities for cost-reduction. The following steps may ensure that buyer-seller relationships are kept at a healthy level:

i) Inform the vendor of the major purchase policies.

ii) Make it a point to give the salesmen a courteous reception when they visit the plant and interview them as per pre-arranged schedule.

iii) Give adequate notice to the vendors so that they can be ready with quotations. Recognise any extra service rendered by salesmen through a letter of appreciation.

iv) Be ready with "home work" so that negotiations can be businesslike and to the point. This requires the obtaining of complete quotations, tabulations, and vendor rating information. When a buyer is armed with such information, his negotiations with the supplier are purposive and the supplier also saves his time and effort.

v) Keep rush orders at a minimum and inform the unsuccessful bidders as to why they have not received the orders.

vi) Allow permissible tolerances in inspection and forward inspection reports to the vendors with suggestions so that they could improve.

vii) Ensure the removal of rejected materials from the buyer's premises promptly.

viii) Do not cancel orders with suppliers at the last minute. Give sufficient notice to the supplier for the cancellation of all order.

ix) Clear the outstanding bill of the suppliers as expeditiously as possible.

Many other factors, such as fair dealing, living up to the agreements in both letter and spirit, assisting suppliers in development, proper appreciation of each other's difficulties and mutual confidence can help in moulding cordial buyer-seller relationship. It is necessary that the buyer should have an adequate and competent staff who could assist him in scheduling interviews with the suppliers, preparing the necessary groundwork, soliciting and refining the opinions of the suppliers for corrective measures and so on.

Attempts must also be made by the materials manager to evaluate his department's relations with suppliers from time to time. He should compare, over a time period, a number of factors, such as the number of visits made to suppliers' plants, number of meetings held with the suppliers to sort out mutual difficulties and complaints regarding gifts, backdoor selling.

7.6.1 Importance of Public Relations

Good public relations and sound ethical principles contribute towards better buyer-seller relationship. Public relation is very important for the image of an organisation and significantly contributes to the buyer/seller relationships. The materials manager is in a position to contribute significantly to the public relations efforts of the company. It is quite possible that the materials manager in discharging his duties may have good relations with some and not-so-good relations with others. The underlying philosophy in any public relations effort is the ability of the members of the organisation to put themselves in the position of the persons with whom they deal and view the situation from their angle as well.

Public relations may be looked upon as an effort to develop a favourable climate and attitude towards the company, or to create a good image for the company. It can also be defined as an effort through which the company hopes to ensure the understanding and goodwill of its customers, employees, suppliers, as well as that of the public in general. By this definition, it follows that this effort consists of two parts. The first part concerns internal relations, and the second pertains to external relations.

i) Internal Public Relations

The materials management function is required to work with other functional departments of a company. Naturally, a good relation and rapport with other departments ensure that materials management can function very effectively. This rapport can be achieved through the realisation of the interdependent nature of the relationships, without tending to overemphasize one function in relation to others.

There are very simple yet effective ways in which such a relationship between materials management and other departments can be established. Apart from formal communication channels, every organisation has its informal channels. These channels are of great help in getting to know the other departments' problems with materials management so that remedial measures can be taken. There are several reports which are of interest to user departments. For example, a report on substitute materials, transport bottlenecks, delay in supply position, and incoming materials quality, may be of great assistance to the production department. Similarly, reports on price trends may be of interest to the finance department. Such formal reports in combination with informal channels can considerably foster good relations within the company.

ii) External Public Relations

Normally, the materials manager is the first point of contact between his organisation and the suppliers. He must recognise the value of time, show understanding and appreciation of the services, information given and suggestions made by the representatives of the suppliers. It is likely that with some representatives no business is possible for a long time. Yet a diplomatic knack of tackling them will keep future business open to both the parties.

During the course of his job, the materials manager writes to many outside agencies. This could act as an effective public relations tool. Prompt replies to suggestions, quick intimation about price changes, courtesy in written communication and telephonic conversation, prompt reception to salesmen, and courteous interviews, may go a long way in building up the image of the company, in general, and the purchase department in particular.

Quite a number of organizations have found it desirable to periodically feed the suppliers about the quality and delivery performance and furnish inspection reports, thus pointing out the areas where improvements are desired. Such initiatives really strengthen the rapport between the suppliers and the buyer.

7.6.2 Training In Relationship Skills Development

In the backdrop of fast changing technology and an ever growing economy, the function of the materials manager is becoming quite challenging. A seller's market as well as the increasing impact of government policies together make the challenge. Furthermore, top management is increasingly expecting the materials department to play a vital role in the company's cost reduction aspects. Therefore, additional skills have to be imparted to prepare an executive to react effectively to changes. An exposure of the purchase manager to sensitivity training and workshops can prepare him to function effectively within the organisation as well as with outside agencies and help him to project a favourable image. Role playing and case studies are some of the well known training techniques which will prepare the materials manager to handle public relations functions effectively.

One of the hallmarks of a professional person is that his devotion to excellence in his chosen field outweighs the selfish desire for personal gains. In this context, agencies like the National Association of Materials Management, the Materials Management Officers' Association of India and the Indian Society for Materials Management can play a significant role in promoting the image of the materials management profession. The advantages of membership in such agencies are not far to seek. The members get an opportunity to meet and exchange ideas. Such agencies do bring out periodicals and the members can effectively use this media to air their views and contribute professional articles. The suggestions of these agencies are considered by the government while formulating import policies or in allocating critical raw materials. These professional agencies can aid the individual materials managers in improving buyer-seller relationship as well as the ethical standards of the profession.

Activity 2

Compare and contrast in respect to (i) buyer-seller interrelationship, and (ii) types of contract management between military hardware and civilian products in India. Make a library/internet search on contract management in military organizatins.

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7.7 NEGOTIATION IN PURCHASING

Negotiation is one of the more important and interesting aspects of the purchasing cycle. It can also be one of the most stressful parts of arriving at a purchasing agreement. Negotiation is complex and costly, and is used primarily for high volume purchases and for new items where costs are unknown. High value purchases do not automatically dictate the use of negotiation. The competitive bidding process is the preferred method of purchasing, because competition is more likely to determine the right price than are most skilled negotiators. When competitive bidding is not feasible, negotiation becomes the appropriate method of purchasing.

7.8 DETAILS OF NEGOTIATION

Webster's defines negotiation as "conferring, discussing, or bargaining to reach agreement in business transactions." For the purchasing agent, negotiation must be used in its broadest sense, as a decision-making process regarding a purchase order. In this context, negotiation is a process of planning, reviewing, and analyzing all data used by the seller and the buyer to reach an acceptable agreement for the purchase order, which includes all aspects of the business transaction, not just price. Thus, *Negotiation* may be defined as "the process of working out a procurement and sales program together, to the point of reaching a mutually satisfactory agreement."

In practice, the term is generally applied in industrial purchasing to the more complex situations involving buyers and sellers, in which both make a number of proposals and counterproposals before an agreement is reached.

7.8.1 Elements of Negotiation

Negotiation depends on the use of communication skills and involves the psychology of persuasion. The purchasing agent must know that negotiation in itself is a useful tool of human behavior, for negotiation is conducted between two individuals, and as such, can be mastered by study and practice.

The purchasing agent should enter negotiation with a positive attitude toward achieving the objective, as well as having decided upon the maximum extent of his potential concessions. Nothing contributes more toward successful negotiation than advanced planning of strategy and setting the objective.

7.8.2 Objectives of Negotiation

The main objectives of negotiation are as follows:

i) to obtain a fair and reasonable price for the quantity requested,

ii) to receive assurances that the supplier will perform on time,

iii) to exert some control over the manner in which the contract is performed,

iv) to persuade the supplier to give the buyer's firm maximum cooperation, and

v) to develop a sound and continuous mutually beneficial relationship with competent suppliers.

Contracts often contain clauses pertaining to changes in the original agreement, which are usually made by negotiation. A typical contract contains the following information:

i) Price (escalation clauses, redetermination clauses, allowable costs in cost-plus contracts, etc.).

ii) Quantity, quality, delivery schedule, and mode of transportation.

iii) Terms or other conditions that may alter the performance of the original contract.

7.8.3 The Negotiation Process

Prior to any negotiation session, the purchasing agent negotiator must evaluate all relevant information and assess his or her own strengths and weaknesses as well as those of the supplier. From this assessment, the purchasing negotiator develops the tactics and strategy for negotiation. This plus the negotiating skills are the controlling factors that can be influenced by the level of preparedness for any and all contingencies.

The first step in planning for negotiation is to establish the objectives. In developing these objectives, actual numerical ranges are established for quality acceptance, actual dates of delivery, and actual monetary value for applicable elements of cost. The major elements of cost traditionally negotiated include quality of material, quantity of material, quantity of labour, labour wages, price of material, factory overhead, and other costs entering the price factor. It must also be noted that the purchasing agent should never enter into negotiations unless the supplier's negotiator has the authority to agree to any or all of the points in the negotiation.

The following issues become highly relevant in the negotiation process:

i) **Supplier's Bargaining Strengths**

The seller's bargaining strength usually depends on the following three factors:

i) the seller's desire for the contract,

ii) the seller's certainty of getting the contract, and

iii) the time available for negotiation

The seller's desire for the contract: The purchasing agent should encounter no difficulty in determining the eagerness of the seller for the contract by noting the frequency of the sales representative's calls about the goods in question and by knowing general market conditions. These are positive indicators of the seller's interest in the contract. The seller's annual financial report, as well as the backlog of orders, volume of operation, and the trends of the industry are valuable information.

The less a seller needs or wants a contract, the stronger is his bargaining position. The presence of an industry boom places the seller in a strong bargaining position. The reverse is true in a general recession or when the seller has excess unused production capacity.

The seller's certainty of getting the contract: If a seller learns that his prices are lower than his competitors' or that he is the preferred source or the sole source, the seller will conclude that the chance of obtaining the contract is almost 100 percent.

Under these circumstances the seller can become most difficult to deal with during any negotiation. In extreme situations, the seller may be unwilling to make any concessions.

When trapped by such circumstances, the purchasing agent may threaten delay and search for an alternate source. Such approach is likely to be ineffective unless the supplier knows that other sources are available and interested in the contract. Another option, when no payments are involved, is for the purchasing agent to threaten to have the item manufactured in the plant. When made realistically and the seller believes that the buyer's plant has the technical know-how and capacity to make the item, this threat gets consideration.

A firm's negotiating position is always strengthened when the firm has a policy that states that only the purchasing agent has the authority to discuss pricing, timing, and other contractual conditions with the seller. Most pre-negotiation leaks give the seller a feeling of self-confidence about getting the contract. Such leaks are often from the technical or production staff, and because they are often undetected by general management, they can be a continuing source of profit loss.

The time available for negotiation: Short lead time drastically reduces the purchasing agent's bargaining strength. Once the seller learns of the short lead time, he merely "drags his feet" and negotiation terms become favourable to him.

ii) Purchasing Agent's Bargaining Strengths

The purchasing agent's bargaining strength also depends on the following three factors:

i) the extent of competition among the potential sellers,

ii) the adequacy of cost and price analysis, and

iii) the thoroughness of preparation by the purchasing agent.

The extent of competition among competitors: The greater the number of potential suppliers, the greater is the purchasing agent's bargaining strength. The general economic climate, among other factors, has a substantial bearing as to the extent to which supplier wants to compete. The backlog of orders, shop load, and inventory position, are the other factors that have a stray bearing on the ever-changing competitive climate. If necessary, the purchasing agent may increase competition by developing new sources of supply, buying supplier companies, providing tools, money, and management to competent but temporarily weak suppliers, or by making the items in-house rather than buying.

The adequacy of cost and price analysis: A comprehensive knowledge of the principles of cost and price analysis is one of the basic responsibilities of an effective purchasing agent, and more so for the- purchasing negotiator. The greater the amount of information available to the purchasing agent concerning the various costs of the supplier, the greater is his bargaining strength.

The thoroughness of the purchasing agent's preparation: The more knowledge the negotiator acquires about the theory and practice of negotiation, the supplier's bargaii1ing position, and the items being purchased, the stronger his bargaining position becomes. A purchasing negotiator without a thorough knowledge of the item being negotiated (how it is used, what items can be substituted for it, its alternate method of production, and his company's future requirements for the product, etc.) is greatly handicapped in negotiation. The purchasing agent is similarly handicapped if he has not studied, analyzed, and evaluated every detail of the supplier's proposal. Whenever feasible, before requesting quotations or entering negotiations, the purchasing agent should estimate the price and value levels of the product to be contracted for.

Knowledge of current economic conditions as well as trends in the market for the product in question are also essential to preparation.

iii) Negotiation Techniques

A competent negotiator determines before, or very early in, the session which of the *concessions* he is prepared to make are of the greatest importance to the supplier. By holding off in these areas while making minor concessions in other areas, the purchasing agent retains assurance of making substantial gains later in the session. Once the purchasing agent makes the concessions important to his adversary, he loses his bargaining strength.

The buyer should strive *never to lose the initiative* that he automatically obtains when he receives the supplier's proposal. The competent buyer always "carries the game" to the supplier. He should keep the supplier on the defensive by making him justify his position.

The *wise use of questions* is a very important technique in negotiation. By properly timing and phrasing the question, the negotiator can control the progress and trend of the negotiation. The *technique of answering* questions is just as important as the technique of asking them. The competent negotiator knows when to answer, when not to answer, when to answer clearly, and when to answer vaguely. Not all questions require an answer.

The *correct answer* in negotiation is not governed by the same rules governing answers in the classroom. In case of negotiation questions, the correct answer is the answer that helps promote short-term tactics and long-term strategy.

Another important characteristic of a competent negotiator is being a *good listener*. By listening the buyer can learn the basic need of the supplier. Suppliers may talk themselves into concessions the buyer could not otherwise gain. Listen carefully to the choice of words, phrases, and tone of voice; at the same time observe any gestures or "body language" used. They can be revealing.

There is also the *human side* to negotiations. The buyer may know the supplier's representative; if not he should strive to learn as much as possible about the personal habits of that representative. When tempers start to get out of hand, as they occasionally do, the experienced negotiator quickly diverts attention from the "stressful" situation at hand. A joke or a tea break can be an effective method for easing the tension. This type of diversion is usually more easily accomplished when each participant knows what situations are most irritating to the other.

In most purchasing negotiations, interdependence is the backbone of bargaining relationships. Neither the buyer nor the seller can achieve any goal without taking the goal of the other into consideration. The end product of negotiation is an exchange of concessions that result in a contract advantageous to both parties. While both buyer and seller benefit from a well-negotiated contract results are seldom divided 50:50. In most cases a 60:40 contract results because one negotiator is more skillful.

The process and techniques of negotiated purchasing deserve special attention for two basic reasons. First, the whole concept of negotiation is widely misunderstood, and in many cases suspect, even by persons engaged in purchasing. Second, technological change has made industrial procurement increasingly complex, particularly in defense-related industries. Simple rule-of-thumb approaches to buying one-of-a-kind machines or systems, for example, are no longer adequate. Nor are they any longer satisfactory in the purchase of less complicated items like raw materials and maintenance supplies. The trend toward long-term purchase agreements on these commodities has placed special emphasis on many aspects of the transaction that are open to negotiation. Responsibility for holding inventory, timing of deliveries, methods of transportation, inspection, and prices are only a few of the factors that must be agreed upon before a purchase is complete.

7.9 COMPETITIVE BIDDING AND NEGOTIATION

When competitive bidding is used in industrial purchasing it usually indicates that there is a market for the item and that some prices level has been established. The product to be bought is an accepted standard and its specifications are relatively simple and clearly spelled out.

Negotiation, on the other hand, calls for face-to-face discussion by buyers and sellers to hammer out details of a contract too critical to be covered by an exchange of paperwork. The product under consideration may be one-of-a-kind of special design or competition. There are rarely competitive markets for such items, and certainly no established prices. Negotiation is definitely called for when buyer and seller have different estimates of what it costs to make, deliver, and service a product. Negotiation invariably involves discussions on a range of elements that go beyond price, such as warranties, technical assistance and service, methods of shipment and packaging, and payment terms. Even contracts for standard items requiring large expenditures over a year or more should be negotiated on the same basis.

Negotiation is generally used in the following situations:

i) When the purchase involves equipment of a unique or complicated nature that has not been purchased before and for which there is little cost information. A conveyor line for a new, automated food-processing plant is an example. Details of the construction, performance, and cost of such an installation require involved technical discussions before a purchase was actually made.

ii) When prices of an item are fixed, by custom, "fair-trade" laws, or actual collusion among suppliers. If there are many suppliers in the field, good negotiating tactics are generally successful in winning concessions from one producer who is anxious to get the business.

iii) When there are few suppliers or only one in the field, but the product in question can be made in the buyer's own plant or bought from abroad or a substitute for it is readily available.

iv) When a number of suppliers have bid on an item, but none of the quotations is completely satisfactory. None may meet the buyer's requirements as to price, terms, delivery, or specifications. In this situation, the buyer must be sure, before he or she attempts to negotiate, that all bids are unsatisfactory in terms of the requirements that he or she first placed before the suppliers. It is highly unethical to lead a supplier into committing himself or herself in a quotation merely to put him or her into a disadvantageous bargaining position. Responsible buyers will notify suppliers in advance that bids may be subject to negotiation.

v) When an existing contract is being changed and the amount of money involved is substantial enough to warrant discussion. Major price changes on high-volume items, for example, are subject to negotiation.

7.10 NEGOTIATING GUIDELINES AND RULES

Negotiation is often a highly technical matter, but it is always a very human matter as well. Because the essential element in a negotiation is bargaining between individuals, the process involves personalities, human motives, people's strength and weakness, and a great deal of psychology. The following general rules are worth mentioning in this context:

i) *Try to have the negotiation carried on your home ground, according to your own arrangements*. There is a psychological advantage to having the other party come to the discussion. It implies that you arc in control and have already won one concession. Provide a dignified, comfortable, well-lighted meeting place, free of distractions. Put the leader of your own negotiating team at the head of the table, and try to keep the members of the other team separated.

ii) *Let the supplier do most of the talking.* At least, in the beginning. Let the supplier give the reasons for his or her demand first. If you use the proper restraint, he or she may talk himself or herself into making concessions that were never intended.

iii) *When your time comes to talk, don't fumble over facts and figures*. Never send out for vital information in the middle of a discussion. Lack of information or lack of confidence puts you at a strong psychological disadvantage.

iv) *Try to avoid emotional reactions to the supplier's arguments or an emotional approach in presenting your own.* Otherwise, you'll obscure the real purposes of the negotiation and possibly endanger your own position. A person who lets pride or anger govern his or her relations with others usually ends up by giving away more than he or she intended.

v) *If the supplier has to retreat on a point, let it be done gracefully.* If you spot something wrong in a cost estimate, for example, don't accuse the other side of trickery or ineptitude. Suggest that a revision is in order.

vi) *Avoid premature showdowns.* You have to come to some sort of a showdown ultimately—that's the reason for the negotiation. But, if you force a supplier into a position in which he or she feels compelled to say, "Here are my terms, take them or leave them," that may end the discussion there. After that kind of an ultimatum it would be difficult for the supplier to give further concessions. So, before you make your final concession, be absolutely sure that it is absolutely final.

vii) *Satisfy the emotional needs of the people with whom you are negotiating.* Most suppliers enjoy selling and persuading, but they are somewhat insecure. Give suppliers a chance to persuade rather than trying to head them off brusquely, and they will be better disposed to make concessions to get your business. And give them the impression that, despite your bargaining with them, you respect their position and regard them as members of your corporate team.

Attributes of the person negotiating a contract play a crucial role for successful negotiation. In this context, one must be familiar with the attributes of good negotiation. The attributes of good negotiators may be as follows:

i) They must be clear, rapid thinkers. The give and take of a complex negotiation requires a person bale to think quickly.

ii) They must express themselves well and easily. In negotiation what you know may not be as important as what you convey to others. The ability to communicate effectively is an absolute must. Ease of expression does not mean glibness. It comes from a knowledge of the business at hand.

iii) They must possess the ability to analyze. They must be able to analyze the statements of others and identify those who favor their position, those who oppose it, and those who favor another solution.

iv) They must be impersonal. In the heat of a hard-fought negotiation, it is sometimes difficult to remain calm. But a negotiator must always approach a problem from the basis of the company objective rather than from personal inclinations.

v) They must be patient. Sometimes letting the other persons talk themselves out or explain their positions helps resolve issues without argument.

vi) They must be able to consider other person's ideas objectively. They should be able to place themselves in their opponents' frames of reference, so they can better evaluate those positions.

vii) They must be tactful, have poise and self-restraint, like people, and have a good knowledge of human nature.

viii) They must possess a sense of humor. You can't win every point in a negotiation. An ability to make concessions and to continue to display good humor will pay dividends in good will, which will help in resolving the remaining issues.

7.11 SUMMARY

Negotiation is the basic process by which competition is furthered in industrial buying and selling. It is the special responsibility of the purchasing agent to negotiate the best possible deal to achieve company objectives, just as it is the special responsibility of sales representatives to negotiate for their companies's objectives. In order to have best-possible advantage and to create a good image of the buyer's company, it is essential that sound purchasing policies based on ethical standards be followed. This will ensure a long-standing relationships between the buyer and the seller. A set of general rules may be developed for this purpose by a company, and the purchasing agent of the company must have adequate skills and attributes that help him or her establish as a successful negotiator.

7.12 SELF ASSESSMENT QUESTIONS

1) Describe a few situations in which negotiation is considered the appropriate method of purchasing.

2) Explain the difference between purchase by competitive bidding and purchase by negotiation.

3) Mention the basic principles and techniques to be followed in purchase by negotiation.

4) What are the factors that influence the buyer-seller relationship? Discuss them in brief.

5) Discuss the important policies that a company is required to use to foster good buyer-seller relationships.

6) 'Sound ethical principles contribute toward better buyer-seller relationships'. Comment.

7) What precautions a company should take to maintain sound ethical purchasing norms and practices?

7.13 REFERENCES AND SUGGESTED FURTHER READINGS

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