

DEPARTMENT OF BUSINESS MANAGEMENT

PURCHASING MANAGING

AUTHORS
MS I FOURIE
PROF J A BADENHORST-WEISS
MR J D NEL

ONLY STUDY GUIDE FOR
MNP2601

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PREFACE

MODULE AIM

The aim of the module is to introduce you to purchasing management in the broader context of strategic supply management, in order for you to understand the tasks and processes of the purchasing function within organisations and some of the key performance indicators thereof.



MODULE OUTCOMES

After studying this topic you should be able to

- put the purchasing function in perspective
 - fully explain all the supply management approaches
 - list and clarify purchasing management tasks
 - illustrate and explain the purchasing process
 - discuss purchasing and supply strategy
 - compile purchasing and supply policies
 - participate in the process of the selection and performance evaluation of suppliers
 - discuss sustainable purchasing and supply management
 - discuss purchasing price determination and cost analysis
 - fully explain the management of quality in purchasing and supply
 - clarify purchasing quantity and inventory management
-

THE MODULE

Welcome to the module Purchasing Management (MNP2601). This module focuses on purchasing management within the organisation as part of a broader strategic supply management approach. Over the past few years, research has proven that purchasing management is most effective when it is seen not as a purely tactical function of an organisation, but as a strategic asset used to impact the bottom line of an organisation under the direction of cross-functional teams. You should therefore keep in mind that the purchasing function does not operate as a separate entity, but is in constant interaction with the other stakeholders, both within and beyond the borders of the organisation. The right interaction with suppliers leads to the delivery of efficient and effective goods or services from suppliers to the correct processes within the organisation, which will optimally satisfy customer expectations.

Over time this interaction has changed and is recognised through management concepts that have developed, such as strategic sourcing and supply chain management. These concepts are explained in this module.

This module gives you an opportunity to look closely at an area which will undoubtedly play an increasingly important role in the prosperity of commercial enterprises and noncommercial institutions, such as government departments and NGOs. The module should therefore be regarded as a snapshot of the broad and dynamic phenomenon of purchasing and supply management in organisations. You will also be introduced to certain fields of application such as purchasing capital equipment, purchasing from small businesses and purchasing services.

PURPOSE OF THE STUDY GUIDE

The purpose of the study guide is to lead you through your study of the prescribed book. Since the prescribed book is your primary source of study material it is crucial for you to buy it. The prescribed book for this paper is:

Hugo, WMJ & Badenhorst-Weiss, JA. 2011. *Purchasing and supply management*. 6th edition. Pretoria: Van Schaik.

The study guide divides the syllabus into *topics*, which in turn are divided into *study units*. Each study unit contains *aims* and *outcomes*, as well as *activities* that you can do to test your knowledge of and insight into small sections of the study material that you have studied. At the end of each study unit are *assessment questions*. We have also included examples and appropriate, interesting articles, mainly from websites. The purpose of these articles and examples is to make the study guide more interesting and practical. You do not have to study them, but they might contribute to the learning process.

EXPLANATION OF CONCEPTS

TOPIC: This is a section of the work which contains a major component of the tutorial matter for the course. Each topic comprises one or more study units.

STUDY UNIT: This represents an identifiable portion of a topic. A study unit is based on one chapter in the textbook. Each study unit has a broad aim and learning outcomes which indicate what you should have learned when you have completed the unit.

THE SYLLABUS

The syllabus for the module in **Purchasing Management** is divided into four topics and 12 study units. Each study unit covers one of the chapters in the prescribed book.

Topic 1 consists of an overview of the purchasing management function. It puts the purchasing function and other supply approaches in perspective; investigates the essentials of the management task of purchasing and supply management (including purchasing planning, coordination and performance evaluation of the purchasing function); and examines the activities (including documentation and stakeholders) involved in purchasing transactions – differentiating between manual and automated processes.

Topic 2 is concerned with managing the supply base. It focuses on purchasing and supply strategy and policies, specifically targeting the strategic sourcing and outsourcing processes; and examines suppliers (particularly the various purchasing and sourcing decisions, the performance evaluation and selection of suppliers, supplier certification, and the various purchaser/supplier relationships).

Topic 3 deals with the key performance indicators of purchasing and supply, such as the relationship between purchasing and supply management and corporate governance, and its impact on social responsibility, ethics, sustainability and risk management; the management of quality in purchasing and supply (including standardisation, value analysis and quality control); price determination and cost analysis; and the various tools required to manage purchasing quantity and inventories effectively and efficiently.

Topic 4 covers the application fields of purchasing and supply management. In this topic we look at the purchasing of capital equipment; purchasing of services; and purchasing from small businesses with a focus on black economic empowerment.

ASSESSMENT

Answer all the assessment questions at the end of each study unit in your study guide. This is important preparation for the examination. You will notice that some questions are directly knowledge-based, while others require insight and application skills. You can expect a mixture of these types of question in the examination.

The prescribed book also includes a list of self-evaluation and multiple-choice questions at the end of each chapter. Make sure that you attempt to answer these questions for your own enrichment.

THE STUDY PROCESS

As mentioned earlier, the study guide, combined with the prescribed book, will enable you to understand the theory in each study unit if you do the activities for each topic and study unit. You will remember something better if you understand it. We therefore suggest that you always follow the study guide when working through the prescribed book. One of the best ways to ensure that you understand the material is to summarise it in your own words. Work through one study unit at a time.

The first tutorial letter which accompanies this study guide contains a proposed study programme that you can follow to ensure that you finish working through all the prescribed sections before the examination. The study programme also makes provision for adequate revision before the examination. If you follow the study programme and work through the study guide and prescribed book carefully, you can rest assured that you will know and understand the work and be able to apply it in practice.




We wish you every success and hope you enjoy this module!






PRESCRIBED STUDY MATERIAL

The following is a summary of the study units and the corresponding chapters in the prescribed book:

STUDY UNIT	CORRESPONDING CHAPTER IN PRESCRIBED BOOK
1	1
2	2
3	3
4	4
5	5
6	6
7	7
8	8
9	9
10	15
11	16
12	17

ICONS USED IN THIS STUDY GUIDE

Icon	Function
	Mind map. Mind maps are provided to help you to see the relationship between various parts of the study material.
	Learning outcomes. The learning outcomes indicate what aspects of the particular topic or study unit you have to master and that you should be able to demonstrate that you have mastered them.
	Key concepts. The key concepts icon draws your attention to certain keywords or concepts that you will come across in the topic or study unit.

Icon	Function
	Study. The study icon indicates which sections of the prescribed book or the study guide you have to study and internalise.
	Read. The read icon will direct you to read certain sections of the prescribed book for background information.
	Activity. The activity icon refers to activities that you must do in order to develop a deeper understanding of the study material.
	Feedback. The feedback icon indicates that you will receive feedback on your answers to the self-assessment activities.
	Assessment. When you see the assessment icon, you will be required to test your knowledge and understanding, and your ability to apply the material you have just studied.

MODULE FRAMEWORK: PURCHASING MANAGEMENT

MNP2601

This module, **Purchasing Management** (MNP2601), is summarised diagrammatically below.

TOPIC	STUDY UNIT
TOPIC 1 THE PURCHASING FUNCTION: AN OVERVIEW	STUDY UNIT 1 The purchasing function in perspective STUDY UNIT 2 The task of purchasing and supply management STUDY UNIT 3 Purchasing processes and procedures
TOPIC 2 MANAGING THE SUPPLY BASE	STUDY UNIT 4 Purchasing and supply strategies and policies STUDY UNIT 5 Evaluation and selection of suppliers

<p>TOPIC 3</p> <p>KEY PERFORMANCE INDICATORS</p>	<p>STUDY UNIT 6</p> <p>Sustainable purchasing and supply management</p> <p>STUDY UNIT 7</p> <p>The management of quality in purchasing and supply</p> <p>STUDY UNIT 8</p> <p>Purchasing price determination and cost analysis</p> <p>STUDY UNIT 9</p> <p>Purchasing quantity and inventory management</p>
<p>TOPIC 4</p> <p>APPLICATION FIELDS IN PURCHASING AND SUPPLY MANAGEMENT</p>	<p>STUDY UNIT 10</p> <p>Purchasing capital equipment</p> <p>STUDY UNIT 11</p> <p>Purchasing services</p> <p>STUDY UNIT 12</p> <p>Purchasing from small businesses: a focus on black economic empowerment</p>

Topic 1

THE PURCHASING FUNCTION: AN OVERVIEW

CONTENTS

- Study unit 1: The purchasing function in perspective
- Study unit 2: The task of purchasing and supply management
- Study unit 3: Purchasing processes and procedures

TOPIC AIM

The aim of topic 1 is to provide an overview of the purchasing management function by exploring its nature and the tasks and processes associated with it.

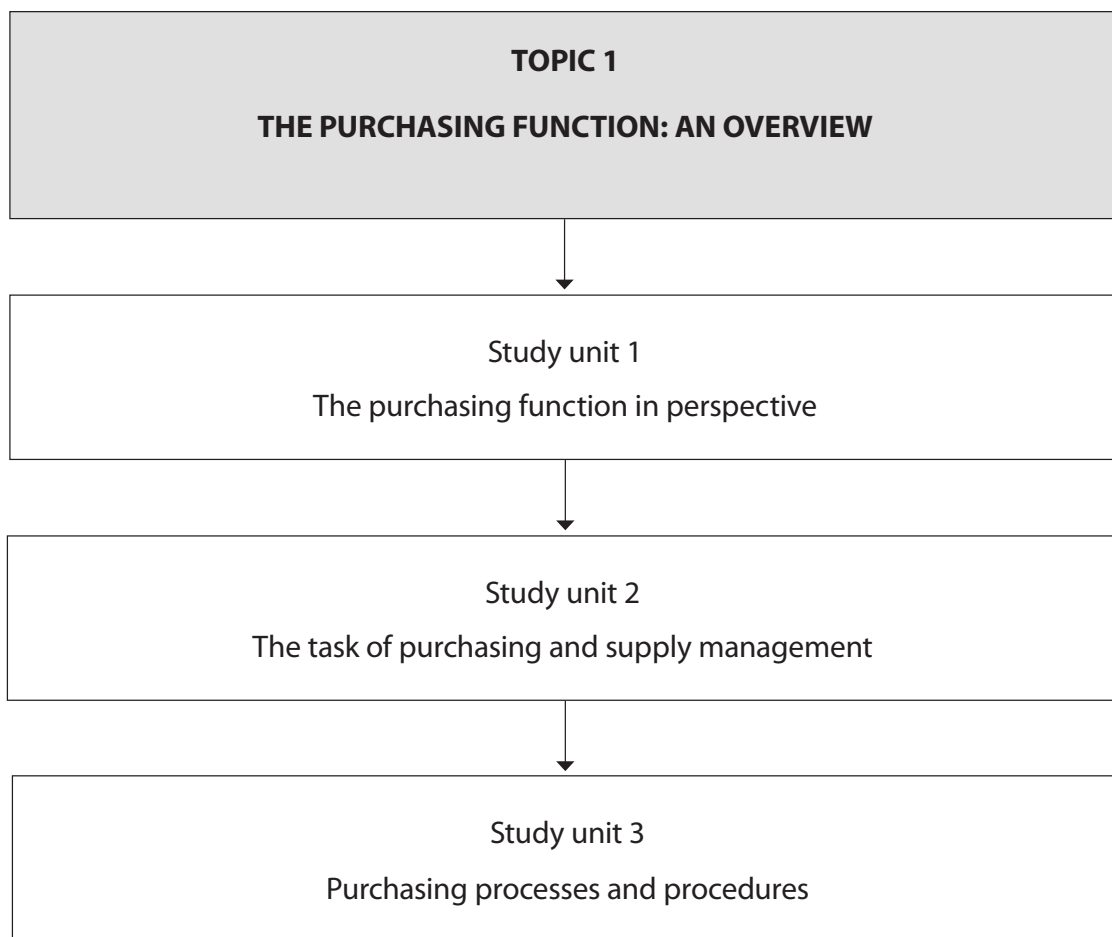


TOPIC LEARNING OUTCOMES

After studying this topic, you should be able to do the following:

- Define the nature of the purchasing function.
- Distinguish between purchasing and other concepts such as strategic purchasing, supply management, supply chain management, and logistics management.
- Describe the objectives of purchasing and supply management.
- Illustrate and explain the importance of purchasing and supply management for business enterprises.
- Discuss each of the basic steps in the purchasing cycle.
- Outline the fundamental principles of the purchasing portfolio.
- Provide a broader perspective on supply-chain management and logistics management.
- Identify the interface between purchasing and supply management and general business management.
- Describe the nature of purchasing and supply planning.
- Explain and illustrate purchasing and supply as part of organisational strategy development.
- Summarise purchasing and supply planning on a tactical and operational level.
- Suggest organisational structures for the management of the purchasing and supply function in different enterprises or institutions.
- Describe the nature of purchasing and supply coordination.
- Illustrate the coordination between purchasing and supply and other functional areas.
- Illustrate the coordination between purchasing supply and the supplier system.

- Explain the objectives and basic principles of evaluating the performance of the purchasing and supply function.
- List the difficulties relating to the evaluation of the purchasing and supply function performance.
- Summarise and illustrate the steps in the process of performance evaluation.
- List the steps in the purchasing process.
- Explain the procedures and parties involved in each of the steps of the purchasing process.
- Apply the purchasing cycle to various scenarios



Study unit 1

THE PURCHASING FUNCTION IN PERSPECTIVE

CONTENTS

Aim

Learning outcomes

Key concepts

Getting an overview

- 1.1 Unravelling the terminology confusion
- 1.2 Objectives of purchasing and supply management
- 1.3 The importance of the purchasing and supply function for businesses
- 1.4 The purchasing cycle: basic steps in supply management
- 1.5 The purchasing portfolio
- 1.6 Supply management and related developments

Summary

Assessment

AIM

The aim of the study unit is introduce you to the purchasing and supply function in organisations.



LEARNING OUTCOMES

After working through this study unit, you should be able to:

- Define the nature of the purchasing function.
- Distinguish between purchasing and other concepts such as strategic purchasing, supply management, supply-chain management and logistics management.
- Describe the objectives of purchasing and supply management.
- Explain and illustrate the importance of purchasing and supply management for business enterprises.
- Discuss each of the steps in the purchasing cycle.
- Outline the fundamental principles of the purchasing portfolio.
- Provide a broader perspective on supply-chain management and logistics management.



KEY CONCEPTS

- purchasing management
- strategic purchasing

- supply management
- supply-chain management
- logistics management
- purchasing and supply objectives
- profit-leverage effect
- the turnover/total cost balance
- return on investment (ROI)
- business functions
- purchasing cycle
- purchasing portfolio
- supply risk
- profit impact
- product classification matrix
- strategic items
- leverage items
- noncritical items
- bottleneck items
- value
- total cost of ownership (TCO)
- integration of processes
- reduction of cycle time



Study chapter 1 in Hugo & Badenhorst-Weiss (2011), including all figures and tables.

GETTING AN OVERVIEW

This might be the first time that you encounter an in-depth examination of the purchasing and supply function. Welcome to this interesting world! Together with other functions such as human resources, marketing, finance and operations (which may be more familiar to you), the purchasing and supply function works towards a common goal of maximising efficiency and providing maximum value to the end customer of an organisation.



Over the last decade, purchasing management has been elevated to a more significant consideration of top-level business executives, both locally and globally. This is due to a variety of changes in the purchasing and supply field, none more so than the top ten listed by Charles Dominick in 2008:

- **Change 10 – Technology proliferated.** Today, eProcurement and eSourcing are two of the most useful practices in purchasing. Ten years ago, those terms were unheard of.
- **Change 9 – Center-led procurement arrived.** In 1998, even top purchasing departments processed purchase orders. Today, purchasing departments aim to centralise the supplier selection process, not transactions, which are delegated to end-users or outsourced.

- **Change 8 – Purchasing grabbed more spend.** When purchasing departments deliver results, management seeks more spend that Purchasing can positively impact. Once sourced by other departments, categories like fleet management, benefits and travel services are now sourced by Purchasing.
- **Change 7 – Social responsibility became a top priority.** Whether for reasons of philanthropy or to avoid media scandals, management counts on Purchasing more than ever to buy from diverse suppliers, make environmentally-conscious decisions and do business ethically.
- **Change 6 – Measurement was mandated.** With the potential of smart purchasing widely known, senior management holds their purchasing departments more strictly accountable for results. The use of purchasing metrics and dashboards is now commonplace.
- **Change 5 – Strategic sourcing went DIY (do-it-yourself).** In the 1990s, strategic sourcing was done mostly by consulting firms hired to help companies reduce spend. Today, many companies have their own refined and documented in-house strategic sourcing processes.
- **Change 4 – Supplier roles expanded.** In 1998, there was talk about “partnering” with suppliers. Today, there’s action. Top purchasing departments actively develop their suppliers and look to the supply base for ideas, better performance and innovation.
- **Change 3 – Global sourcing went mainstream.** Ten years ago, only the progressive companies were searching abroad for suppliers. Now, in some countries, it is difficult to find products manufactured domestically.
- **Change 2 – The Chief Procurement Officer (CPO) position was adopted.** This past year alone has seen an unprecedented number of people with the title “Chief Procurement Officer.”
- **Change 1 – The supply chain was recognised.** In the last decade, companies more closely analysed the way material flows into, through and out of the organisation. This “supply chain” focus has those who once just placed orders now responsible for inventory, warehousing, outbound logistics and distribution.

Source:

<http://www.nextlevelpurchasing.com/articles/sourcing-purchasing.html> (accessed on 10 October 2010).

There are a lot of terms here that may be new to you – *purchasing, strategic sourcing, supply, supply chain* and many more. This study unit focuses on explaining the organisation’s purchasing and supply function. It covers issues such as the nature of the purchasing

function; making sense of the differences between the concepts mentioned earlier; purchasing and supply objectives; the importance of the purchasing and supply function; the influence of the purchasing function on other business functions in organisations; and steps in the purchasing cycle, the purchasing portfolio and supply management and related developments.



Study the introduction in chapter 1 in Hugo & Badenhorst-Weiss (2011).

1.1 UNRAVELLING THE TERMINOLOGY CONFUSION

Purchasing management gained recognition as a fully-fledged function of business enterprises later than any other field of business management. In the past few decades, the purchasing function has been characterised by major dynamic changes because of certain developments in the management of enterprises. We covered the ten most influential in the previous section. As a result, the role of the purchasing management function has changed from an administrative activity, involved in a simple transferral of goods, to an interdependent managerial function known as supply management which acknowledges the continuous interaction between variables to efficiently realise the firm's mission and objectives.

In more recent developments, the purchasing function is managed within an integrated management approach known as supply-chain management. In this approach, all supplier and buying organisations involved in the process of putting a product on the market, from raw materials to the final product (including the final consumer), are perceived as a unified entity. An empowered management team, consisting of key members of primary functions and organisations involved in the supply chain, manages the process from raw material to final product, with a view to rendering a product or service according to the customer's value demands or satisfaction.

In this journey of recognition there are a myriad of purchasing and supply terms, and different concepts have been used incorrectly or interchangeably. These terms include, but are by no means limited to: purchasing management, strategic purchasing, supply management, supply-chain management and logistics management.



Study section 1.1 in Hugo & Badenhorst-Weiss (2011).



ACTIVITY 1.1

After studying the above-mentioned section in your prescribed book, define the concepts "purchasing management", "strategic purchasing", "supply management", "supply chain management" and "logistics management" in your own words.



Feedback

Purchasing management deals with the process used to obtain goods and services to satisfy the needs of an enterprise by the following steps:

- identifying the need
- finding and choosing the right supplier to fulfil the need
- negotiating matters such as price, quality and quantity with the supplier
- ensuring that the goods or services fulfilling the need are delivered according to the agreed conditions
- maintaining files and records to document the transaction

Now, if we add the word “strategic” to purchasing – does the meaning change? We agree with Christopher Barrett, who writes on the Procurement Leaders Blog added on 10 October 2006, that “strategy” is a word that is overused and undervalued. He continues:

The 'S' word is getting a real hammering these days, often wantonly, often inappropriately, and often – just plain too often." If people thought more clearly about its real definition, then we would all be better off – so here is a view. ... There is only one clear definition of a strategic action: Deferred Pleasure. A strategic decision is one that, on the face of it, only makes sense in the longer term. If in military terms a location is deemed to be strategic, that means you should put disproportionate effort into defending or gaining it. The same is true in strategic purchasing – you could take a position on a category, or with a supplier, where you are taking the risk that in the longer term you will be better off. Committing to 100% supply (or indeed deliberately taking a supplier off your supply list), taking a long-term price fix and investing in joint development are all examples of strategic purchasing.

Source: <http://blog.procurementleaders.com/procurement-blog/2006/10/10/strategic-purchasing-overused-and-undervalued.html> (accessed on 15 October 2006).

Supply management can be defined as using the same purchasing management activities as a strategy in order to attain organisational objectives (not only purchasing objectives). Far more emphasis is placed on the management of the suppliers (supply base).

There are numerous definitions of supply-chain management in contemporary literature because it is an evolving concept, representing a collection of management philosophies rather than a single approach. The supply chain is a series of connected suppliers and customers. Each customer is a supplier for another enterprise lower down in the supply chain, until the stage at which the finished product reaches the final consumer.

Supply-chain management therefore covers the flow of goods from all levels of supply through the manufacturing and distribution chain to the final consumer. A supply chain can be regarded as a network of organisations which are involved, through upward (with suppliers) and downward (with customers) links, in the various processes and activities that provide value to the ultimate consumer in the form of products and services.

Supply-chain management supports vertical coordination (coordination of independent suppliers and distribution intermediaries) rather than vertical integration (ownership of suppliers and distribution intermediaries). In vertical coordination, the core business or activities of the enterprise are identified and all other activities outsourced (purchased instead of made). Of course vertical integration means that the enterprise takes as much ownership as possible of all the core activities necessary to get the product to the final consumer.

Supply chain integration occurs when the boundaries between internal functions and between enterprises in the supply chain are broken down. The purpose of the integrated supply chain is to eliminate duplication and activities that do not add value to the transformation and flow of products and services to the final consumer. As the link between members of a supply chain is strengthened, the cooperation goals are not only the supply of the final product, but also the joint development of new products for the final consumer.

All enterprises are part of one or more supply chains. The emphasis in supply-chain management is on the management of the whole supply chain (instead of merely focusing on the internal functions and direct suppliers and customers). This is obviously a complex task and strategic alliances, long-term contracts and joint information networks are a vital component of supply-chain management.

Supply-chain management introduced a new era for business, which has emerged globally. It is becoming increasingly difficult for businesses to gain a competitive advantage, and sustaining such an advantage is almost impossible. In order to survive in such an environment, enterprises must be professionally managed to achieve success or risk losing considerable market share.

Although the introduction of the supply-chain management approach or philosophy provided the means for enterprises to improve their competitiveness, it must be noted that the concept is merely an enabler. It enables business enterprises to react to intense global competition and to use information technology and new forms of interorganisational relationships, thereby increasing customer satisfaction, market share and profits.

"Logistics management" is also a widely used term most often associated with the military. They define logistics management as the science of planning and carrying out the movement and maintenance of forces. That is, those aspects of military operations that deal with the design and development, acquisition, storage, movement, distribution, maintenance, evacuation and disposition of material; the movement, evacuation, and hospitalisation of personnel; the acquisition of construction, maintenance, operation and disposition of facilities; and the acquisition of furnishing of services. Quite a mouthful!

Source: <http://www.logisticsworld.com/logistics.htm> (accessed on 28 October 2006).

In business terms, logistics management entails planning, implementing and controlling the efficient, effective flow and storage of raw materials, in-process inventory, finished goods, services and related information from the point of origin to the point of consumption (including inbound, outbound, internal and external movements) for the purpose of conforming to customer requirements – in other words, having the right thing, at the right place, at the right time.

Remember that the second learning outcome for this study unit requires you to be able to distinguish between the terms "purchasing management", "strategic purchasing", "supply management", "supply-chain management" and "logistics management". We suggest that you summarise these sections in order to achieve this outcome.

1.2 OBJECTIVES OF PURCHASING AND SUPPLY MANAGEMENT

The objectives of the purchasing and supply function (and all the other functions) are derived from the objectives of the organisation. In all organisations, objectives have to do with maximum efficiency or effectiveness. This means that the organisation has to deliver

maximum outputs with minimum inputs, leading to maximum profitability. In nonprofit institutions (e.g. universities and state hospitals), the result will be the best product or service at the lowest possible cost.



Study section 1.2 in Hugo & Badenhorst-Weiss (2011).



ACTIVITY 1.2

Every purchasing and supply activity is linked to an objective. Formulate an objective for each of the following activities in the space provided below:

ACTIVITY	OBJECTIVE
(1) Holding inventory	
(2) Price determination	
(3) Selecting suppliers	
(4) Performing procedures	
(5) Purchasing research	



Feedback

Examples of various purchasing objectives are to:

- (1) *minimise inventory losses and investment in inventory*
 - (2) *purchase goods and services of the required quality, competitively at minimum cost*
 - (3) *trace or develop reliable alternative sources and maintain sound lasting relations with reliable suppliers*
 - (4) *develop and operationalise policy, procedures and systems that will ensure that the administrative costs of purchasing are kept to a minimum*
 - (5) *identify and analyse problem areas and rectify them effectively*
-

1.3 THE IMPORTANCE OF THE PURCHASING AND SUPPLY FUNCTION FOR BUSINESSES

The purchasing and supply function is becoming increasingly important to organisations, mainly because it is usually the greatest spender of organisational funds and directly affects the organisation's profitability.



Study section 1.3 in Hugo & Badenhorst-Weiss (2011).

1.3.1 Reasons for the increasing importance of the purchasing function

The role of the purchasing function in an organisation is influenced by various factors. They are discussed in your prescribed book, and include:

- the globalisation of world trade and its impact on competitive advantage
- the adjustment of organisational structures to become more internationally oriented
- rapid developments in information technology
- increased supply risks
- the shortened lifespan of products
- increasingly stringent quality specifications and control
- recycling material and conserving the environment
- constant rises in inventory costs (specifically interest and transport costs)



ACTIVITY 1.3

The reasons for the growing importance of the purchasing and supply function can be divided into two broad categories: assured supply of requirements and cost reduction. Work out the following reasons for yourself, and then place them in one of the two categories in the columns below:

- more stringent quality standards
- holding inventory
- political uncertainty
- foreign suppliers
- shortages of materials
- cost of developing new products
- greater competition for the enterprise
- price control
- inflation

COLUMN 1 ASSURED SUPPLY	COLUMN 2 COST REDUCTION



Feedback

- *More stringent quality standards belong in column 1, since the higher the quality standards, the fewer the number of suppliers able to meet the requirements. You might have argued that more stringent quality standards relate to cost, since the higher the quality is, the higher the purchase cost (purchase price) will be. However, column 2 is about cost reduction.*
- *Holding inventory could be placed in both columns. Sometimes enterprises are forced to keep more inventories to assure their supply because of uncertainties (such as shortages) in the supplier market. The purchasing function tries to buy as effectively as possible to keep inventory levels to a minimum and reduce the cost of holding inventory.*
- *Political uncertainty may influence the supplier market, so it belongs in column 1.*

- Foreign suppliers could be placed in both columns. Using overseas suppliers may reduce purchasing costs by creating more competition in the market, but the buyer has to allow for import costs. Foreign suppliers can also ensure the supply of materials to the enterprise, regardless of the state of the local market.
 - Shortages of materials belongs in column 1. The purchasing manager has to prevent stoppages in the flow of materials by becoming aware of the risk in good time, and taking the necessary steps to counteract it.
 - Since development costs relate directly to the buyer's attempt to obtain the right material at minimum cost for the development of new products, this reason belongs in column 2.
 - Greater competition also belongs in column 2. The enterprise is forced to cut costs in order to sell its product at a competitive price (more cheaply).
 - Price control on the enterprise's finished product forces it to cut costs in order to make a better profit. (Price control on raw materials usually means that suppliers charge the maximum price permitted by government. Suppliers will therefore not be interested in negotiating). Price control therefore belongs in column 2.
 - Inflation causes the prices of purchased goods to rise. This puts pressure on the purchasing function to buy more effectively. Hence, inflation belongs in column 2.
-

1.3.2 The importance of the purchasing and supply function for successful business operations

This section concentrates on the financial impact of the purchasing function on the organisation, including its influence on the return on investment.

1.3.2.1 Profit leverage effect

Purchasing costs (including the price of purchased goods) represent the main part of an enterprise's total expenditure. In a manufacturing enterprise, purchasing costs represent 50% to 60% of every rand flowing into the enterprise; in a retail enterprise, 70% to 80%; and in a wholesale enterprise, over 80%. It follows that any saving in purchasing costs must have a major impact on an enterprise's profitability.

The effect of savings in purchasing costs on an organisation's bottom line is illustrated by the profit leverage effect. Essentially, the profit leverage effect explains how a small percentage of saving in the purchase price may develop into a relatively large percentage increase in the organisation's profit.

This is clarified in section 1.3.2 of the prescribed book, and we expect you to understand the principles involved.



ACTIVITY 1.4

Which of the following statements about the principal contribution of purchases are true and which are false?

- (1) The purchasing function contributes more to a retail enterprise's profitability than to a manufacturing enterprise's profitability.
- (2) The purchasing function contributes more to profitability in a manufacturing enterprise than in a service enterprise.

- (3) A percentage saving in purchasing cost has a greater influence on an enterprise's profitability than the same percentage increase in sales.



Feedback

Statement (1) is true because purchasing costs represent a larger proportion of the total costs of a retail enterprise than they do in a manufacturing enterprise.

Statement (2) is true because the purchasing costs of a service enterprise are minimal. Consider, for example, how little a lawyer (service enterprise) buys compared with a furniture factory.

Statement (3) is true because an increase in sales is usually accompanied by additional costs (e.g. more advertising or special discounts).

1.3.2.2 The influence of more efficient purchasing on the organisations' ROI

In your prescribed book, there is a clear explanation of how to calculate ROI and the possible influence of more efficient purchasing on return on investment. The section also indicates what a positive effect improvement in purchasing and supply management can have on ROI.

1.3.3 The influence of supply management on general business operations

The other enterprise functions cannot perform their tasks without the purchasing function. For example, purchasing provides the operations/production function with materials and machinery which are used in the production process. Purchasing buys the products marketed by a commercial enterprise and influences the price and quality of, as well as the demand for, the finished product which has to be marketed. The personnel department is supplied with instruments like stationery, computers, training equipment and cafeteria services.

Consult your prescribed book for the influence of the purchasing function on the following departments: operations/production, marketing, personnel, administrative and finance and public relations.

1.4 THE PURCHASING CYCLE: BASIC STEPS IN SUPPLY MANAGEMENT



Study section 1.4 in Hugo & Badenhorst-Weiss (2011).

The purchasing cycle indicates how buyers should perform the basic purchasing task. These purchasing procedures should be designed in accordance with the broad policy

and strategy of the purchasing function, and should also coordinate well with the other functions of the enterprise.

The steps in the purchasing cycle are also called the “purchasing process” or “purchasing procedures”. The purchasing process consists of the activities that have to be followed in every purchasing transaction. Purchasing documents like requisitions, order forms, invoices and delivery notes are used to record transactions and create the necessary information flow. Information about every purchasing transaction has to flow between the user, the buyer, reception, inspection, finance and the supplier.



ACTIVITY 1.5

Davinder Singh is the purchasing manager of a newly established business unit of the Gemcor group. The new business unit, Gemtalk, will manufacture telephones and fax machines. Purchasing procedures have to be devised for Gemtalk as soon as possible so that buyers can act accordingly. Obviously the accompanying purchasing documents also require Davinder’s urgent attention.

- (1) Tabulate the steps or the activities in Gemtalk’s purchasing cycle or purchasing procedures.
- (2) Indicate the purchasing documents that are associated with every step of the procedure.



Feedback

After studying the relevant sections in the prescribed book, you should be able to identify the steps in Gemtalk’s purchasing procedure and the accompanying documents. They would probably include the following:

- *Identify and describe the need.*
 - *Identify sources and select suppliers.*
 - *Conduct bidding and negotiation.*
 - *Place the order/conclude the contract.*
 - *Follow up and expedite/contract administration.*
 - *Receive and inspect incoming goods.*
 - *Analyse the invoice and close the order.*
-

Make sure that you know and understand how the activities in the purchasing procedure function so that you are able to explain the course of each purchasing transaction, and the documents associated with each element. Remember that the activities will not always be executed in exactly the same way in every transaction of every enterprise. The amount of attention devoted to each activity will depend on the competitive situation between suppliers (how many suppliers), how much money is involved and the strategic importance of the product or material or service. When purchasing light bulbs or nails for a furniture factory, for example, the activities will be executed very quickly. This is an example of straight repurchasing involving relatively little money, so it is not necessary to spend a lot of time on each activity. On the other hand, when buying capital equipment for an enterprise, one would obviously have to pay much more attention to the activities in the purchasing cycle. This is explained in further detail in study unit 3.

1.5 THE PURCHASING PORTFOLIO



You've just taken responsibility for purchasing at a major international logistics company, and you're reviewing all the fuel purchases over the past two years. The company spends a fortune on fuel, and it's hired you, in part, to look for ways to cut costs.

The problem is that, because of the diverse nature of your company's transportation methods (which cover air, ground, and ocean freight), each individual department purchases fuel separately. So the air division purchases its own jet fuel, the trucking division purchases its own diesel, and the shipping freight division purchases its own oil.

How could you possibly reduce costs on such a necessary, but ultimately scattered, commodity? The Kraljic Portfolio Purchasing Model helps you do this.

The Kraljic Portfolio Purchasing Model was created by Peter Kraljic and it first appeared in the Harvard Business Review in 1983. Despite its age, it's a popular and useful model used in companies worldwide. Its purpose is to help purchasers maximise supply security and reduce costs, by making the most of their purchasing power. In doing so, procurement moves from being a transactional activity to a strategic activity – because, as Kraljic said, "purchasing must become supply management."

Source: http://www.mindtools.com/pages/article/newSTR_49.htm (accessed on 18 October 2010).



Study section 1.5 in Hugo & Badenhorst-Weiss (2011).

The prescribed book continues this section by explaining the product classification matrix, and enabling you to address the fuel issue by considering the supply risks and profit impact of the item on your logistics business. This discussion will be expanded in study unit 4.

1.6 SUPPLY MANAGEMENT AND RELATED DEVELOPMENTS



Study section 1.6 in Hugo & Badenhorst-Weiss (2011).

1.6.1 Supply-chain management

Supply-chain management introduced a new era for business, which has emerged globally. It is becoming increasingly difficult for businesses to gain a competitive advantage, more so than ever before. Sustaining such advantage is almost impossible. In order to survive in such an environment, enterprises must be professionally managed to achieve

success or risk losing considerable market share. Supply-chain management is, therefore, fast becoming vital for competitive advantage, using customer-driven supply chains, efficient logistics, demand-driven sales planning, lean manufacturing, information processing and sourcing. These important *processes* are explained in the prescribed book.

The supply chain comprises several *key concepts* as discussed in the prescribed book, namely value and creation of customer value; total cost of ownership (TCO); integration of processes; and reduction of cycle time. When you have finished studying this section in the prescribed book, do the following activity:



ACTIVITY 1.6

Discuss the four most important or key principles of supply-chain management. Can you identify any other principles of supply-chain management?



Feedback

The four most important (core) principles are discussed in the prescribed book. However, other principles also guide the processes of supply-chain management. They include principles such as strategic partnerships, total quality management (TQM), systems integration (using enterprise resource planning (ERP) or electronic data interchange (EDI)) and human resource training and development.

Supply-chain management introduced a new era for business, which has emerged globally. It is becoming increasingly difficult for businesses to gain a competitive advantage, more so than ever before. Sustaining such advantage is almost impossible. In order to survive in such an environment, enterprises must be professionally managed to achieve success or risk losing considerable market share.

- **Strategic partnerships:** *A high degree of cooperation and some integration of enterprises in the supply chain are necessary to limit wastage and increase value. A high degree of integration and coordination in supply-chain management is possible only if long-term partnerships agreements are concluded between buyers (enterprises) and suppliers in the supply chain. These agreements can be regarded as the glue that binds the supply chain together.*

Buyer-seller partnerships in the supply chain are not legal partnerships, but rather a cooperation agreement in an open relationship, to the benefit of both parties involved. The key features of such a partnership are (1) recognition of common interests and needs; (2) a willingness to openly share information as well as the advantages stemming from the relationship; and (3) trust. Cooperation is obtained by merging the cross-functional teams of the various organisations in the supply chain (and systems integration, which will be discussed later) – hence the importance of cross-organisational teams in supply-chain management.

The professional staff of the purchasing and supply function will play an important role in the selection of supply partners, in negotiations (according to the agreement of the partnership) relating to factors such as price and the management of the relationship during the period of the agreement.

- **Total quality management:** *TQM is an enterprise-wide concept whereby inputs, process and outputs in each area are subject to quality control. TQM is applied not only in enterprises but also throughout the whole supply chain. Through the ISO 9000 series standards,*

suppliers ensure quality control. Numerous other concepts and developments such as benchmarking, just-in-time systems (JIT), employee empowerment, customer-focused service and kaizen form an integral part of TQM. Kaizen means that higher objectives are continually formulated for, say, cost savings in the supply chain.

- **Systems integration:** Systems integration can be achieved through ERP or EDI. EDI makes it possible for different enterprises to integrate their systems and databases despite compatibility differences. EDI can transfer the following four types of data between buyers and suppliers in the supply chain:
 - (1) trade data (documents such as requests for quotations (RFQ), purchase orders, acknowledgements, delivery instructions, dispatch and receipt notes, invoices, credit notes and statements of account)
 - (2) technical data (product specifications, machinery and equipment installation, data on design and manufacture with the aid of computers and performance data)
 - (3) query response data (queries about prices and checking the progress of an order)
 - (4) monetary data (electronic transfer of money, computer to computer)

EDI is a powerful instrument in the integration of the supply chain. It improves the flow of information and information exchange as well as the response time of customers at different levels of the supply chain.

ERP is a fully integrated system containing a database into which the enterprise and its chosen partners in the supply chain can integrate. ERP developed from the material resource planning II (MRP II) system. (MRP II has the same goals as ERP, but does not integrate the activities in the whole supply chain). ERP gives suppliers total access to the schedules of customers (purchasing enterprises) and makes it possible to disseminate information on demand (needs) through the supply chain to ensure a rapid and accurate response by the supply chain. ERP supports JIT in the supply chain.

- **Human resources development and training:** The human factor is a major problem in supply-chain integration. Examples of problems are power struggles, an “it’s not my problem” attitude and bureaucratic tendencies. Training is one the main tools that can be used to solve these problems. The introduction of teams, task forces and matrix structures will further improve cross-functional and interorganisational cooperation. Some organisations empower their employees so that they can assume ownership of their work and take a personal interest in improving their performance. Self-managed teams are one of the offshoots of employee empowerment, and allow teams to work without direct supervision and control.

The **characteristics of supply-chain management** provide further insights into the nature of the management philosophy. The prescribed book provides a sufficient overview of the most important aspects concerning this management approach.

1.6.2 Logistics management

Figure 1.5 in the prescribed book is a great visual aid in gaining understanding of logistics management. We defined the concept in the Feedback to activity 1.1, and concluded that logistics management is “having the right thing, at the right place, at the right time”. After you have studied this section, you may want to expand on your answer to that question.

We strongly recommend that you do additional reading on the matters discussed in this section, because new viewpoints, perceptions, philosophies, concepts and techniques are constantly developing.

SUMMARY



Read the case study “SA Synthetic Bio-fuels (Pty) Ltd” at the end of chapter 1 in Hugo & Badenhorst-Weiss (2011).

We hope that the contents of this study unit have given you some guidelines in answering this case study. As a starting point you are now aware of the correct definition of the myriad of purchasing and supply management concepts, as well as the objectives and importance of the purchasing and supply function. We also focused on the impact of effective purchasing management for the welfare of any organisation. You should now also have a sound knowledge of the elements and procedures of a purchasing cycle. Take your time and attempt to advise SA Synthetic Bio-Fuels (Pty) Ltd on the correct course of action to take.

Make sure that you fully understand the basic principles explained in this study unit, as they form the foundation of the rest of the course. The objectives of purchasing management, for example, will feature throughout, since all activities and applications explained are aimed at realising these objectives.

Study unit 2 emphasises the task of purchasing and supply management.



ASSESSMENT

Revise chapter 1 in the prescribed book. Once you have done this, do the following tasks:

- (1) Write an essay in which you define the nature of the purchasing function.*
- (2) Distinguish between purchasing and other concepts such as strategic purchasing, supply management, supply-chain management and logistics management by defining them in your own words.*
- (3) Write a report in which you describe the objectives of purchasing and supply management.*
- (4) Illustrate and explain the importance of purchasing and supply management for business enterprises.*
- (5) Discuss each of the basic steps in the purchasing cycle. Illustrate your answer with a schematic representation.*
- (6) Outline the fundamental principles of the purchasing portfolio.*
- (7) Provide a broader perspective on supply-chain management and logistics management.*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 1 in your prescribed book.

Study unit 2

THE TASK OF PURCHASING AND SUPPLY MANAGEMENT

CONTENTS

Aim

Learning outcomes

Key concepts

Getting an overview

- 2.1 Purchasing and supply management as part of business management
- 2.2 Planning for purchasing and supply management
- 2.3 Organising purchasing and supply management
- 2.4 Coordinating purchasing and supply management
- 2.5 Control: performance evaluation of the purchasing and supply function

Summary

Assessment

AIM

The aim of the study unit is to highlight the management tasks of purchasing and supply managers, specifically the tasks of planning, organising, coordinating and controlling the function.



LEARNING OUTCOMES

After working through this study unit, you should be able to do the following:

- Identify the interface between purchasing and supply management and general business management.
 - Describe the nature of purchasing and supply planning.
 - Illustrate and explain purchasing and supply as part of organisational strategy development.
 - Summarise purchasing and supply planning on a tactical and operational level.
 - Suggest organisational structures for the management of the purchasing and supply function in different enterprises or institutions.
 - Describe the nature of purchasing and supply coordination.
 - Illustrate the coordination between purchasing and supply and other functional areas.
 - Illustrate the coordination between purchasing supply and the supplier system.
 - Explain the objectives and basic principles of performance evaluation of the purchasing and supply function.
 - List the difficulties relating to the performance evaluation of the purchasing and supply function.
 - Summarise and illustrate the steps in the process of performance evaluation.
-



KEY CONCEPTS

- management
 - business management
 - purchasing and supply planning
 - levels of purchasing and supply planning
 - strategic
 - functional
 - operational purchasing and supply objectives
 - relationship between the management level, the formulation of objectives and the time frame in purchasing and supply planning
 - organisational structure
 - centralised purchasing and supply organisational structure
 - decentralised purchasing and supply organisational structure
 - combined purchasing and supply organisational structure
 - internal organisational structure of purchasing and supply
 - cross-functional teams
 - coordination of purchasing and supply management
 - other functional areas
 - supply and the supplier system
 - purchasing and supply control
 - performance evaluation
 - evaluation process of the purchasing and supply function
-



Study chapter 2 in Hugo & Badenhorst-Weiss (2011), including all figures and tables.

GETTING AN OVERVIEW

We agree with David Coates when he says that the task of management is all about organising groups of people to work together productively with clarity of purpose (http://www.rankyouthwork.org/publications/managing_projects/managing_workers.htm (accessed on 20 October 2010). This is particularly the case within the purchasing and supply arena. The “if you don’t know where you are going any road will do” syndrome is part of the back office legacy that purchasing and supply professionals have to deal with in taking their purchasing and supply management task into the next level.

However, achieving simplicity and clarity is not easy. It means shaving away constantly at the sort of multiple purchasing objectives which an organisation normally likes to set itself, until one reaches an absolutely clear definition of a mission and role; and then ensuring that all stakeholders within and beyond the borders of the organisation are involved in the debate. Thus the statement of purpose for the purchasing and supply management task becomes owned by everyone concerned, from buyer to supplier and back again.

If the practice of purchasing supply management were an exact science, then we suspect that the mysteries surrounding the impact thereof on organisational proficiency and efficiency would have been solved long ago. If you could apply method A to gain result B in all circumstances, the task of being a purchasing and supply manager would be a lot easier.

In this study unit, we discuss the task of the purchasing and supply management process – planning, organising, coordination and control. We hope that understanding this information will encourage you to assess your own input in the daunting purchasing and supply management task and discover ways of increasing your own effectiveness.



Study the introduction to chapter 2 in Hugo & Badenhorst-Weiss (2011).

2.1 PURCHASING AND SUPPLY MANAGEMENT AS PART OF BUSINESS MANAGEMENT

In study unit 1 the purchasing function was put in perspective within the organisation, and developments beyond the boundaries of an organisation. In this section, the management tasks of the purchasing and supply manager are put into perspective in relation to the overall management of the enterprise or institution.



Study section 2.1 in Hugo & Badenhorst-Weiss (2011).



ACTIVITY 2.1

Explain the task of purchasing and supply management as part of the integrated business management process.



Feedback

This is a straightforward question, and you should be able to answer it adequately at this stage of your studies. You needed to use section 2.1 of the prescribed book as the foundation for your answer, incorporating the planning, organising, coordinating and control of purchasing and supply management.

2.2 PLANNING FOR PURCHASING AND SUPPLY MANAGEMENT

Planning is future-oriented, and usually starts with the first task in managing a particular function (such as purchasing) or a business or institution.



ACTIVITY 2.2

Formulate your own definition of planning.



Feedback

Planning can be defined in an infinite number of ways, depending on the context in which the word is used.

Business enterprises need to establish where they want to be in five or ten years' time. They need to plan for new ventures, products and markets. Senior managers and management committees alike must practise the art of involving their workers while accepting the ultimate responsibility. The whole purpose of agreeing a strategic objective is to transfer it to those who must achieve it.

After this step, organisations need to prepare on a more intermediate level, which concerns aspects such as budgets and staff requirements. It takes into account the strategic objective and purpose of the enterprise, while at the same time setting realistic, measurable and achievable objectives for the project in question.

Once these objectives have been discussed and agreed the plan is delegated to the worker on a tactical level whose task it is to put in the detail. Time can be invested in enabling the worker to achieve the agreed objectives and ensuring that they are in pursuit of the agreed direction.

Planning involves pinpointing the manner in which a set goal will be achieved. Planning must precede all other management actions. The other management elements – organising, coordinating and control – only come into play once planning has been completed.



Study section 2.2 in Hugo & Badenhorst-Weiss (2011).

2.2.1 The nature of purchasing and supply planning

It is essential to remember that the planning of the purchasing and supply function should fit into the broad framework of enterprise planning. Since the purchasing and supply component is not an end in itself for the enterprise, this planning and the resultant objectives are subordinate to and should support the planning and objectives of the enterprise as a whole.

Why is purchasing and supply planning important? Since planning relates to the future influence of current decisions, it is the management element used to bridge the gap between an enterprise's current situation and the situation towards which management would like to lead it.

Managers are increasingly realising the importance of planning for the provisioning of materials and services needs to the business or institution. The following general factors

have led to what is called the “resource crisis”, which has made purchasing and supply planning increasingly more crucial over the past two decades:

- the energy crisis
- the scramble for commodities
- shortages of semifinished products
- inflation
- fluctuating exchange rates
- government control in producer countries



ACTIVITY 2.3

Read the following translation of a report which appeared in *Beeld* (13 May 2005), to illustrate the importance of purchasing and supply planning. Indicate the relationship between the report and the reasons we have given for the growing importance of purchasing and supply planning. Why is it necessary for buyers to keep themselves informed of such market forecasts?



SA power still cheapest in the world

By Leo Kok

South African electricity is still the cheapest in the world, but the pressure on Eskom's available capacity will also put pressure on its prices shortly. This is evident from the latest survey of electricity prices in a group of 14 countries by the international NUS group. South Africa, with an average price of \$0,0389 per kilowatt hour (kWh), is the cheapest country. Its price is considerably lower (approximately 27%) than that of Canada, which, at \$0,0531 per kWh, is the second cheapest country.

Mr George Rahr, managing director of the NUS in South Africa, says that government's electrification projects and the growth in the South African economy have almost exhausted Eskom's excess capacity. The pressure is now on Eskom to recommission its unused power stations and to provide for new power stations in order to meet the demand. Pressure on Eskom's capacity will ultimately filter through to electricity prices, as Eskom needs to provide for the cost of new power stations. Higher electricity prices will also put a damper on unnecessary use.

It is still unsure whether Eskom or a private entity will meet the growing demand, but the NUS say that Eskom will ultimately be responsible for 70% of the capacity. Rahr says the fact that the South African electricity sector still has to be regulated will make it difficult for Eskom to increase its prices at will in order to collect money for the country's future needs. This was clear from the National Electricity Regulator's (NER's) decision to restrict Eskom's 2004 price increase to 2,5%, but it will, according to Rahr, be brought to a head in 2007.

According to the NUS, it is not only local use that will put pressure on prices. The survey indicates that the increasing price of oil is filtering through to all energy costs, and as such it will in the future also manifest in the price increases for which Eskom applies. Rahr says that either Eskom or the planned private companies, which will shortly be allowed to tender for power delivery, will initially have to focus on so-called peak-time power stations. It is smaller power stations that will probably not use coal, but an alternative such as natural gas, that will deliver power during peak times.



Feedback

It is clear from the article that the impact of purchasing and supply planning on Eskom's strategic intent is enormous. There is pressure on the company to increase its provision capacity and recommission some of its power stations. Should this be necessary, a variety of materials and services would be required. Planning for the efficient and effective purchase and subsequent supply of these materials and services would impact on the cost of the expansion and, ultimately, the price of electricity. Should the price of electricity increase drastically because of an increase in the cost of electricity generation, it will affect not only Eskom but all South Africans.

This is the kind of information that buyers have to be aware of, since it has a direct impact on planning purchasing and supply in the long, medium and short term. It underscores yet again the importance of purchasing and supply planning, no matter what raw material, product, commodity or service one is purchasing.

2.2.2 Levels of purchasing and supply planning and objectives

Purchasing and supply planning is a decision-making process, and like all management decisions, can be divided into three levels: strategic planning, functional or tactical planning and operational planning. These three levels are known as the hierarchy of planning. (For examination purposes you should remember that "levels" and "hierarchy" of purchasing and supply planning refer to the same thing.)

Figure 2.1 in the prescribed book illustrates the interrelationship between levels of planning, levels of management, the time framework of planning and the setting of objectives at each level. Study all the corresponding sections in the prescribed book, and you should understand the hierarchy of purchasing and supply planning.



ACTIVITY 2.4

Provide examples of objectives on the different levels of purchasing planning by completing the following table as specifically and practically as you can.

(NOTE: Keep the three-tier hierarchy reflected in figure 2.1 of the prescribed book in mind.)

OBJECTIVES ON THE DIFFERENT LEVELS OF PURCHASING AND SUPPLY PLANNING

HIERARCHICAL LEVEL OF PLANT	OBJECTIVES ON DIFFERENT LEVELS
1 Mission and long-term objectives	
2 Integrated objectives	
3 Operational objectives	



Feedback

Compare your objectives at each level with the suggested answer:

PURCHASING AND SUPPLY PLANNING HIERARCHY

Mission and long-term objectives (they are strategic – relate directly to long-term planning)	<ul style="list-style-type: none">● Uninterrupted supply of products and services with minimum inventory investment● Promoting business relations with the external environment, particularly the supply market● Securing competitive position by keeping input costs to a competitive level● Extending and maintaining quality standards (e.g. discrepancies easily arise between purchasing, marketing and production)
Integrated objectives (functional – relate to medium-term planning, between one to three years, possibly five)	<ul style="list-style-type: none">● Need planning● Forecasting purchase quantities● Inventory planning● Quality planning in the form of specifications; and standards of products and services● Supply planning● Objectives are stipulated regarding planning suppliers● Drawing up a purchasing budget● Planning exceptional projects, e.g. purchase of capital goods● Purchases for expansion programmes of the production plant (if applicable)
Operational objectives (operational – relate to short-term planning-the planning of day-to-day activities)	<ul style="list-style-type: none">● Product need planning indicated under management objectives is refined into day-to-day objectives for market research● Negotiations; choice and selection of supplier sources● Internal organisation, procedural manual and operational activities

NOTE: We have only provided broad guidelines for more specific objectives that should be set. Specific objectives will differ from one enterprise or institution to the next.

2.2.3 Strategic purchasing and supply planning

As indicated in figure 2.1 in the prescribed book, strategic purchasing and supply planning is at the top of the planning hierarchy. The prescribed book explains purchasing and supply strategy and indicates its importance.



ACTIVITY 2.5

Thinking back on the discussion of purchasing and supply planning thus far, what concepts of strategic purchasing planning have you already discovered? Do you remember the following?

- top management
- long-term
- policy
- mission
- supply of products and services
- business opportunities
- competitive position

Explain in your own words what purchasing and supply strategy entails.



Feedback

For the sake of completeness you could compare your definition of purchasing and supply strategy with the one below.

A purchasing and supply strategy is a long-term plan of action aimed at long-term supply of products and services through optimal application of enterprise resources, in such a way that purchasing objectives are achieved, business opportunities in the supply market are used optimally, the enterprise's competitive position is maintained and supply market risks are kept to an acceptable level.

The place of purchasing and supply strategy is depicted in figure 2.2 of the prescribed book, and the development of a purchasing and supply strategy is discussed. An enterprise can develop specific and effective purchasing strategies in the following areas:

- *Specific purchasing objectives must be linked to the enterprise strategy.*
 - *Human resource management (qualified and motivated purchasing staff) must emphasise efficiency.*
 - *Close relations must be established with suppliers.*
 - *The purchasing department must be integrated with other functions.*
 - *The right atmosphere must be created in the purchasing department.*
-



ACTIVITY 2.6

Explain the process and important aspects of the development of a purchasing and supply strategy by means of a schematic diagram.



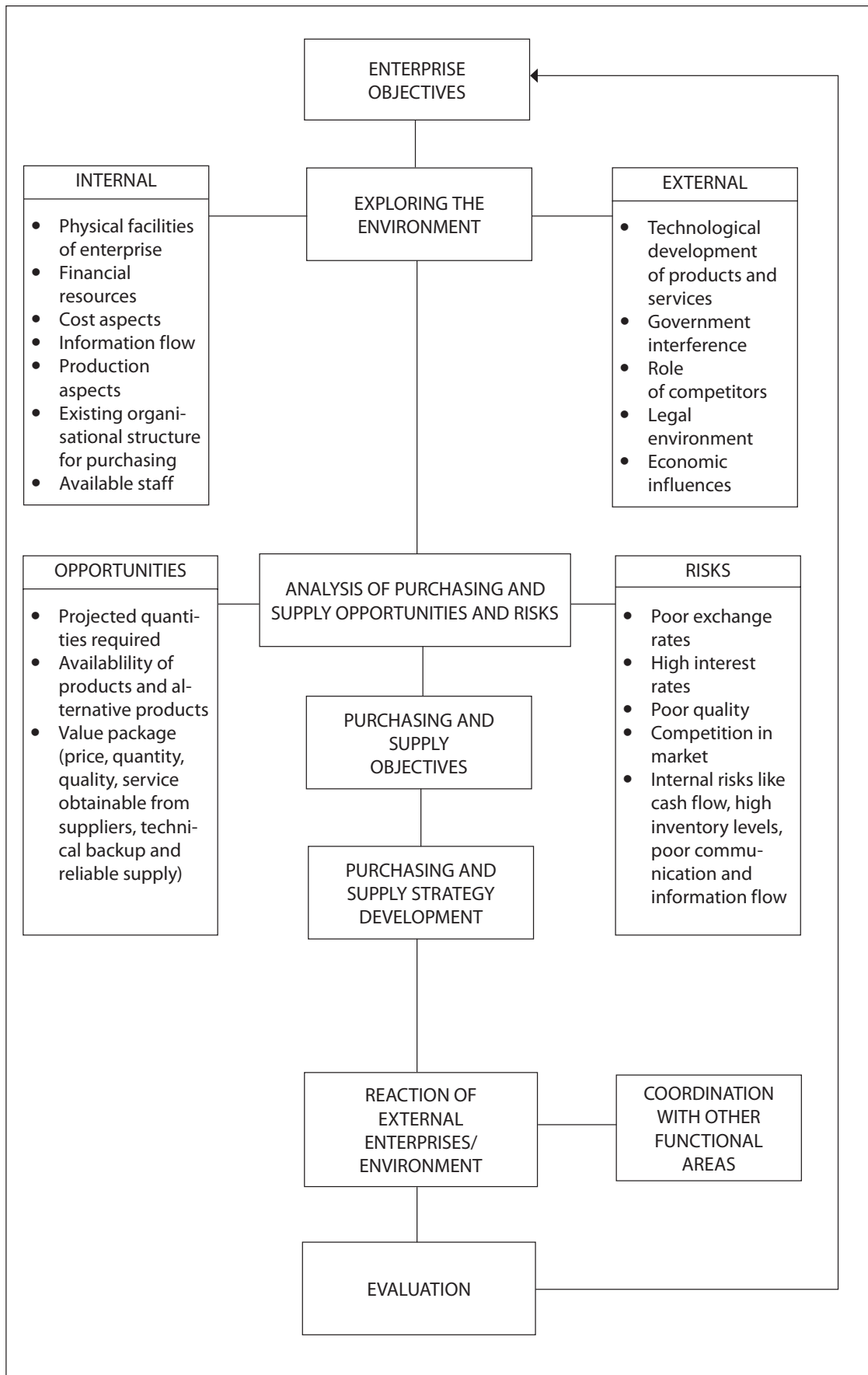
Feedback

The following is a summary of the process of designing a purchasing and supply strategy:

- *use of the enterprise's objectives as a basis for planning a purchasing and supply strategy (phase I)*

- *analysis of the purchasing and supply environment, internal and external (phase II)*
- *analysis of purchasing and supply opportunities and risks (phase III)*
- *setting purchasing and supply objectives (phase IV)*
- *developing a purchasing and supply strategy to achieve the objectives (phase V)*
- *continual evaluation to accommodate changes in the external environment (phase VI)*

You can study the diagram below, but nothing stops you from designing your own diagram. The main thing is to indicate all the key elements and make sure that you do not omit any key activities.



2.2.4 Tactical purchasing and supply planning

Strategic planning of the purchasing and supply function is top management's responsibility. Tactical planning is executed at functional management (purchasing and supply function) level. Tactical planning and objectives help to attain the objectives at strategic level. The prescribed book deals with this under the following subheadings:

- Needs
- Purchasing and supply programme planning
- Planning the purchasing and supply system
- Extraordinary projects

2.2.5 Operational purchasing and supply planning

Operational purchasing and supply planning is executed at the lowest managerial (supervisory) level. The operational plan and objectives contribute to realising objectives set at tactical and strategic levels. The prescribed book explains this under the following subheadings:

- Materials requirement planning
- Supply planning
- Planning the purchasing and supply system
- Extraordinary projects

2.3 ORGANISING PURCHASING AND SUPPLY MANAGEMENT

If an enterprise has a sound organisational structure, then authority and responsibility are clearly demarcated, management capacity is used effectively and the enterprise functions as a harmonious whole. Because of the growing importance of the purchasing function, the purchasing and supply department must be organised in such a way that it links up effectively with the overall organisational structure.



Study section 2.3 in Hugo & Badenhorst-Weiss (2011).

2.3.1 Position of the purchasing and supply function in the enterprise's organisational structure

Organisation of the purchasing function is affected by factors such as:

- the extent of the monetary value
- the perceived contribution of purchasing and supply to the enterprise's profit
- the possibility of increasing the profit
- the variety and nature of materials to be purchased
- the type of supplier market
- time-based competition
- the size of the enterprise
- management's commitment to integration

This section is clearly explained in the prescribed book under the following headings:

- centralised purchasing and supply organisational structure
- decentralised purchasing and supply organisational structure
- combined purchasing and supply organisation structure



ACTIVITY 2.7

Read the case study below and decide which purchasing and supply organisational structure would benefit the furniture manufacturer most. Substantiate your answer.

A furniture manufacturer in South Africa has factories in three provinces which make furniture from a very rare wood which it imports from Brazil. The enterprise does not have a proper purchasing organisational structure, so different people at each factory are responsible for importing the timber. By chance, while on a visit to Brazil, the managing director discovers that the three factories often compete for timber from the same supplier and, moreover, pay different prices.

Without consulting the prescribed book, tabulate your reasons for deciding on either a centralised or a decentralised purchasing organisational structure.

CENTRALISATION	DECENTRALISATION



Feedback

You could have interpreted the question as you wish, as long as you substantiated your decision accordingly. Compare your table with the one provided below:

CENTRALISATION	DECENTRALISATION
<ul style="list-style-type: none">• Materials supply to enterprise occurs in a coordinated fashion• Advantages of bulk purchases can be more fully exploited• Permits greater specialisation by buyers• Standardised purchasing procedures and uniform standards (e.g. for quality of materials) can be set for the enterprise as a whole• Centralised purchasing facilitates purchasing research, cost analysis and development of new suppliers	<ul style="list-style-type: none">• Plant managers are directly responsible for cost, so that plant autonomy is maintained• Closer relationship between purchasing department and consumer departments, hence prompter action• Can use nearby suppliers more effectively• Closer links between decentralised purchasing departments and the departments of individual plants serviced by the purchasing department

In practice, one rarely finds a fully centralised or a fully decentralised system. Usually a combination of the two is used. In the case of an enterprise like Mica hardware suppliers with branches throughout Mpumalanga, certain identified commodities are managed and purchased from their Pretoria headquarters; for example, the computer system and bathroom requirements like taps, baths and latrines. Other items like sand and gravel are purchased from local suppliers by the individual branches. This saves transport costs and time, and is more practically manageable on a decentralised basis.

The relevant sections in the prescribed book provide various organograms for possible purchasing and supply organisational structures.

2.3.2 Internal organisational structure for purchasing and supply

The internal organisation of a purchasing and supply department relates directly to the activities that have to be performed. Because all organisations have unique purchasing and supply activities, their internal organisation differs considerably. The main advantages of organising the function by means of internal subdivisions are (1) that it enables buyers in enterprises to specialise, and (2) everybody knows what tasks are allocated to him or her and to other colleagues.



ACTIVITY 2.8

Mufasa Pies, a countrywide retail chain, has its headquarters in Tshwane. All purchasing and supply activities are performed centrally from this city. Mr Chauke is the chief buyer and has six buyers, with different personalities and strengths, who report to him. Mr Chauke decides to organise the personnel to enable them to specialise in a particular part of the purchasing process. Suggest a particular grouping of activities to Mr Chauke so that each purchaser can use his or her particular strength.



Feedback

There is no right or wrong grouping of purchasing and supply activities. The five main areas or subgroups that the prescribed book suggests are usually found are the following:

- (1) *purchasing and negotiation*
- (2) *follow-up and expediting*
- (3) *administration*
- (4) *purchasing research*
- (5) *inventory*

Note that the purchasing and supply function can also be organised in such a way that buyers specialise in buying specific products/materials/services (commodities). In this type of internal organisation, the buyer will take responsibility for the entire process of purchasing the specific commodity (from identifying the need to the delivery of the material/service). An enterprise's internal purchasing and supply organisation depends on various factors, such as the nature of the purchase and the type and number of staff available in the purchasing and supply department.

2.3.3 Cross-functional teams

Modern enterprises or institutions are using cross-functional teams more and more to purchase important materials, products or services. The prescribed book discusses cross-functional teams by referring to the philosophy behind these teams, the participants involved and the advantages.

2.4 COORDINATING PURCHASING AND SUPPLY MANAGEMENT

Coordinating as a task of purchasing and supply management is a conscious attempt to harmonise the tasks and activities of this function to ensure full cooperation in the pursuit of purchasing and supply objectives. The main coordinating mechanisms of purchasing and supply management with other function in organisation, with suppliers and customers is certainly computer systems such as EDI, materials requirements planning (MRP), MRP II and distribution requirements planning (DRP).



Study section 2.4 in Hugo & Badenhorst-Weiss (2011).

The section is discussed under three subheadings: 2.4.1 – the nature of purchasing and supply coordination; 2.4.2 – coordination between purchasing and supply and other functional areas; and 2.4.3 – coordination between purchasing and supply and the supplier system.

2.5 CONTROL: PERFORMANCE EVALUATION OF THE PURCHASING AND SUPPLY FUNCTION

Control can be defined as a systematic attempt to ensure that the objectives of the enterprise or institution are achieved by measuring actual performance and comparing it with set standards, and taking corrective action in order to accomplish the enterprise's mission and goals.



Study section 2.5 in Hugo & Badenhorst-Weiss (2011).

2.5.1 Objectives and basic principles of performance evaluation

Through feedback of information on actual purchasing and supply performance (measured against quantitative norms and criteria), a control system enables management to ensure that the purchasing and supply strategy is implemented from the highest to the lowest level in the enterprise or institution. A control system also enables the purchasing and supply manager to continually monitor and strive to improve the actual performance of the function. Finally, it means that the other functions in the enterprise are able to perform optimally because inputs of products and services are purchased and supplied when required.

2.5.2 Difficulties relating to the performance evaluation of the purchasing and supply function

The following problems relating to the performance evaluation of purchasing and supply management are explored in the prescribed book:

- the diversity and complexity of purchasing and supply activities
- the difficulty of expressing purchasing and supply activities in quantitative terms
- the difficulty of setting quantitative standards for purchasing and supply activities
- the fact that traditional purchasing objectives have hardly any practical value in the performance evaluation of purchasing and supply management
- the direct influence of external factors on purchasing and supply performance

2.5.3 Steps in the process of evaluating the purchasing and supply function

Effective control, as a management task, is achieved by following a series of steps:

- Step 1: Identify objectives and determine the scope of the purchasing and supply function.
- Step 2: Establish performance measures and performance indicators (metrics) for evaluation.
- Step 3: Measure actual performance.
- Step 4: Evaluate actual performance.
- Step 5: Report (give feedback).

SUMMARY



Read the case study “Tech Venture CORP Pty Ltd of Singapore Outsourcing to Newtech Africa Pty Ltd” at the end of chapter 2 in Hugo & Badenhorst-Weiss (2011).

You should be able to give Vejay Pillay numerous helpful hints on how to set up clear, achievable and measurable strategies, as we explained the management tasks of planning, organising, coordinating and control in the purchasing and supply function in this study unit. These tasks of purchasing and supply management should be viewed as parts of an integrated process in any enterprise or institution. Also bear in mind that because of the service or supportive nature of the purchasing and supply function, its planning, organising and control should always be undertaken with due regard for the other functions of the enterprise.

Study unit 3 explains how a typical purchasing cycle is executed, by explaining the process methodically and highlighting the procedures followed and stakeholders involved in each step.



ASSESSMENT

Revise chapter 2 in the prescribed book. Once you have done this, answer the following questions:

- (1) Identify the interface between purchasing and supply management and general business management.*
- (2) Write an essay in which you describe the nature of purchasing and supply planning.*
- (3) Write a report in which you explain and illustrate purchasing and supply as part of organisational strategy development.*
- (4) Summarise purchasing and supply planning on a tactical and operational level.*
- (5) Suggest a purchasing and supply organisational structure for a national store such as Clicks according to the most contemporary management approach. Give reasons for your suggestion.*
- (6) Suggest a purchasing and supply organisational structure for a gold mine group such as Anglo-American (Pty) Ltd with mines and interests all over the globe, but concentrated in Africa, in Southern Africa specifically. Give reasons for your suggestion.*
- (7) Describe the nature of purchasing and supply coordination.*
- (8) Illustrate the coordination between purchasing and supply and other functional areas.*
- (9) Illustrate the coordination between purchasing supply and the supplier system.*
- (10) Explain the objectives and basic principles of performance evaluation of the purchasing and supply function. Give examples to substantiate your answer.*
- (11) List the difficulties relating to the performance evaluation of the purchasing and supply function.*
- (12) Summarise and illustrate the steps in the process of performance evaluation.*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 2 in your prescribed book.

Study unit 3

PURCHASING PROCESSES AND PROCEDURES

CONTENTS

Aim

Learning outcomes

Key concepts

Getting an overview

3.1 Procedures in the purchasing process

Summary

Assessment

AIM

The aim of the study unit is to provide a step-by-step overview of purchasing processes and procedures.



LEARNING OUTCOMES

After working through this study unit, you should be able to do the following:

- List the various steps in the purchasing process.
- Explain the procedures and parties involved in each of the steps in the purchasing process.
- Apply the purchasing cycle to various scenarios.



KEY CONCEPTS

- origin of the need
 - specifications
 - identifying the source
 - selecting suppliers
 - negotiating and bidding
 - ordering and contracting
 - following up and expediting
 - receiving, inspecting and distributing
 - handling faulty consignments and rejections
 - analysing the invoice
 - closing the order
 - maintaining files and records
 - measuring supplier performance
-



Study chapter 3 in Hugo & Badenhorst-Weiss (2011), including all figures and tables.

GETTING AN OVERVIEW

Every organisation, regardless of industry, buys goods and uses services. The complexity of the process directly correlates to the amount of goods and services purchased; the kind and number of suppliers used; and the buying organisation's established purchasing policies and procedures.

By its very nature the purchasing cycle lends itself to automation, using technologies provided by organisations such as SAP, TradeWorld and CommerceOne. However, it is of the utmost importance to note that managing the purchasing cycle requires more than an electronic tool that can be purchased from one of the many superb technology suppliers. Although they promise paperless and painless purchasing at the touch of a button, it is just not that simple.

So, with your foundational knowledge in purchasing and supply management now firmly laid, it is time to examine how a typical purchasing cycle is executed. This is done by explaining the process methodically; highlighting the procedures followed and stakeholders involved in each step; and illustrating the purchasing cycle with an example.



Study the introduction to chapter 3 in Hugo & Badenhorst-Weiss (2011).


3.1 PROCEDURES IN THE PURCHASING PROCESS

Of course, the purchasing activities or procedures employed by individual firms in the purchasing process (also known as the purchasing cycle) will be adapted according to the specific requirements or needs of the firm, the purchasing function's organisational structure, the special characteristics of the supply market and the existing procedures of the other functions in the enterprise – particularly production and finance. Clearly, where the purchasing and supply function forms part of supply-chain management, structures and procedures will be adapted to fit in with the supply chain as a whole. This means that no standard purchasing procedure is equally suitable for all businesses. Therefore, the following discussion of the most important purchasing procedures is necessarily of a general nature.



Study section 3.1 in Hugo & Badenhorst-Weiss (2011).

The rest of the chapter in the prescribed book deals in more detail with each of the steps in the purchasing cycle. Once you fully understand the sequence of the cycle, proceed to study the rest of the chapter:

Steps in the purchasing process	 Section to study in Hugo & Badenhorst-Weiss (2011)
Origin of the need	Section 3.2
Description or specifications	Section 3.3
Supply source identification	Section 3.4
Selection of suppliers	Section 3.5
Bidding and negotiating	Section 3.6
Placing the order/concluding the contract	Section 3.7
Following up and expediting/contract administration	Section 3.8
Receipt, inspection and distribution	Section 3.9
Handling faulty consignments and rejections	Section 3.10
Analysing the invoice	Section 3.11
Closing the order	Section 3.12
Maintaining files and records	Section 3.13
Measuring supplier performance	Section 3.14



Activity 3.1

Apply the purchasing cycle to a scenario of your choice.



Feedback

We have included two examples of how to implement the purchasing cycle. The first is purchasing capital equipment for a fictional consulting company, StanTech (Pty) Ltd. Buying capital equipment will be further explained in study unit 10.

The second example is for an automated purchasing cycle applied to the purchasing of food and beverages for a fictional casino in KwaZulu-Natal.

Example 1: Buying capital equipment

Imagine that you are Stanley Coetzee, the CEO of StanTech (Pty) Ltd, a mining consulting company. You decide to buy a small plane for ease of air travel when consulting with mining companies in remote areas of the SADEC region. How will you go about the purchase?

1 Origin of the need

Before you start shopping, defining exactly what you need can help narrow down the field. How many passengers will you typically carry? How far will you fly? How quickly do you need to get there? What types of airstrip will you land on? Will you be flying in congested airspace? Are there certain styles of plane, such as antiques and classics, which you find more appealing? How will your needs change over the next three to five years?

It is important to remember that you can charter a plane on almost any day from numerous organisations. However, owning a plane will give you pride of ownership, increased flexibility in flight times and increased control over upkeep.

To help clarify the trade-offs, add up how much you currently spend on rentals, and compare this amount to the annual cost of owning an aeroplane. If you fly 50 to 75 hours a year and spend R5 000 an hour on rentals, you are already spending R250 000 to R375 000 a year. An inexpensive plane with a grass tie-down might even cost you less.

If you decide to go ahead with the acquisition, you need to describe the specifications of the plane.

2 Specification

Choosing the best type and model of plane depends on how you plan to use it, which you determined in the previous step. It may be useful to consider the following aspects:

- **Performance** – What is the range? Manufacturers calculate the maximum distance the plane can fly at 75% power without refuelling. Will the plane be able to land at your local airport? Standard airports have 3 000 to 4 000 feet runways, and local strips may be smaller.
- **Cruise** – How fast do you need to travel? Cruise speed is measured as the speed at 75% power, and is usually expressed in statute miles per hour.
- **Number of seats** – How many seats will you need? Most planes can effectively carry fewer passengers and luggage than the number of seats they have.
- **Seating configuration** – What is your seating preference? Tandem may be faster due to its narrower configuration and may give the pilot more visibility and more legroom. However, side-by-side seating makes communication between occupants easier.
- **Avionics level** – What is the level and condition of the instruments and other electronics? Multiple communication radios are helpful for longer flights or flying in congested airspace.
- **Construction** – Low-wing planes generally have better flight visibility for flying in crowded airspace; high-wing planes may be better for sightseeing. Which is more appropriate for your personal needs?
- **Landing gear** – Which type of landing gear do you prefer, conventional or tricycle? Conventional is more rugged and may have lower wind resistance, but a tricycle gear is less complex and may have lower maintenance costs.
- **Age** – How old is the plane? Will you be able to find replacement parts easily?
- **Physical condition** – Look for rust, cracked paint and worn parts.

- **Engine** – Note the manufacturer and size. Continental and Lycoming are the most common, and therefore replacement parts are the least expensive. Also consider fuel consumption. Will you be able to fill up with the right kind of fuel easily and cheaply?
- **Gross** – What is the capacity of the plane? It is measured as the allowable total weight of the plane, passengers and cargo.
- **Useful load** – Similar to gross, the useful load measures carrying capacity. It is the gross weight minus the weight of the empty plane.
- **Stall** – What is the stall speed (usually expressed in statute miles per hour)?
- **Cost** – How much will it cost you every year? Include costs of purchase, storage, maintenance and flights.

3 Supply source identification

Once you've decided on a model and a price range, how do you find a used plane for sale? There are three sources of information:

- **Word of mouth** – Join clubs at your local airstrip, look at the bulletin boards and ask around.
- **Print classifieds** – Look in the classifieds sections of local papers, or look in your local bookstore for classified magazines specialising in small aircraft.
- **Online** – Check out the online classified on the "Where" page.

4 Select suppliers

Once you have identified a number of possible purchases, use the following steps to select a supplier.

- **Conduct a phone screen.** Before you make a trip to see a plane, make sure you ask the following questions:
 - flight time for the airframe and engine
 - date of the last major overhaul, last annual inspection and last avionics check
 - list of all applicable airworthiness directives and whether or not the plane is in compliance
 - compression readings for each cylinder at the last time measurements were taken
 - damage history, major and minor (if any)
 - description of the avionics
 - overall condition of the interior and exterior
 - price
- **Doing a buyer inspection.** Walk around the plane to see if it sits level. Look at paint for consistency; uneven paint may be an indication of replacement parts. Make sure the paint is not cracking or flaking. The wear on the paint is a good indicator of how the plane has been treated. Has it been left outside baking in the sun and buried under snow, or has it been stored in a covered hangar? Also look for dents, rust and missing pieces to get a general sense of how well the plane has been maintained. Go inside the cabin. How well do the doors close? What is the general feel of the interior? Is it worn? Does it have an odour? Look at the avionics. Does the plane have a Mode C transponder? Does the plane have an emergency locator transmitter? If either of these is missing, find out why. As a final step, examine the logbooks. Look for the frequency of flights, repairs and inspections.
- **Take the plane for a test flight.** Open the windows during the start to hear if the engine sounds normal. If it sounds rough, don't even take the plane up, walk away. Watch all the gauges during takeoff. Do the engines operate smoothly? Do a few turns. How does the aircraft feel? Check all the avionics.
- **Pre-purchase inspection.** It is strongly recommended that you have a mechanic inspect the plane before you buy it. In this inspection, make sure you confirm that the ADs

(airworthiness directives) are up to date, all maintenance was performed and recorded correctly, and all inspections are up to date. Make sure you find a mechanic who is familiar with the make and model so that he/she knows which areas to focus on. Also ask for estimated repair costs for anything found wrong.

5 Bidding and negotiation

Once you have made your supplier selection, it is time to make a bid and negotiate contract specifics. Remember to take the following into account:

- **Financing** – *If you are borrowing the money from a bank, calculate your down payment amount and the monthly payment based on current interest rates. If you are buying the plane entirely with your own money, don't forget to include the opportunity cost. That is, how would you have invested the money if you hadn't bought the plane, and how much interest are you forgoing through this purchase?*
- **Insurance** – *There are two types, liability and hull. The liability protects your assets against claims arising from an accident involving the use of your plane. The hull insurance covers physical damage to your aircraft and is often required by lending institutions.*
- **Storage** – *Options range from grass tie-downs to heated hangars. Tie-downs are cheaper, but hangars provide protection from sun, precipitation, wind and vandalism. Tie-downs range from grass spots, where you'll have to install your own anchors, to marked stalls on concrete pavement. There are several choices of hangar, the most common being the T-hangar. Planes are arranged in rows facing in alternating directions. Some hangars are two walls with a roof, providing limited protection from wind and vandalism. Some are heated but cost more. Some are chaotic, cramming in as many aircraft as possible. An additional cost may be "hangar rash", which occurs when the tips of the wings of one aircraft brush against another. Prices vary based on the type of amenities and the location.*
- **Operations** – *Airport fees and fuel. The actual amount depends on usage.*
- **Maintenance** – *Includes the annual inspection and other yearly maintenance.*
- **Other** – *Includes taxes and fees.*

6 Placing the order/concluding the contract

The costs of buying a plane include a down payment, principal and interest on a loan, insurance, storage, the annual inspection, regular maintenance, taxes and fuel. All these aspects must be included when placing the order and concluding the contract.

7 Following up and expediting/contract administration

Did you confirm the date of delivery? Did you determine the arrangements to be made before you can take receipt of the plane, such as finance, storage, insurance and so forth?

8 Receipt/inspection of plane

Receipt of the requirements must be followed by an immediate inspection to ascertain whether all predetermined agreements have been fulfilled. Now is the time to sort out any outstanding arrangements.

9 Analysing the invoice and closing the order

It is very important to store all documentation associated with the transaction properly. In closing the order (payment), all relevant documents (copies of the order, invoice, receiving note

and quotations) are submitted to the financial function under cover of a request for payment. Since these are payment vouchers, they will be filed by the financial department. If payment is made by electronic means, all the details of the transaction are electronically saved for future reference. This will ease the navigation of any problems that may arise during the ownership period of the plane.

Source:

Adapted from http://www.ebuyingguides.com/how/uplaneb_h.htm (accessed on 21 October 2010).

Example 2: Buying fast-moving consumer goods



Imagine that you are Siphso Shabalala, the Food and Beverage buyer for sister companies Casino Jabulani and Casino of the Drakensberg, the largest casinos in KwaZulu-Natal, South Africa. With its exquisite indigenous Zulu architecture, state-of-the-art amphitheatre and unique array of dining experiences, this is truly the ultimate casino destination in South Africa. The casino offers cuisine for every palate: Zulu, Indian, Cape Malay and fine Italian dining. You play an integral role in the purchasing department, ensuring that every dining outlet has the freshest, highest-quality food available for its guests.

In 2008, the management team at Casino Jabulani realised that food costs were far too high, exceeding 70% in some cases. They were losing money rapidly and felt it was imperative that they regain control over the food and beverage department. Their buffet, located at Casino of the Drakensburg, was an obvious problem area. Buffets are known for contributing to higher food costs, but have become a staple in the casino industry.

Gamers are looking for three things when it comes to dining – a varied menu, the ability to control their own time and unlimited portions. Unfortunately, these requirements can only be met by a buffet. In addition to the buffet at their sister property, Casino Jabulani felt it was necessary to take a closer look at all of their outlets at both properties and find a system that would reduce food costs, cut down on manual labour and streamline many of their ordering procedures. When their point-of-sale representative introduced them to the FoodTech system, they realised that all these goals were attainable.

After careful consideration, Casino Jabulani selected the FoodTech Food and Beverage Management System and purchased the software in October 2008. FoodTech met all of their needs and would provide the casino with a strong inventory and purchasing solution. Management was mostly concerned with accountability and obtaining real numbers that would help to justify food costs, purchases and inventory levels.

According to Shabalala, “Before FoodTech we had no information to rely on that would explain what was going on with our numbers.” Previously, the purchasing department had used paper-based forms and would verbally call in or fax their orders to the vendors (suppliers are often referred to as “vendors” in the automated process).

All the paperwork was then handed over to administration and accounting for reconciliation. Quite frequently there were serious discrepancies between inventory numbers, orders and invoices. With FoodTech, Casino Jabulani was able to eliminate this manual labour, as all of these processes were automatically handled through the system. They have now established strong purchasing, receiving and inventory procedures and have saved over 12 hours a week in the purchasing department alone.

Casino Jabulani initially chose a distributed deployment of the software to a handful of users in the casino. Over the years they began expanding and incorporating more users, thus migrating to a centralised installation through Microsoft's Terminal Services. The FoodTech system is now easily accessible to the staff members in purchasing, accounting and food and beverage departments, with over 20 concurrent users.

Ruben Rogers, IT administrator for Casino Jabulani, maintains the FoodTech system by handling all updates and changes that are made throughout the year. "Updates are very easy to apply and the support department at SCI is always extremely helpful throughout this process. We have been extremely successful with the centralised deployment and will continue to grow," says Rogers.

Their first priority in implementing the system was to focus on establishing new procedures for inventory and purchasing. Casino Jabulani began using FoodTech's inventory templates and purchase order forms to create a standardised approach to handling these procedures, and threw out the Excel spreadsheets they had been using. By formalising these practices they were able to make the processes of taking inventory and ordering more efficient. "What used to take approximately five hours to complete a full inventory in the warehouse now only takes two," claims Shabalala. Entering purchase orders in FoodTech made it possible to have all of their information consolidated and easily accessible to the various departments.

With the new purchasing procedures in place, Quinones began using FoodTech's vendor interfaces for his major distributors. He no longer spent three hours a week entering vendor price changes or nine hours a week completing his orders. FoodTech was able to import vendor bids and catalogues instantly, and also allowed Shabalala to bid competitively between his three major vendors for the best price. "I began to notice immediately that two of my vendors had consistently lower prices than our third vendor for identical items," states Shabalala. Eventually, they obtained contract pricing through one particular vendor and no longer needed to bid competitively, since 90% of their orders went through contract.

Shabalala also created purchase orders to submit electronically to his vendors, and then imported those vendor invoices into FoodTech. "Importing invoices takes less than ten minutes now!" he exclaims. With over R500 000 a month in purchases, Shabalala orders three times a week, making it imperative that he automates as much of this process as possible. Shabalala reviews a variety of reports, including the Purchase Recap. Cost of Goods and Transfer Activity report, with the Vice-President of Finance in order to see where they stand in comparison to previous months. By reviewing these calculations and verifying them with their Micros point-of-sale system, they have a stronger understanding of their food usage and are more consistent in their spending.

What purchasing transaction did you choose? Be aware of the impact made by the differences in item or service, industry, supplier and so forth. We strongly recommend that you do additional reading on the matters discussed in this section, because new viewpoints, perceptions, philosophies, concepts and techniques are constantly developing.

SUMMARY



Read the Purchasing Practice Section “Purchasing Department vs Purchasing Process” at the end of chapter 3 in Hugo & Badenhorst-Weiss (2011) and attempt to answer the three questions.

In this study unit the purchasing cycle was examined, giving some insight into the basic activities which represent the day-to-day tasks of purchasing and supply management, and the documents and stakeholders represented in each step. We went one step further by applying the purchasing cycle to a particular set of circumstances.

This brings us to the end of the first topic, which addressed the purchasing function in a broader supply context. Topic 2 will deal with all the elements involved in managing the supply base of an organisation.



ASSESSMENT

Revise chapter 3 in the prescribed book. Once you have done this, answer the following questions:

- (1) List the various steps in the purchasing process.*
- (2) Explain the procedures and parties involved in each of the steps of the purchasing process.*
- (3) Apply the purchasing cycle to various scenarios.*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 3 in your prescribed book.

Topic 2

MANAGING THE SUPPLY BASE

CONTENTS

Study unit 4: Purchasing and supply strategies and policies

Study unit 5: Evaluation and selection of suppliers

TOPIC AIM

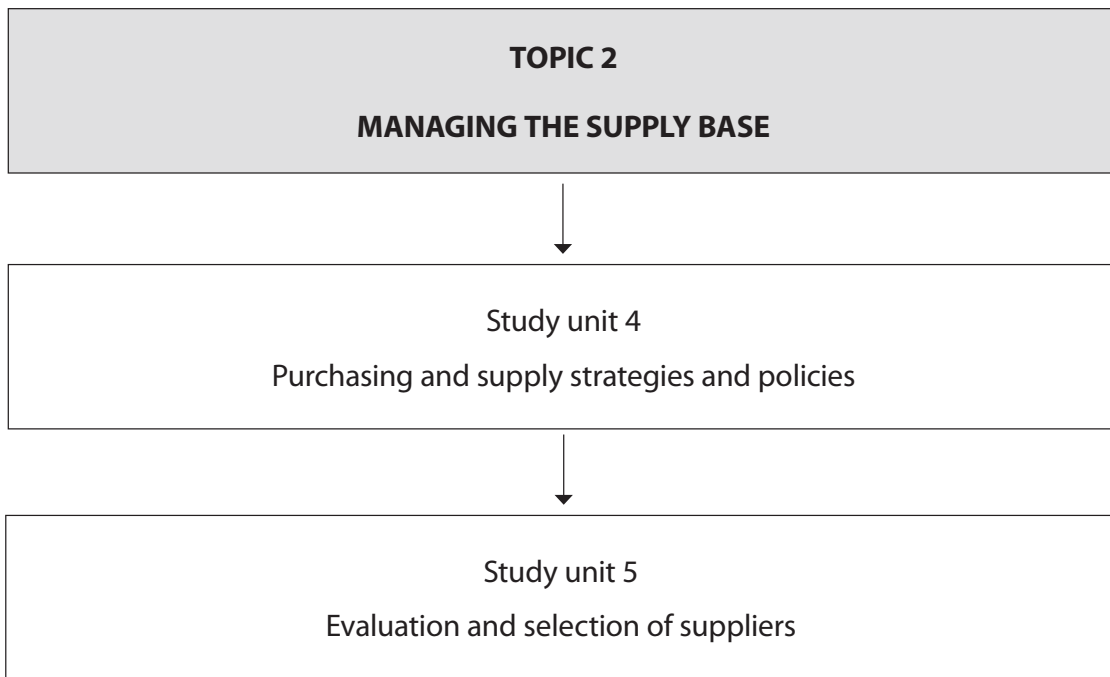
The aim of topic 2 is to go beyond the tactical purchasing management function by examining the strategic management of the supply base in accordance with the strategic sourcing approach; the selection and performance evaluation of suppliers; supplier policies and strategies; and to highlight the ethical aspects, corporate governance and social responsibilities in purchasing and supply management.



TOPIC LEARNING OUTCOMES

After studying this topic, you should be able to do the following:

- Define strategic sourcing.
- Explain, with the aid of a diagram, the strategic sourcing process.
- Explain the underlying principles driving organisations to outsource certain goods or services.
- Tabulate the advantages and disadvantages of outsourcing.
- Explain the outsourcing decision process.
- Briefly outline and highlight the most important areas in which purchasing and supply policies are needed.
- Compile a supplier policy suited to a particular organisation.
- Illustrate the dynamic environment in which purchasing decisions must be made.
- Identify the key criteria for supplier selection.
- Discuss the supplier selection process by applying it to a practical example.
- Distinguish between various supplier relationships.
- Define supplier relationship management.



Study unit 4

PURCHASING AND SUPPLY STRATEGIES AND POLICIES

CONTENTS

Aim

Learning outcomes

Key concepts

Getting an overview

4.1 The process of strategic sourcing

4.2 Outsourcing: to make or to buy

4.3 Supply policies and strategies

Summary

Assessment

AIM

The aim of this study unit is introduce you to the purchasing and supply strategies and policies available to your organisation, focusing on strategic sourcing and outsourcing. We then look at the most important aspects to include in a supplier policy to provide a framework for buyers to select and interact with suppliers.



LEARNING OUTCOMES

After working through this study unit, you should be able to:

- Define strategic sourcing.
- Explain, with the aid of a diagram, the strategic sourcing process.
- Explain the underlying principles driving organisations to outsource certain goods or services.
- Tabulate the advantages and disadvantages of outsourcing.
- Explain the outsourcing decision process.
- Briefly outline and highlight the most important areas in which purchasing and supply policies are needed.
- Compile a supplier policy suited to a particular organisation.



KEY CONCEPTS

- purchasing and supply policies and strategies
- strategic sourcing
- strategic sourcing team

- market research
- strategy development
- contract negotiation
- supplier relationship management
- outsourcing
- rationale for outsourcing
- outsourcing decision process
- noncost factors
- total cost of ownership
- relationship analysis
- supplier policy
- local, national and international suppliers
- distributor
- manufacturer
- supply-base optimisation
- supplier development
- reciprocity
- captive suppliers
- environmental protection



Study chapter 4 in Hugo & Badenhorst-Weiss (2011), including all figures and tables.

GETTING AN OVERVIEW

As an introduction to study unit 4, read the following directors' insight written by Gavin Maas, Sales Director of Miraculum, entitled "Beneath the surface of strategic sourcing".

Strategic sourcing is about managing the cost of purchased goods and services, and this is one of your most important value creation levers, even more so than, in many instances, market share. How can this be achieved? Through the utilisation of the traditional purchasing levers we all know so well: we negotiate price with our suppliers and aggregate purchasing to qualify for volume discounts. In addition, we become more critical in our supplier selection.

Right? Partly. But much like an iceberg, most of the opportunity in strategic sourcing is hidden. The traditional purchasing levers we use so often can be equated to the visible tip of that iceberg. They represent only a part of the opportunity offered by strategic sourcing. More importantly, they are rarely sustainable on their own.

They must be supported by what lies beneath the surface: world-class purchasing practice which makes use of the more advanced cost management techniques that focus on reducing the total cost of acquisition AND the total cost of ownership. This includes finding opportunities within our own organisations to reduce costs.

For example, you could try to identify and then eliminate price disparities on similar products; change specifications to purchase components or equipment which may be less expensive or more readily available; purchase equipment or materials which requires reduced maintenance, improves yields, reduces wastage or lowers energy consumption.

You could also improve management of inventories and write-offs, rationalise order processes and eliminate backdoor systems. Indeed, you could do a great many things – very little of which traditionally falls within the ambit of the procurement specialist. But, the re-engineering demanded in order to leverage internal opportunities for lowering total cost of ownership is very much a part of the strategic sourcing process. And so is looking for joint opportunities with your suppliers and, if necessary, your competitors.

What does it cost your supplier to produce the widget you need for your gadget? Couldn't you change your specifications so that your supplier could develop something which might suit your needs better or as well and cost you both less? Think how much you (both) could save if you shared your forecasts with your supplier so that you could optimise order quantities and production runs. You could also work together to find ways to reduce packaging returns; improve R&D; jointly evaluate capex plans; reduce transport requirements and eliminate double handling; value-analyse specifications, product variances and tolerances; examine quality assurance needs and share warranty risks.

Clearly it would not be appropriate to apply each of these levers to your procurement process for every item you buy. Strategic procurement practice is about identifying the lever that would deliver the most significant value against a particular purchase or commodity group. Little of this would be possible without solid and considerable human purchasing and re-engineering skills. And while none of this has anything to do with the technology-focused approach of e-procurement; it is important to apply strategic sourcing skills prior to, or in combination with, a technology solution, to ensure that the benefits of strategic sourcing are installed and maintained.

Source: <http://www.miraculum.com> (accessed on 30 September 2006).



Study the introduction to chapter 4 in Hugo & Badenhorst-Weiss (2011).



ACTIVITY 4.1

Study the different perspectives given in the introduction to chapter 4 and formulate your own definition of strategic sourcing. You may also consult other sources.



Feedback

Every student will respond to this activity in his or her own way. Make sure, however, that your definition of strategic sourcing includes the following points:

- *It is a strategic management process.*
 - *Commodities and suppliers are analysed.*
 - *Supplier relationships are formed and managed.*
 - *Best practices and appropriate strategies are employed.*
 - *Strategic sourcing is executed in support of long-term organisational goals.*
 - *The process is managed by a cross-functional team.*
-

4.1 THE PROCESS OF STRATEGIC SOURCING

Now that you know what strategic sourcing is, it is essential to familiarise yourself with the following steps in the strategic sourcing process:

- build the team
- conduct market research
- develop a strategy
- negotiate a contract
- manage supplier relationships



Study section 4.1 in Hugo & Badenhorst-Weiss (2011).

4.2 OUTSOURCING: TO MAKE OR TO BUY

The pressure of a rapidly changing world demands skill and flexibility in enterprises. The enterprises that are most successful in this ever-changing world are those that focus and capitalise on what they are good at, and thus try to gain the upper hand. It is better to outsource the activities that do not add value to the enterprise's primary function (or product) to enterprises which specialise in such activities.



Study section 4.2 in Hugo & Badenhorst-Weiss (2011).

4.2.1 Introduction

Make-or-buy, subcontracting and outsourcing decisions are closely entwined. The outsourcing or subcontracting decision requires the same type of analysis as the make-or-buy decision.

One of the critical and strategic decisions with which enterprises are confronted is the make-or-buy decision. This decision can shape the whole enterprise's character, and is crucial to its productivity and competitiveness. Management thinking has changed dramatically in the past few years as a result of increasing internationalisation, pressure to reduce costs, downsizing and concentration on the core activities of the enterprise. The trend is to purchase goods and services that were previously supplied internally from outside suppliers, outsourcing to suppliers and subcontracting parts of the production process to other, usually smaller, manufacturers.

Traditionally, large organisations tended to choose the "make" option. This led to backward integration, large organisations (conglomerates) and ownership of a large group of manufacturing and subassembly plants. Purchases involved mainly raw materials that were processed in the enterprise.

The new management philosophy emphasises flexibility and focusing on the enterprise's strengths, proximity to customers, increasing emphasis on productivity and competitive-

ness. This has reinforced the idea of buying from outside. It is impossible for any enterprise to be superior in all aspects of manufacturing or service provision. When it purchases requirements from competent suppliers outside, the enterprise can better concentrate on its principal mission. This philosophy has already led to substantial downsizing of large organisations. The task of the buyer in this process is to seek world-class suppliers who can meet the enterprise's long-term needs.



ACTIVITY 4.2

Distinguish between the three concepts (1) purchasing (instead of making), (2) subcontracting and (3) outsourcing. Give examples to illustrate your explanation.



Feedback

Components of the final product can be purchased (as opposed to the enterprise itself making them) when they are standard components obtainable in the market. Suppliers of these components provide the same components to other customers. In subcontracting, a nonstandard (custom-made) component that the enterprise itself previously manufactured is subcontracted (outsourced) to another manufacturer who can do a better job. Outsourcing means that noncore activities in the enterprise are contracted out to suppliers who can do the job better than the enterprise. It therefore has nothing to do with the enterprise's production process (or core activity).

4.2.2 The rationale for outsourcing

The underlying principle driving outsourcing may range from tactical to strategic, and is clearly outlined in your prescribed book. The section also addresses the advantages and disadvantages that outsourcing may have for an enterprise.



ACTIVITY 4.3

Tabulate the advantages and disadvantages that outsourcing may hold for an enterprise.



Feedback

You could have identified these advantages and disadvantages of outsourcing after studying the corresponding section in the prescribed book:

ADVANTAGES	DISADVANTAGES
<ul style="list-style-type: none"> • Cost savings • Specialisation by smaller, more streamlined enterprises • Better competitive position • Enlarged production capacity • Limit or eliminate inventory by employing just-in-time (JIT) • Increased responsiveness to changes in the market 	<ul style="list-style-type: none"> • Captive suppliers • Unsuccessful development of suppliers • Loss of control and skills • Loss of service provider focus • Lack of clarity of responsibility • Lack of cost control • Ineffective management • Loss of confidentiality • Double outsourcing

Can you think of any other factors?

4.2.3 The outsourcing decision process

The outsourcing decision process includes the following phases:

- Phase 1: assessing technology and demand trends
- Phase 2: defining core activities
- Phase 3: analysing the strategic position
- Phase 4: considering noncost factors and making a decision
- Phase 5: conducting a total cost analysis of core activities
- Phase 6: analysing the relationship



ACTIVITY 4.4



Read the following newspaper article:

Toyota SA to double output

By Don Robertson

Motor manufacturer Toyota SA plans to double its current annual production to 200 000 units, of which 100 000 will be exported. "The first phase of a five-year expansion project is the construction of a new paint shop at a cost of R1-billion, said Kunio Komada, managing director of Toyota Japan. This year Toyota SA will begin exporting the Hilux and a sports utility vehicle to Europe and the rest of Africa. Initial annual production will be 88 000 units, but "will increase substantially in the future", he said.

Komada said he was confident that Toyota SA would remain viable even if the Motor Industry Development Programme was scrapped or altered when it is reviewed later this year. The programme, which gives vehicle and component manufacturers a rebate on import duties based on a percentage of the value of exports, was introduced in September 1995.

Johan Van Zyl, president and chief executive of Toyota SA, said exporters needed further government and regional assistance to increase business, particularly with the strong rand. "More support will result in major benefits in terms of both our production and export numbers." Speaking at a gathering this week, Komada said Toyota Japan had no plans to acquire the outstanding 25% of Toyota SA currently owned by Wesco. "We have sufficient interest in Toyota SA to be able to make all the decisions", he said.

Source: Sunday Times (23 January 2006).

Would you advise Toyota to outsource the construction of the new paint shop? Write a report to substantiate your answer.



Feedback

In answering a question of this kind, you are expected to apply the theory to the facts presented in the article. You should thus have discussed the various phases in the outsourcing decision process, and drawn a conclusion that is relevant to Toyota. Whether you advised Toyota to outsource or not is irrelevant to a certain extent –making a choice and substantiating your choice with valid arguments is what counts.

4.3 SUPPLY POLICIES AND STRATEGIES

You now know which strategic sourcing process to follow within your organisation, and how to determine whether you will outsource certain goods or services to outside companies. Now it is important to set up a framework for your organisation which provides a guideline for taking decisions about suppliers and devising a strategy to deal with such organisations.

Such supplier policies and strategies, like any organisational policy and resulting strategy, are drawn up either by top management themselves or on their instructions. In large enterprises, a formal policy helps employees, and specifically the purchasing department, to take decisions without constantly referring back to management because of uncertainty. Policy creates certainty, order and a measure of control in an enterprise or department. This section deals with the problems or considerations that generally influence the supplier policy of enterprises.

Before studying the section in the prescribed book, think about each of the following key questions which purchasers face in this realm of purchasing.

- What do you know about suppliers?
- What experience have you had of them?
- What impact do suppliers have on your organisation?
- Should an enterprise use only local suppliers, or should it use overseas suppliers as well?
- Which products can be purchased locally and which have to be obtained from distant suppliers?
- Is it sensible to purchase from only one supplier per product, or should one have several suppliers for each product?

- In which circumstances would one buy from a manufacturer rather than from a middleperson (intermediary)?
- What should be one's guideline on the size of a supplier?
- Is reciprocity a sensible policy?
- In what circumstances would an enterprise manufacture (make) a product itself instead of purchasing it, and vice versa?
- Should the enterprise become involved in supplier development?
- Is a captive supplier sound policy?

These key questions are guidelines that an enterprise should consider when formulating supplier policy. The prescribed book clearly explains each of these key issues or policy guidelines.

Now, study section 4.3 in Hugo & Badenhorst-Weiss (2011).

4.3.1 Local, national or international suppliers

A supplier policy should address the problem of choosing a local, national or international supplier. Each option has certain advantages and disadvantages. Many factors have to be considered before a policy can be formulated on the choice of suppliers: for example, the product itself, competition, the size of the buying organisation and the supplier, expectations of clients, etc. are all factors that will influence the policy.

4.3.2 Purchasing from a distributor or manufacturer

Again there are advantages and disadvantages to buying from either a distributor or a manufacturer. Certain factors will influence the policy decision. These factors can easily be derived from the discussion of the advantages and disadvantages in the prescribed book.

4.3.3 Supply base optimisation: one supplier or more

Choosing to have one or more suppliers is a vital decision. On the one hand, according to recent beliefs and management developments, organisations want to choose one supplier and enter into a long-term agreement with him or her. On the other hand, one supplier can pose a risk with regard to continuous supply if something unexpected happens that has a major impact on the supplier's existence.

4.3.4 Size of suppliers

Many factors determine the policy decision on the size of the supplier. Factors such as extent of requirements, type of product (standard or custom-made), subcontracting possibilities etc. may influence the policy decision.

4.3.5 Supplier development

This section covers the following three types of development:

- purchases from disadvantaged suppliers
- product or service not available
- normal performance appraisal

Preferential procurement, or buying from previously disadvantaged businesses, has become essential in South Africa – so crucial in fact that large companies are compiling policies devoted solely to this function. Read through the following excerpt from Rand Water’s commercial equity policy.



RAND WATER COMMERCIAL EQUITY POLICY

1 The context in which the Commercial Equity Policy should be viewed

Rand Water is, through various initiatives and interventions, endeavouring to correct and redress both the historical advantages and disadvantages accorded to or imposed upon certain sections of the South African population during the course of past unfair discriminatory policies and practices.

One such initiative by Rand Water is to make rapid progress towards the inclusion of Previously Disadvantaged Individuals in the supplier base of goods and services supporting its activities. The first part of the initiative consists of the introduction of a policy to achieve the objective of a diverse supplier base within a reasonable time whilst at the same time enabling Rand Water to continue to provide an effective and efficient service to its customers. This policy is termed the Commercial Equity Policy, which will remain in force until the Board of Rand Water decides that the policy has served its purpose. The second part of the initiative is that the policy makes provision for the setting and review of targets, at least annually, in order to ensure that reasonable progress is made towards achieving the ultimate objective.

2 Definitions of Previously Disadvantaged Individuals and Tenders from Target Groups

The term “Previously Disadvantaged Individuals” used in this policy is intended to describe individuals who are South African citizens and have been socially and economically disadvantaged by the legacy of the South African political dispensation prior to 28 April 1994. For the purpose of the policy the presumption is made that individuals who fall into population groups that had no franchise in national elections immediately prior to the introduction of the 1994 constitution and the tricameral parliamentary system, are Previously Disadvantaged Individuals. This is subject to persons who obtained South African citizenship after 2 February 1990 being able to demonstrate traceable South African parentage. It is incumbent on individuals to demonstrate their claims to fall into such population groups on the basis of identification and association with and recognition by the members of such group.

The term “Tenders from Target Groups” denotes tenders from entities comprising specific combinations of Previously Disadvantaged Individuals as equity shareholders or managers as defined under the section on “Status of the Enterprise” included in the policy.

3 The objective of the Commercial Equity Policy

The objective of Rand Water's "Commercial Equity Policy" is to correct the imbalances of past discriminatory practices with regard to race, gender and disability by proactively transforming the supplier base for the provision of goods and services which support Rand Water's activities. The objective will have been achieved when the Board of Rand Water is of the opinion that its supplier base for goods and services to support its activities is sufficiently representative of Previously Disadvantaged racial groups, women and disabled persons. This is therefore a limited period intervention.

4 Proactive measures to be adopted to achieve the objective of the Commercial Equity Policy

The proactive measures to be adopted by Rand Water in order to achieve its Commercial Equity Policy objective are:

- 4.1 Price preferences will be accorded to tenderers whose firms or joint ventures comprise specific combinations of Previously Disadvantaged Persons as equity shareholders or managers and where tenders can be defined as "Tenders From Target Groups". The preference will be calculated in accordance with the section on "Preferences for Tenders from Target Groups" described elsewhere in this policy.*
- 4.2 An annual review by end users and commercial equity managers will identify all goods and services procured by Rand Water during each year and identify which goods and services can readily be supplied through "Tenders from Target Groups".*
- 4.3 The users of the required goods and services will, with the commercial equity managers, be required to break down all appropriate work into practical contract components which will facilitate the participation of "Tenders from Target Groups".*
- 4.4 The users of the required goods and services will, with the commercial equity managers, strive to ensure that specifications are made more understandable and are based only on the minimum requirements for the job in order to facilitate participation of "Tenders from Target Groups".*
- 4.5 The commercial equity managers will provide counselling and training service to entities submitting "Tenders from Target Groups" in order, where appropriate, to:*
 - (i) Provide pre- and post-tender counselling.*
 - (ii) Assist with negotiating financial arrangements with financial institutions.*
 - (iii) Assist with support for strategic thinking to eliminate dependency of tenderer/contractor on Rand Water.*
 - (iv) Encourage and directly assist in the formation of firms to supply goods and services to Rand Water.*
 - (v) Give guidance and advice with respect to matters such as quality, production, procurement, finance, etc.*
- 4.6 The Commercial Manager, in consultation with the user, may recommend that the General Manager – Finance waives sureties for work to be performed under contract if, in his opinion, the risk to Rand Water of default is insignificant and participation of "Tenders from Target Groups" is thereby facilitated. The maximum amount of the value of the surety that may be waived or reduced is to be set by the Board annually.*

- 4.7 (i) Where monopolies, sole suppliers or exclusive suppliers of goods or services to Rand Water exist, the organisation may require that the supplier breaks down the contract into logical component parts in order to facilitate the procurement of a stated percentage of the contract value from "Tenders from Target Groups". These include:
- subcontracting portions of the contract
 - procuring manufactured components/subassemblies
 - procuring of consumables
 - procuring of services, e.g. transport, legal, etc.
 - procuring of professional services, e.g. engineering, design, etc.
- (ii) The percentage of contract value, which is procured in the manner specified under this clause, will be considered as and reported as procurements from target groups.
- (iii) Suppliers who are not willing to be helpful with this requirement may not be considered further in the placing of the order for the work.
- 4.8 Rand Water will make special interim arrangements to pay entities whose special circumstances may require it. Such interim payments will be made on the recommendation of the Commercial Manager and on the authorisation of the General Manager – Finance and may be made 14 days after receipt of invoice and certification of completion of work.
- 4.9 The Commercial Manager will recommend to management certain categories of goods and services for which only "Tenders from Target Groups" may be submitted. Tenders for work on this basis will be awarded provided the award does not exceed an open market or "shadow price" by more than ten per cent.
- 4.10 Rand Water will, where considered necessary, provide additional supervision for work to be performed by entities in the category "Tenders from Target Groups" and the cost of such additional supervision will be taken into account in the adjudication of tenders. The maximum cost to be incurred in this activity will be stipulated by the Board from time to time at the annual review of targets.

Source: <http://www.randwater.co.za> (accessed on 10 October 2008).

The rest of the policy covers aspects such as preferences for tenders from target groups, status of enterprise submitting tenders, database, publicising the policy, registration requirements for all tenderers, penalties for the abuse of the policy, accountability and responsibility, target-setting and performance measurement. This ensures that every employee in the organisation is equipped with a tool to guide his/her decision-making process, with regard to purchasing from disadvantaged enterprises.

4.3.6 Reciprocity

Reciprocity simply means "I buy from you because you buy from me." Whether or not to accept a policy on reciprocity is an issue arousing much controversy and debate. Some organisation managers feel that it is not good business practice, while others promote the policy.

4.3.7 The decision to make or buy

The decision "to manufacture oneself or to buy from a supplier" is also a contemporary one. It is closely related to the next policy issue of subcontracting and outsourcing. Many

issues have to be considered before a policy decision can be taken. An important consideration is the cost implications.

4.3.8 Captive suppliers

Captive suppliers are suppliers who are too dependent on one client for their survival. Although everybody agrees that this is not a healthy situation, cognisance should be taken of the situation of disadvantaged suppliers that need to be developed and grow before they can service more clients.

4.3.9 Environmental protections

Environmental issues deal with the responsibility of the buying and supplying organisations towards the environment. You all should be aware of efforts such as the “buy green” campaign. Such campaigns focus the public’s attention on responsibility towards the environment.



ACTIVITY 4.5

Southern African Telecommunication Company (SATC) is a private telecommunications service supplier in Southern Africa. Imagine you are the purchasing manager of SATC. Draft a detailed policy on supplier relations which includes the policy points raised in section 4.3.



Feedback

You can start the policy document with a general statement of intent on maintaining good long-term relations with selected suppliers. You can then single out one or more of the approaches (or policies) to supplier relations. Factors that may influence supplier relations must be dealt with one by one as separate sections of the policy document. These factors include confidentiality, visits to or from suppliers, policy on affirmative-action purchases, supplier development, use of international suppliers, employing one or more sources, and what is expected of a supplier of SATC.

SOUTHERN AFRICAN TELECOMMUNICATIONS COMPANY (SATC) POLICY ON SUPPLIER RELATIONS

CONTENTS

- (1) Long-term supplier relations
- (2) Confidentiality
- (3) Policy on reducing the number of suppliers
- (4) Obligations of suppliers
- (5) Visits to/from suppliers
- (6) Selection and performance appraisal of the supplier
- (7) Black economic empowerment or affirmative-action purchasing (preferential procurement)
- (8) Purchasing from one or more source(s)
- (9) Certifying suppliers
- (10) Developing suppliers
- (11) International purchasing

This policy includes all forms of contact with suppliers irrespective of what products, services or equipment will be purchased.

1 LONG-TERM SUPPLIER RELATIONS

Modern purchasing practice is to maintain good long-term relationships with reliable suppliers. Loyal, competent suppliers are a source of power for the South African Telecommunications Company (SATC) when it comes to its competitive position in the market. A sound long-term relationship is based on a good understanding, loyalty, mutual respect and trust to the benefit of both parties. It is therefore the policy of SATC to maintain the highest possible standards with regard to business ethics, professional courtesy and competence in all transactions with suppliers. The relevant South African legislation will be subscribed to during business transactions. The following guidelines for supplier relationships are prescribed for SATC employees:

- (1) Receive representatives from suppliers promptly and considerately and give all representatives the same fair treatment.*
- (2) Provide equal opportunities to all qualified suppliers with regard to specifications and price quotations.*
- (3) Guarantee the confidentiality of all specifications and price quotations provided by suppliers.*
- (4) Avoid disclosing any information about awarding transactions, be it information about prices, suppliers or anything else. Unsuccessful suppliers need only know that a better offer has been made. No correspondence will be entered into or explanations given because guideline 1 (2) will apply at all times.*
- (5) Avoid taking advantage of obvious mistakes that suppliers have made and show understanding of their problems by always being cooperative and supportive.*
- (6) Remain fully familiar with the supplier's methods, services and materials and encourage them to have their products tested (by the SABS).*
- (7) Keep suppliers fully informed of changes in SATC's products, procedures and needs.*

Re-quoting or re-tendering will be permitted only in highly exceptional cases in consultation with and with the approval of top management.

2 CONFIDENTIALITY

All information pertaining to purchasing transactions is confidential. It is unethical, illegal and potentially harmful to the reputation and the competitive position of SATC to disclose information about the quotations, or technological or strategic considerations of one supplier to another. All employees should guard against leaking information, say, during the course of telephone conversations, from documents which are lying open on a desk during interviews with suppliers or during conversations between employees while suppliers are within earshot. All files should be locked away and treated as confidential. Care should also be taken not to leak information during visits to suppliers.

3 POLICY ON REDUCING THE NUMBER OF SUPPLIERS

SATC has adopted a policy of reducing the number of suppliers in conjunction with other policies such as striving for the best quality, the greater use of supply contracts, term contracts, continual monitoring and assessment of suppliers' performance and long-term relationships with suppliers. It is the policy of SATC to do more purchasing transactions with fewer, but more competent suppliers, because the concomitant improvements in quality, service, deliveries and lower costs (owing to the concentration of purchasing power) greatly contribute to

SATC's effectiveness, competitiveness and client service. This policy makes it possible for SATC purchasers to pay more attention to managerial and strategic factors instead of doing a mass of paperwork and spending energy and system capacity on inefficient suppliers.

A programme of certifying suppliers will be followed to put this policy into practice. Accordingly, suppliers who take the trouble to cooperate with SATC and to meet its needs (with regard to quality, service and costs) will have preference when it comes to awarding future contracts.

4 OBLIGATIONS OF SUPPLIERS

The following is expected of suppliers to SATC and these requirements will be explained clearly to them:

- *All personal and written communication with SATC will be done with the purchasing section, except when this department asks for other sections to deal with the consignment for technical or other reasons. In a case like this the purchasing section must either receive copies of the correspondence or be kept up to date by means of verbal communication.*
- *All purchasing contracts should be negotiated with the purchasing section only. (The purchaser will, if he or she deems fit, and because of the nature of the product/service, involve technical, legal and other specialists at SATC in the negotiation process and/or communications.)*
- *All possible information should be disclosed to the purchasing section and another SATC representatives in connection with technical, engineering and systems matters, as well as policies and services which could lead to the improvement of the future or current use of the supplier's product or service.*
- *The purchasing section and other SATC representatives should be informed of new products or services as soon as the relevant information is available.*
- *The purchasing section should be informed of changes in economic circumstances which could have an influence on purchasing and operational decisions.*

Any false declaration in tenders/quotations should be avoided (e.g. about quality, specifications, or hidden price increases). Deviations from the specifications and quality can lead to cancellation of the contract.

5 VISITS TO/FROM SUPPLIERS

5.1 Visits from suppliers

Suppliers should be received in a friendly and courteous fashion during the hours that are set aside for visits from suppliers. If a supplier cannot be seen because of pressure of work, he or she should be notified in good time and an alternative appointment should be made within a reasonable period. Exceptions will be made for suppliers who live far away.

5.2 Visits to suppliers

Visits to suppliers should be preceded by a formal appointment and the purpose of the visit should be clearly stated. The purpose of the visit could be to pay a courtesy call or to visit the supplier's plants to evaluate the supplier, product processes and facilities.

If an SATC employee is paying a courtesy call, he or she should try to communicate with the managers of the supplier. Valuable information about the future plans of the supplier can be obtained in this way. The SATC employee should be considerate and not waste the time of

the persons concerned. The SATC employee should note carefully and guard against having his/her sound judgment influenced when being entertained, and receiving favours and gifts.

When the supplier is visited for an evaluation of the suitability of his or her products/services, the SATC employee should note down his or her observations according to a pre-planned check list (see also the policy on selection and evaluation of suppliers). SATC employees should be considerate and professional at all times during visits and in this way create a positive image of SATC.

6 SELECTION AND PERFORMANCE APPRAISAL OF THE SUPPLIER

6.1 Guidelines for selection

The choice of a supplier is the responsibility of the purchaser, in consultation with the user or technical expert, quality control and financial expert in the company – if necessary, and various aspects must be taken into account.

The initial evaluation and selection are the responsibility of the purchasing section with regard to price, quality and delivery (if it is an existing supplier). If there is a deviation from the specifications for a tender/quotation, the requisitioner (or technical expert) will be called in to assist in determining the technical acceptability of the item.

When a new supplier is considered, the appraisal should also include an evaluation of the supplier's expertise, technical and financial ability and the production capacity and stability.

Preference will be given to the following types of suppliers on condition that price, quality and service are not sacrificed:

- *suppliers who tender/quote fixed prices*
- *locally manufactured products or products containing local components*
- *current suppliers who live up to expectations as assessed by performance appraisal*
- *suppliers who develop new and improved products, or who design and develop products for the exclusive use of SATC*
- *suppliers who have geographically distributed branches in SATC's main regions*
- *well-known suppliers who are financially sound and have built up a reputation for complying with specifications and delivery schedules*
- *suppliers who behave in a responsible way towards the environment and society with regard to production processes (e.g. the responsible use of natural resources and prevention of pollution of the environment), the harmful side-effects of products, packaging and recycling*
- *small business enterprises in accordance with SATC policy on affirmative action in purchasing*
- *suppliers who are actively involved in affirmative action in the small business community (e.g. by subcontracting)*

6.2 Guidelines for performance appraisal

It is vital for the profitability and competitive position of SATC that suppliers should supply the right products of the right quality at the minimum cost and at the right time. To ensure that SATC has first-class suppliers (which will contribute to the profitability and competitiveness of the company), it is important to monitor the supplier's performance continually with the delivery of orders. With the help of users, the purchasing section should monitor the supplier's performance with regard to quality, price and deliveries in particular. Suppliers should continually be informed of the results of the performance appraisal.

7 BLACK ECONOMIC EMPOWERMENT OR AFFIRMATIVE-ACTION PURCHASING (PREFERENTIAL PROCUREMENT)

This guideline is applicable to the purchase of selected products and services which are of such a kind that they can be supplied by small developing suppliers. Highly technical products and services, as well as products and services which are subject to technological obsolescence, are therefore excluded from this policy guideline.

It is the policy of SATC to make a contribution to solving the country's socioeconomic problems. This enterprise seeks especially to make a contribution to developing communities in society where the need is greatest. It is the declared policy of SATC to underwrite a programme of affirmative-action purchasing and this policy contains the following guidelines:

- *Ten per cent of all orders for products and services will be awarded to suppliers who comply with quality and delivery requirements, from the previously unprivileged sector of the community. If these suppliers (according to the policy of SATC on the performance appraisal of suppliers) meet expectations, 15 per cent of a subsequent order will be awarded to those suppliers up to a maximum of 50 per cent (provided that the scope of the larger order is within the physical capacity of the particular supplier).*
- *As far as is possible in practice, technical and managerial help will be given to suppliers from the above sector for a reasonable period so that they can become fully-fledged suppliers.*
- *The suppliers, who have preference in terms of this policy, must have the ability and the will to develop into fully-fledged suppliers of SATC in the long term.*
- *Products/services will be subjected to SATC quality standards.*

8 PURCHASING FROM ONE OR MORE SOURCE(S)

The policy of reducing the number of suppliers in favour of longer-term agreements does not necessarily mean that SATC wants to use only one supplier per item. It is the policy of SATC to use more than one supplier to provide the same items/services. The risk attached to supplying is reduced by using more than one supplier. SATC will use (at least) two suppliers in all purchasing transactions, except in the following circumstances:

- *when the annual volume of the transaction in rand does not warrant more than one source of supply (below R500 000)*
- *when the supplier holds a patent or uses a special process that places it in a monopolistic position*
- *when the supplier's performance makes it desirable to use its product only*
- *when the new items must be compatible with existing stock or equipment*

9 CERTIFYING SUPPLIERS

According to the policy of appraising the performance of suppliers, they will be evaluated on the basis of their performance with regard to quality, price, service, delivery and leadership in technology. (The criteria for appraisal and the method that should be used are dealt with in detail in the Purchasing Procedure Manual.) Once percentages have been awarded for the different performance categories, suppliers will be classified as follows:

- A = *strongly recommended*
- B = *preferably recommended*
- C = *could be considered*
- D = *not recommended (blacklist)*

If a supplier falls into category A for a period of at least two years, he or she will be certified and will receive preference in awarding tenders. Hence a full evaluation will be unnecessary (unless the product or the enterprise's situation changes, say if a new owner takes over the company or key people resign). It is SATC's policy to give preference to certified suppliers irrespective of the type of product or service they supply.

It is possible for a supplier to lose its certified status, because performance appraisal is a continuous process.

10 DEVELOPING SUPPLIERS

SATC will become involved in the development of suppliers with regard to (1) affirmative-action purchasing, (2) purchases where the product/service which SATC needs is unavailable on the market, and (3) normal performance appraisal.

10.1 Affirmative-action purchasing

It is the policy of SATC to assist smaller business enterprises to develop into fully fledged suppliers (which form part of the policy of affirmative action purchasing) if they are prepared to and have the ability to develop. The following support will be given:

- *managerial support, for instance advice on quality control*
- *making facilities available, for example inspection equipment*
- *support for purchasing, for example by making expertise available for the purchasing of material*

10.2 Product/service that is unavailable

If SATC needs a particular product/service and such a product/service is unavailable on the market, SATC can come to an agreement with a reliable supplier of other products or services to manufacture and/or supply the particular product or service. If necessary, SATC will help such a supplier by training staff, helping with the conversion or extension of facilities or implementing new facilities. (If SATC has the necessary facilities itself to manufacture/supply the product/service and can do so more cheaply and more effectively, it will not enter into such an agreement. A typical "make or buy" analysis therefore needs to be done.)

10.3 Normal performance appraisal

SATC can make a contribution to the development of suppliers by conducting normal performance appraisals by pointing out their weaknesses to them in an objective way.

11 INTERNATIONAL PURCHASING

The basic objective of the purchasing department is to ensure continuous provision of goods and services to the other sections in SATC, when they are needed, and to provide the best quality at the lowest possible prices, from the best suppliers available.

SATC tries as far as possible to do its purchasing within South Africa, and in this way to contribute to the country's economic development. Because of the nature of SATC's activities, certain items are, however, only available overseas and must of necessity be imported from overseas. The purchasing section should be aware at all times of the total costs involved in international transactions. Additional costs such as exchange rate risks, land, air and sea transport, source inspection, import and export documentation, taxes, tariffs, letter of credit

costs and possible larger buffer stock should be taken into account when the total procurement costs are determined.

SUMMARY



Read the case study on “Exporting” at the end of chapter 4 in Hugo & Badenhorst-Weiss (2011).

This study unit dealt with the various purchasing and supply strategies (such as strategic sourcing and outsourcing) and policies (focusing particularly on the considerations to take into account when enterprises deal with suppliers). Various perspectives on the strategic sourcing concept were given, and the associated process was explained.

It should now be clear that strategic sourcing forms part of the integrated supply-chain management concept, and takes care of the supply side of the supply chain. However, in certain circumstances it is necessary for an organisation to obtain products, services, activities or operations (which was previously done internally) from a source of supply outside the enterprise. This is referred to as outsourcing, and is an important strategic issue that was covered in some detail in this study unit. The driving motivation is usually a leaner, more flexible and profitable organisation. However, the decision to outsource or not cannot be taken lightly, particularly in the case of core activities and core competencies. A phased process of decisionmaking was proposed in this study unit.

Once the strategic sourcing (and subsequently the outsourcing) process is dealt with within an organisation, a formal policy on suppliers is essential to provide guidelines for purchasing and supply personnel when they select and interact with suppliers. This study unit covered the principal issues that should be covered in such a supplier policy.

The next study unit takes the process a step further and discusses the evaluation and selection of suppliers in more detail.



ASSESSMENT

Revise chapter 4 in the prescribed book. Once you have done this, answer the following questions:

- (1) Define the concept “strategic sourcing” in your own words.*
- (2) Identify the most important practices and tools for the implementation of strategic sourcing.*
- (3) Fully explain the strategic sourcing process with the aid of a diagram.*
- (4) Define “subcontracting” and “outsourcing” in your own words.*
- (5) Explain why organisations wish to outsource certain activities or part of the production process.*
- (6) Explain the relationship between the parties in an outsourcing agreement.*
- (7) Tabulate the advantages and disadvantages of outsourcing.*
- (8) Explain the outsourcing decision process with the aid of a practical example.*

(9) *Compile a supplier policy for a large telecommunications firm. Highlight the most important issues of the purchasing and supply policies and strategies, including the following:*

- *using local, national or international suppliers*
- *buying from a manufacturer or a distributor*
- *using one or more suppliers*
- *using large or small suppliers*
- *deciding to make or buy*
- *using a captive supplier*
- *using reciprocity*
- *using supplier development*
- *using electronic buying auctions*
- *highlighting the three main aspects of environmental issues*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 4 in your prescribed book.

Study unit 5

EVALUATION AND SELECTION OF SUPPLIERS

CONTENTS

Aim

Learning outcomes

Key concepts

Getting an overview

- 5.1 The environment of the purchasing decision: purchasing policy formulation
- 5.2 Supplier selection criteria
- 5.3 The supplier selection process
- 5.4 Supply-chain relationships
- 5.5 What is supplier relationship management?

Summary

Assessment

AIM

The aim of this study unit is to outline the characteristics of a good supplier and the key criteria to use for supplier selection within the context of the dynamic environment in which purchasing and sourcing decisions are made; the evaluation of suppliers' performance; and the need for supplier certification.



LEARNING OUTCOMES

After working through this study unit, you should be able to do the following:

- Illustrate the dynamic environment in which purchasing decisions must be made.
- Identify the key criteria for supplier selection.
- Discuss the supplier selection process by applying it to a practical example.
- Distinguish between various supplier relationships.
- Define supplier relationship management.



KEY CONCEPTS

- purchasing policy formulation
- purchasing decision
- sourcing decision
- Code of Practice of the South African Bureau of Standards (SABS)

- supplier evaluation criteria
 - key performance indicators (KPIs)
 - cost
 - quality
 - delivery
 - environmental issues
 - ethics
 - social responsibility
 - broad-based black economic empowerment (BBBEE)
 - supplier selection process
 - exploratory stage or pre-evaluation phase
 - selection stage or evaluation phase
 - supplier management phase or post-evaluation phase
 - supplier certification
 - supply-chain relationships
 - supplier relationship management
-



Study chapter 5 in Hugo & Badenhorst-Weiss (2011).

GETTING AN OVERVIEW

Choosing the right supplier is a major responsibility of the purchasing manager because successful purchasing and supply depends mainly on selecting and managing suppliers well. The growing importance of choosing the *right* supplier to provide the *right* quality of goods and services at the *right* price in the *right* quantity, delivered to the *right* place at the *right* time using the *right* supply chain, can be attributed to increasing costs; growing competitiveness; escalating use of outsourcing; accepting opportunities presented by e-commerce; integrating organisations; and adopting JIT, TQM and supply-chain management.

In order to select suitable suppliers, the purchasing manager must be able to appreciate the environment of the purchasing decision; understand the complexity of the sourcing decision; identify the key criteria for supplier selection; have knowledge of supplier evaluation methods; and recognise the need for supplier certification. Once such suppliers are selected, it is important to construct the correct buyer/supplier relationship, and manage this relationship in a constructive and ongoing manner. A myriad of factors need to be taken into account.

Join us as we explore all of these aspects in this study unit.



Study the introduction to chapter 5 in Hugo & Badenhorst-Weiss (2011).

5.1 THE ENVIRONMENT OF THE PURCHASING DECISION: PURCHASING POLICY FORMULATION



Study section 5.1 in Hugo & Badenhorst-Weiss (2011).



ACTIVITY 5.1

Graphically represent the dynamic, complex internal and external environment in which purchasing and supply management must operate and make decisions.



Feedback

Study figure 5.1 in the prescribed book. You will see that external aspects, such as international, regional (SADEC), national and local characteristics and internal aspects such as inventory policies, will influence the purchasing and supply manager in his or her decisions.

5.2 SUPPLIER SELECTION CRITERIA

The choice of suppliers is a critical decision for the purchasing and supply function, and for that matter, for the whole enterprise or institution. To facilitate this decision-making process, a possible set of supplier selection criteria is discussed in the prescribed book, including the following:

- quality and quality accreditations
- price, cost and cost structure
- delivery
- time
- flexibility
- service
- financial status
- systems: operations planning and control (OPC), and e-commerce
- technology and process capability
- supply-chain management
- environmental issues, ethics and social responsibility
- broad-based black economic empowerment (BBBEE)
- capabilities, responsiveness and motivation: present and future
- geographic location



Study section 5.2 in Hugo & Badenhorst-Weiss (2011).

Note the different selection criteria that will apply to different purchasing and supply situations. After you have studied this section in the prescribed book, do the following activity.



ACTIVITY 5.2

Joe Mazibuko sees a gap in the market for selling smart ethnic designer clothing for men and women. He decides to open an enterprise called *Madiba Fashions* in the Pavilion Shopping Centre, Durban. His target market is upper-class people from their twenties up to middle age.

On the basis of these facts, we want you to advise Joe on the following points:

- (1) What characteristics should Joe look out for when selecting a good supplier or suppliers?
- (2) What are the implications for Joe's enterprise if he selects a supplier who does not have the required characteristics?
- (3) What additional service can Joe expect from a good supplier that will give him a competitive advantage in the market?



Feedback

Did you think of Joe's and his customers' expectations regarding uniqueness, quality, price and availability? Did you consider what the implications would be if the same outfits were freely available in other shops; if the quality of the material and craftsmanship were not up to scratch; if the selling price was disproportionate (allowing for uniqueness and quality); or if the outfits were not available on time?

Did you consider that there might be sporadic needs and requests for extra outsize garments or special outfits for occasions like the opening of Parliament, state banquets or weddings?

Activity 5.1 set out a rather simple scenario. Now, refer again to the article on Toyota in section 4.3.4. Toyota is expanding its operation by building a new R1 billion paint shop. Consider the complex supplier evaluation criteria to be used in this instance, and how vastly they would differ from those of Madiba Fashions.

5.3 THE SUPPLIER SELECTION PROCESS

It is important to know the systematic process of selecting suppliers, because it will help you to select the right suppliers for your enterprise in the right way.

Before studying this section, check how well you can answer the questions below:

- if you were asked to purchase a product or service, what logical steps would you take when selecting the organisation?
- What information sources would you use to find possible suppliers if you were required to purchase, say, office equipment for your enterprise?
- What factors would you consider if you had to choose between suppliers?



The prescribed book explains the process involved in selecting suppliers, and although it is important, it is actually quite a simple process. It consists of the following three stages and seven steps:

- **Phase 1: The exploratory stage (*pre-evaluation phase*)**

- Step 1: Identification of potential suppliers: sources of information for initial selection and evaluation
- Step 2: Prescreening to reject unsuitable suppliers

- **Phase 2: The selection stage (*evaluation phase*)**

- Step 3: Conduct research on potentially suitable suppliers.
- Step 4: Choose the evaluation method and analyse the suppliers.
- Step 5: Select the supplier or suppliers.

- **Phase 3: The supplier management stage (*post-evaluation phase*)**

- Step 6: Ongoing measurement of supplier performance
- Step 7: Supplier accreditation

You need not repeat the whole process of selecting a supplier every time you place an order. But you have to go through the process when you are purchasing a large volume of products or services over a given period, which is usually associated with a contract. The process is particularly important when purchasing a product or service for the first time and when a contract is due to expire shortly.



ACTIVITY 5.3

Jay Naidoo, a manufacturer of wood furniture, uses exclusive woods like teak, stinkwood, rosewood and yellowwood for his products. Jay is looking for a reliable long-term supplier who should preferably be able to supply all four of these types of wood on an annual contract. The decision regarding timber suppliers is vital to Jay, since his factory cannot produce anything without timber. Timber may therefore be regarded as Jay's critical product. But Jay also needs sawing, planing and lathing equipment to make furniture. In addition, he needs screws, screwdrivers and linseed oil (to treat the wood).

- (1) How will Jay set about selecting a supplier or suppliers to provide the timber?
- (2) How will Jay set about selecting a supplier or suppliers to provide his equipment?
- (3) How will Jay set about purchasing screws, screwdrivers and linseed oil?



Feedback

- (1) *The prescribed book gives examples of several information sources in which you can trace suppliers. What example(s) would be relevant, considering the fact that Jay uses rare, exclusive timber? Have you thought about the factors that will be important to Jay when he makes his final choice of timber suppliers?*
- (2) *Have you considered the fact that sawing, planing and lathing equipment is fairly common and that several well-known makes are readily available on the market? (Equipment of which several makes are commonly available on the market is called*

standard equipment.) You should also realise that one does not purchase equipment very often and that it involves a fairly large capital expenditure.

- (3) Screws, screwdrivers and linseed oil are low-value standard products which are widely available with minor variations in price.



ACTIVITY 5.4

Because Jay Naidoo makes exclusive furniture, the quality of the wood is extremely important. Jay also depends heavily on regular, punctual delivery of timber, since the risks of storing timber means that he cannot keep too much stock. Price is comparatively unimportant, since Jay's clients (because of the exclusiveness of his product) are not all that sensitive to price.

After a preliminary investigation, Jay identifies three potential suppliers of timber. All three of these suppliers (one of whom is an overseas supplier) are financially stable, but they have different strengths and weaknesses.

Knysna Sawmills has the highest prices, their quality is good and delivery is reliable. Eastern Cape Wood has the lowest prices and reasonable quality, but delivery is uncertain because of labour unrest and low productivity in the area.

USA Timber Exporting has the second-lowest delivery price and reasonable quality and delivery (allowing for distance and customs clearance). [Delivery price is the price of the product plus transport cost to the place of delivery.]

Which supplier do you think Jay will contract? Give reasons for your answer.

We expect you to use the weighted-point supplier performance evaluation when justifying your answer. Start by assigning a value for excellent, good, reasonable and poor, as well as a value for price, delivery and quality, in accordance with the importance of these factors for Jay's timber supply.

Try to find an answer yourself, before referring to the solution below.



Feedback

Jay will select **Knysna Sawmills**. In the weighted-point supplier performance evaluation, – Knysna Sawmills scored the best not only for quality, but also overall.

Calculation:

Categories		Weights	
Good	3	Quality	5
Reasonable/average	2	Price	2
Poor	1	Delivery	3

SELECTION EVALUATION STATEMENT

Supplier	Price (Weight = 2)	Quality (Weight = 5)	Delivery (Weight = 3)	Total
Knysna	$1 \times 2 = 2$	$3 \times 5 = 15$	$3 \times 3 = 9$	26
Eastern Cape	$3 \times 2 = 6$	$2 \times 5 = 10$	$1 \times 3 = 3$	19
USA	$2 \times 2 = 4$	$2 \times 5 = 10$	$2 \times 3 = 6$	20

Consult the relevant section in your prescribed book for a more detailed version of the weighted-point supplier performance evaluation.

5.4 SUPPLY-CHAIN RELATIONSHIPS



Study section 5.4 in Hugo et al. (2011).

Various writers have tried to describe what, in their opinion, makes up an ideal supply-chain relationship. In his book *The science of high-performance supplier management – a systematic approach to improving procurement costs, quality, and relationships*, Randy Moore (2002) launches his discussion with potential readers from buying organisations with the following paragraph:

Your suppliers are out to get you. Well, perhaps they aren't out to get you – they're only out to get your money. They lay awake at night thinking up ways to transfer funds from your bank account to their bank account. Don't feel persecuted. It's just business and not personal. A supplier's business process is designed to maximise revenues and minimise the cost of performance. Isn't that your basic business model too?

5.5 WHAT IS SUPPLIER RELATIONSHIP MANAGEMENT?

Is the following not an accurate description of what is currently happening in the business environment?

A network of buyers and suppliers contending for structured agreements to obtain a fair amount of business for their organisations to survive, and even thrive, in the unstable market conditions that prevail in most sectors of most economies today.

Managing these structured agreements by developing and maintaining certain relationships between buying organisations and suppliers becomes vital for sustained business.

Buying organisations and suppliers alike are devoting a fair amount of resources to extract as much value as they can from their relationships by attempting to apply repeatable procedures to their interactions and aiming for predictable results.



Study section 5.5 in Hugo et al. (2011).

SUMMARY



Read the case study on “WallMart” at the end of chapter 5 in Hugo & Badenhorst-Weiss (2011).

The selection of suppliers is one of the main tasks of the purchasing function. Make sure that you understand all the sections in this study unit thoroughly. If you do, you will be able to reproduce and apply the knowledge to any situation that you are faced with within your organisation – from ordinary tasks, such as buying stationery, to more complex situations, such as obtaining a supplier to service specialised equipment.

The next study unit discusses the guidelines for sustainable purchasing in order to direct any employee in making decisions about the purchasing function’s impact on the following aspects: corporate governance, social responsibility, ethical conduct, environmental sustainability and risk management.

This brings us to the end of topic 2 and concludes the discussion on managing the supply base. In topic 3 we focus on the key performance indicators of purchasing and supply management – sustainability, quality, price and quantity.



ASSESSMENT

Revise chapter 5 in the prescribed book. Once you have done this, answer the following questions:

- (1) List the reasons for the growing importance of supplier selection.*
- (2) Illustrate the environment in which purchasing decisions must be made.*
- (3) Identify the key criteria for supplier selection.*
- (4) Discuss the supplier selection process by applying it to a practical example.*
- (5) What constitutes a buyer/supplier relationship?*
- (6) Distinguish between various buyer/supplier relationships.*
- (7) What is supplier relationship management?*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 5 in your prescribed book.

Topic 3

KEY PERFORMANCE INDICATORS

CONTENTS

Study unit 6: Sustainable purchasing and supply management
Study unit 7: The management of quality in purchasing and supply
Study unit 8: Purchasing price determination and cost analysis
Study unit 9: Purchasing quantity and inventory management

TOPIC AIM

The aim of topic 3 is to introduce you to four of the most important activities of the buyer, namely sustainable purchasing and supply management; quality management; determining fair purchasing prices and analysing cost; and quantity and inventory management.

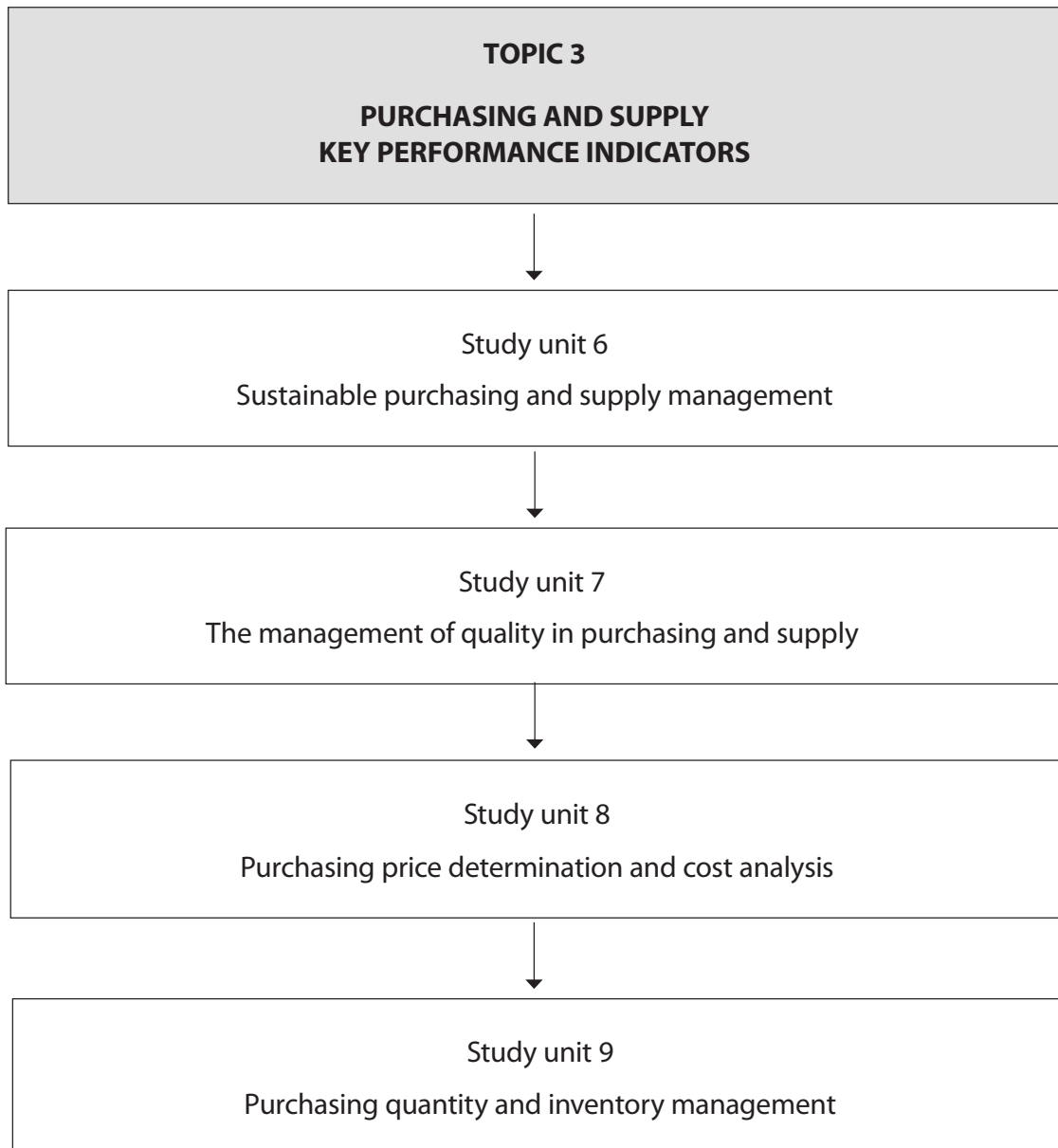


TOPIC LEARNING OUTCOMES

After studying this topic, you should be able to do the following:

- Briefly explain the role of purchasing and supply management in corporate governance.
- Identify and explain the social responsibilities of purchasing and supply management.
- Define business ethics.
- Clarify purchasing and supply ethics and ethical conduct.
- Identify and explain possible areas of unethical conduct in purchasing and supply management.
- Describe a code of ethical conduct.
- Suggest a code of ethical conduct for different enterprises.
- Explain the role of fraud in purchasing and supply management.
- Identify areas in environmental sustainability where purchasing and supply-chain management can make a contribution.
- Classify and describe the risks inherent in purchasing and supply management.
- Compile a list of purchasing and supply management risks.
- Identify and explain the possible origin of risks in the different phases of the purchasing process or procedure.
- Suggest and explain strategies to deal with or eliminate purchasing and supply risks.
- Explain the concept of quality in relation to the supply function.
- Analyse the multiple roles that purchasing has in ensuring internal service quality and supplier quality programmes.
- Identify the costs associated with implementing a supplier quality programme.
- Write a detailed report explaining the three quality management systems (QMS): Total Quality Management (TQM), the Six Sigma system, and the International Standards Organisation (ISO) system.
- Suggest appropriate aids available to assist in quality decisions: standardisation, international standards, value analysis exercise and description of quality.

- Design and implement a quality control programme for supply management.
- Distinguish between the elements of value and the way prices can influence the purchased value.
- Define the concepts “the right price” and “a competitive price”.
- List and define various cost elements.
- Indicate the behaviour of cost related to volumes.
- Explain the interface between different market forms and price determination.
- Explain price determination for different types of product.
- Clarify price analysis as a method to determine a fair price.
- Differentiate between the various approaches for determining prices.
- Clarify cost analysis as method to determine a fair price.
- Explain the learning curve as a price and cost analysis tool.
- Explain the principles of break-even analysis.
- Briefly describe hedging of prices.
- Briefly explain efficient inventory management in a lean supply context.
- Describe the reasons for holding inventory.
- Illustrate the importance of keeping inventory to a minimum within a business enterprise.
- List and define the various categories of inventory.
- Analyse the different cost elements of holding inventory.
- Outline the ABC classification of inventory.
- Write a report explaining the most significant aspects of the various methods and techniques of inventory planning and control, focusing on both independent and dependent demand items.
- Describe the symptoms of poor inventory management.



Study unit 6

SUSTAINABLE PURCHASING AND SUPPLY MANAGEMENT

CONTENTS

Aim

Learning outcomes

Key concepts

Getting an overview

- 6.1 Corporate governance and purchasing and supply management
- 6.2 Corporate social responsibilities of purchasing and supply management
- 6.3 Ethical aspects of purchasing and supply management
- 6.4 Green supply-chain management
- 6.5 Risks and risk management in purchasing and supply

Summary

Assessment

AIM

The aim of this study unit is to highlight the importance of sustainable purchasing and supply management, focusing on corporate governance, social responsibility, ethical conduct, environmental sustainability and risks associated with purchasing and supply.



LEARNING OUTCOMES

After working through this study unit, you should be able to:

- Briefly explain the role of purchasing and supply management in corporate governance.
- Identify and explain the social responsibilities of purchasing and supply management.
- Define business ethics.
- Clarify purchasing and supply ethics and ethical conduct.
- Identify and explain possible areas of unethical conduct in purchasing and supply management.
- Describe a code of ethical conduct.
- Suggest a code of ethical conduct for different enterprises.
- Explain the role of fraud in purchasing and supply management.
- Identify areas in environmental sustainability where purchasing and supply-chain management can make a contribution.
- Classify and describe the risks inherent in purchasing and supply management.
- Compile a list of purchasing and supply management risks.
- Identify and explain the possible origin of risks in the different phases of the purchasing process or procedure.
- Suggest and explain strategies to deal with or eliminate purchasing and supply risk.



KEY CONCEPTS

- corporate governance
 - King Reports (I, II and III)
 - corporate citizenship
 - corporate social responsibilities
 - business ethics
 - purchasing and supply ethics
 - ethical conduct
 - unethical conduct
 - ethical code of conduct
 - fraud
 - green supply-chain management
 - opportunities for greening the supply chain
 - risks
 - uncertainty
 - speculative purchasing and supply management risks
 - event purchasing and supply management risks
 - core business risks in purchasing and supply management
 - incidental business risks in purchasing and supply management
 - event risks impacting on purchasing and supply management
 - external downside risks
 - operational risks
 - risk avoidance
 - risk assumption
 - risk elimination
 - risk reduction
 - behaviour-based management techniques
 - buffer-orientated techniques
-



Study chapter 6 in Hugo & Badenhorst-Weiss (2011), including all figures and tables.

GETTING AN OVERVIEW

We hope that you now have a solid understanding of the fundamentals of the purchasing and supply management function. We now turn our attention to those areas of performance which determine the success of purchasing and supply efforts, starting with a look at sustainable purchasing. Conversely, we can say that sustainable purchasing is a process whereby organisations meet their needs for goods and services optimally; in other words, in such a way that they achieve value for money, on a whole-life cost cycle basis, in terms of generating benefits not only to the organisation, but also to society and the economy, whilst minimising damage to the environment.

In this study unit we focus on sustainable purchasing by looking at the impact of purchasing and supply on social responsibility, corporate governance, ethical conduct, environmental responsibilities and the risks to consider.



Study the introduction to chapter 6 in Hugo & Badenhorst-Weiss (2011).

6.1 CORPORATE GOVERNANCE AND PURCHASING AND SUPPLY MANAGEMENT

Attention to ethical conduct and formal policies in this regard has become increasingly important worldwide as a result of high-profile corruption and unethical conduct in the purchasing and supply arena. Corruption is on the rise in South Africa, and has placed not only ethical conduct, but also corporate governance under a spotlight.



Study section 6.1 in Hugo & Badenhorst-Weiss (2011).

Corporate governance compels business organisations to act and report responsibly, and to take precautionary measures to ensure the financial wellbeing of the organisation and the protection of the interests of all stakeholders. The majority of large business organisations internationally, including South Africa, have embraced this concept and established their own corporate governance policies.



Read this extract of Barloworld's well-written charter on corporate governance.

BARLOWORLD CORPORATE GOVERNANCE

Barloworld and its subsidiaries are fully committed to the principles of fairness, integrity, accountability, responsibility and transparency associated with good corporate governance.

The management of Barloworld has conducted its business with the highest degree of ethics and probity since the company was founded in 1902. The rapid evolution of the global market in which Barloworld operates and the parallel growth of civil society has greatly increased the range of stakeholders in our activities. The board and management have evolved a series of processes and procedures constituting systems of corporate governance that are designed to ensure that the company makes profits in a manner that conforms to the strictest requirements for transparency and sensitivity to the needs of the business, physical and social environments. These systems are continually evolving with the changing needs and expectations of stakeholders.

The company is incorporated in South Africa under the provisions of the Companies Act, 1973, as amended. It is listed on the JSE Securities Exchange South Africa, and complies with the Code of Corporate Practices and Conduct contained in the King Report on Corporate Governance

in South Africa published in March 2002. Amendments to the JSE Securities Exchange listing requirements and continuing obligations making certain disclosure requirements of the Code of Corporate Practices and Conduct mandatory came into effect on 1 September 2003 and have been applied in this report. As a company with a secondary listing on the London Stock Exchange, we have taken note of the Combined Code of Principles of Good Governance and Code of Best Practice adopted by that exchange. Where the relevant provision of the combined code is an indicator of best practice, the company has taken note of it. The company is not registered with the Securities and Exchange Commission in the United States and has unsponsored American Depositary Receipts. Accordingly, the Sarbanes-Oxley Act of 2002 does not apply to it. The principles of that Act have however been considered in formulating our corporate practices.

Board accountability and delegated functions

The general powers of the directors of Barloworld Limited are conferred in the company's articles of association. They have further unspecified powers and authority in respect of matters which may be exercised or done by the company but which are not expressly reserved to the members of the company in a general meeting, either by the South African Companies Act or the provisions of those articles.

In accordance with a formal charter which has been reviewed during the year, the board has reserved to itself the following responsibilities:

- Approval of the strategic plan and the annual business plan, the setting of objectives and the review of key risks and performance areas, especially in respect of technology and systems
- Monitoring the implementation of board plans and strategies against a background of economic, environmental and social issues relevant to the company and international political and economic affairs, as well as the mitigation of risks by management
- Appointment of the chief executive officer and maintenance of a succession plan
- The appointment of directors, subject to election by the company in general meeting
- Determination of overall policies and processes to ensure the integrity of the company's management of risk and internal control

The charter expresses the board's philosophy in regard to customer satisfaction, quality and safety of products and services; optimisation in the use of assets and drawing the best out of employees; respect for human dignity and observance of fundamental human rights; national and international corporate citizenship, including sound relationships with regulatory authorities.

While retaining overall accountability and subject to matters reserved to itself, the board has delegated to the chief executive officer and other executive directors authority to run the day-to-day affairs of the company. Audit, general purposes, nominations and remuneration committees assist the board in the discharge of its duties. Each committee acts within terms of reference, under which certain functions of the board are assigned with defined purposes, membership requirements, duties and reporting procedures. Board committees may take independent professional advice at the company's expense when necessary. The committees are subject to regular evaluation by the board in regard to performance and effectiveness. Chairmen of the board committees are required to attend annual general meetings to answer any questions raised by shareholders.

Source: <http://www.barloworld.com> (accessed on 12 July 2006).

6.2 CORPORATE SOCIAL RESPONSIBILITIES OF PURCHASING AND SUPPLY MANAGEMENT



Study section 6.2 in Hugo & Badenhorst-Weiss (2011).

In the prescribed book you will find a discussion of the corporate social responsibilities of the purchasing and supply function related to community, diversity, environment, ethics, financial responsibility, human rights and safety.

6.3 ETHICAL ASPECTS OF PURCHASING AND SUPPLY MANAGEMENT

It would be great if the front pages of newspapers acknowledged the purchasing and supply profession for the fine work that it does. But sadly, most news coverage of the purchasing and supply arena comes when something unethical has been exposed.



Study section 6.3 in Hugo & Badenhorst-Weiss (2011).

This section is discussed under the following headings:

- Business ethics
- Purchasing and supply ethics and ethical conduct
- Areas of unethical conduct among purchasers

Now that you know what business ethics – particularly ethics in purchasing and supply – entail, you must realise that you do not want your business enterprise to be responsible for a lapse in purchasing and supply ethics. So how do you ensure that your organisation displays ethical conduct in the areas of purchasing and supply? According to Chas Dominick, you start by putting these five components in place:

- **An ethics policy**, also known as an ethics code of conduct. An ethics dispute should never be the result of a difference of opinion between the procurement department and a company employee. Every organisation should have a written policy making it clear what top management considers ethical and what it considers unethical. If you don't have an ethics policy, don't wait for an ethics dispute to arise before you realise that you need one!
- **Ethics training**. The good thing about having an ethics policy is that the rules are in tangible, indisputable form. The unfortunate thing is that no-one reads ethics policies! Supplement an ethics policy with procurement ethics training for anyone who is involved with the purchase of products or services and/or who meets with suppliers.
- **An ethics ombudsman**. Some organisations appoint an ethics ombudsman – a person in the organisation to whom an employee can confidentially communicate any real or perceived ethical violations. Because it is difficult to confront internal customers who

may be more “politically powerful”, having an ethics ombudsman can make procurement employees more comfortable about revealing examples of questionable ethics.

- **A process with checks and balances.** Every major procurement should require management review to confirm that all guidelines have been followed and that no ethical violations have occurred or will occur. Periodically, audits should be performed to verify that all procurement activities were conducted ethically and in accordance with procedures. Audits also serve as a deterrent to future unethical behaviour.

Source: <http://www.nextlevelpurchasing.com/articles/ethical-procurement.html> (accessed on 21 October 2010).

- Ethical code of conduct

The first port of call when guiding ethical conduct in purchasing and supply management is to create a policy (or code of conduct) on ethical conduct, which should form part of any organisation’s purchasing policy. Such a policy document provides guidelines to purchasers on what is acceptable and what is not. A code of ethical conduct has many different aspects, but always includes a section on the purchasing and supply environment, as in the example below.



Code of Ethics of Northam Platinum Limited

The document’s table of contents include:

Message from the Chairman and Managing Director

- 1 *Introduction*
- 2 *The Company and its Employees*
- 3 *The Company and the Environment*
- 4 ***The Company and its Suppliers and Customers***
- 5 *The Company and the Community*
- 6 *Outside Employment and Directorships*
- 7 *Use of Company Assets*
- 8 *Confidential Information*
- 9 *Share Investments*
- 10 *External Liaison or Communication*
- 11 *Breach of Code IBC*

Source: <http://www.northamplatinumlimited.com> (accessed on 20 July 2006).

We have included a generic example of the specific aspects that may be included in section 4 of the code:

Generic code of conduct for procurement practitioners

General conduct

1. *Procurement practitioners must ensure that they are never beholden to an economic operator.*

2. *Throughout the procurement cycle, procurement practitioners must exhibit responsible behaviour and strive for transparent and collegial decisions.*
3. *Information on the procurement process must not be disclosed to persons who have no need to know.*

Information and conduct during the pre-tendering phase

4. *Procurement practitioners, and in particular buyers, may need to establish contacts with the private sector. The procurement practitioner benefits from acquiring technical familiarity with the goods, services and works within his competence in order to more effectively draft tender requirements, evaluate offers received and assess whether a contract must undergo.*
5. *Buyers may accept requests from economic operators for meetings. They may also request a meeting, provided this will enhance their knowledge of the market. To improve their knowledge, beyond the Internet or the specialised press, buyers may attend exhibitions or fairs to obtain information on the characteristics of a competitive market.*
6. *Economic operators are interested to know the organisation and activity of the procurement services in their field. To encourage such exchanges, joint exhibitions or forums should be encouraged with the professional partners (local chambers of commerce, professional federations, labour unions etc.).*
7. *In this context, the information that may be exchanged or disclosed concerns: information on completed procedures, when a contract has been awarded, subject to the protection of industrial and commercial confidential information; and the description of the organisation and the activity of the procurement services and other administrations involved in the process.*
8. *In order to preserve equal treatment of suppliers/bidders, information on the estimated value of a project or the scheduled date of the consultation, etc., must not be disclosed.*
9. *Any communication or information on a draft contract may be disclosed only through the advertising or publication procedures defined in the procurement code.*
10. *The drafting of the statement of needs is the sole responsibility of the contract authority, in order to avoid gearing the requirements to a specific offer.*

Information and conduct during the tendering phase

11. *Except in the case of correction notices, the procurement code governs the conditions for achieving equality of treatment among candidates, and the transparency of procedures.*
12. *To avoid any risk of favouritism or suspicion, when private operators come to the office to obtain the consultation papers, those papers must be delivered by an officer not involved in the procurement process, or who has no information on the proposed contract.*

Information and conduct during the post-award phase

13. *All decisions taken by a procurement practitioner must be based exclusively on the provisions in the contract as previously agreed, particularly with regards to the definition and application of penalties.*
14. *Supervision and management of contract performance require collegiality and a paper trail of decisions, particularly with respect to penalties, certification of performance, and possible amendments to the contract.*
15. *Relations established with economic operators under public contracts may not serve as a pretext for any private contracting.*

Information and conduct at all phases of the procurement cycle

16. *Procurement practitioners must not solicit or accept gifts, favours or other advantages for themselves, their family their friends, or for persons with whom they have business or political dealings.*
17. *Regardless of the position occupied, and under all circumstances, procurement practitioners must exhibit good judgement and responsibility. They have the duty to inform their correspondents that they are subject to this code and cannot deviate from it.*
18. *Customs or usages may treat certain gifts and other advantages as acts of courtesy or hospitality that are appropriate in contacts between procurement officers and economic operators. This applies to minor gifts and conventional gestures of hospitality, in the form of modest invitations, calendars and pens of low value, advertising materials, and minor office furnishings.*

Gifts

19. *Every procurement practitioner is advised to consider each of the following points before accepting any gift, which must be minor, of low value, not regularly provided, and neutral.*
20. *Regardless of the nature of the gift received, procurement practitioners must: report them immediately to their hierarchical superior in order to avoid any suspicion; mention them in a specific document, including the origin, nature and destination of the good delivered in order to guarantee traceability in case of subsequent challenge or audit; use them, to the extent possible, for the benefit of the entire office (e.g. passing a box of chocolates, sharing calendars or distributing pens); and request their supervisor's advice in case of doubt as to what is acceptable or not and on the steps to take.*
21. *Gifts or invitations that do not fall within the framework described above must also be recorded, with the name of the company concerned, and returned to the sender with a letter.*
22. *Invitations to receptions or promotional, cultural, sporting or charitable events are subject to the same rules. Being on holiday is no defence against the rules defined more broadly in this code. Procurement practitioners must in no case solicit such invitations from a supplier.*
23. *Any participation in an activity in the course of duty must be assessed in light of the context. In the case of participation at a professional seminar for one or more days, for example, the administration may pay the cost of registration and the officer will be placed on mission expenses.*
24. *Participation in visits or trips may only be justified on purely professional grounds. The costs of travel and accommodation must be covered by a mission order.*

Source: <http://www.oecd.org/document/62/> (accessed on 20 October 2010).

It is clear that purchasing and supply professionals have ample opportunity to gain an advantage dishonestly, avoid an obligation or cause losses to other parties. To understand how they can achieve this and help you to prevent it, study the section on fraud in purchasing and supply management at the end of section 3.2.

6.4 GREEN SUPPLY-CHAIN MANAGEMENT



Study section 6.4 in Hugo & Badenhorst-Weiss (2011).

The prescribed book discusses the impact of purchasing and supply management on environmental responsibilities by addressing the development from green purchasing to green supply-chain management and identifying the opportunities for greening the supply chain (see example below).



Woolworths starts nitrogen refrigeration truck trial

By Irma Venter

In a quest to operate quieter delivery trucks and to reduce its carbon footprint, retailer Woolworths has announced that it will start testing nitrogen refrigerated trucks for the delivery of perishable goods. The retailer says ecoFridge refrigeration “is fundamentally different” from the widely-used mechanical systems, and that it is one of only a handful of retailers in the world to pilot the system. “With no moving parts, it is designed to be one of the quietest transport refrigeration systems of its generation, operating at zero decibels”.

Woolworths says the ecoFridge can accurately maintain multiple temperature zones in one truck, which allows it to transport products that may need to be stored at different temperatures in one vehicle. It is also said to be 70% to 80% faster than mechanical systems in reducing the temperature to the required level, with the drop from 30°C to -18°C achieved in less than 40 minutes. (Diesel systems can take up to 120 minutes, says the retailer.) Woolworths says that the ecoFridge system is virtually maintenance free, requiring annual inspection only.

Woolworths Supply Chain and IT national transport GM Johan Schafer tells Engineering News that the purchase price of the ecoFridge system is roughly the same as that of the normal refrigerated systems. “This could, however, change if increased volumes find their way to South Africa”. Schafer says that the benefit in cost is currently achieved through the lower operational and maintenance cost of the unit, as it has no moving parts. The life span of the unit is also roughly twenty years, compared with the average five to eight years of normal diesel-operated units.

Another benefit is that the ecoFridge uses naturally occurring nitrogen instead of diesel, which means that the refrigeration units can eliminate between 24 t to 30 t of carbon dioxide a year, per truck. Only one of Woolworths’ trucks is currently fitted with the ecoFridge unit, with four trucks earmarked to form part of the trial.

Source: <http://www.engineeringnews.co.za> (accessed on 18 October 2010).

6.5 RISKS AND RISK MANAGEMENT IN PURCHASING AND SUPPLY



Study section 6.5 in Hugo & Badenhorst-Weiss (2011).

In summary, in this section we discovered that when a purchasing and supply manager is absolutely certain about a certain event, for example that a supplier will deliver a certain number of items on a specific date, there is no delivery risk. The purchasing and supply

manager's certainty can be the result of the fact that the supplier has the specified amount of stock already available, the transport carrier is totally dependable, and both the supplier of the item and the transport services have shown in the past that they are reliable.

However, when the purchasing and supply manager is uncertain about an aspect such as price increases because of volatile raw material (commodity) prices, this uncertainty creates risks for the enterprise and needs to be managed.



ACTIVITY 6.1

You are the purchasing and supply manager for Ambo Pharmaceuticals (Pty) Ltd, and top management asks you to start a Risk Management Awareness Programme in the purchasing and supply function. You decide to run a workshop on purchasing and supply risks within your department to help you determine how to proceed with this programme within the pharmaceutical industry. Briefly summarise the conclusions of the workshop.



Feedback

You could have started by noting that pharmaceutical companies operate in an environment that is continually changing, and that the changes affect the operation of the business enterprise on a daily basis. This compels pharmaceutical companies to identify expected opportunities or risks as quickly as possible and then to take appropriate action to manage them efficiently.

Risks are a great threat to the wellbeing of any organisation, and you should have included an overview of the classification of risks associated with purchasing and supply management as found in sections 6.5.1 and 6.5.2 of the prescribed book.

You should have highlighted the fact that purchasing and supply managers should follow a risk management process, which obviously starts with identifying the risks, evaluating and classifying (categorising) them and then making decisions on which alternative methods for risk control would be the most appropriate. After the method or strategy is implemented, the situation should be continuously re-assessed or monitored.

It is essential for workers to realise that they must be constantly aware of possible risks (and opportunities) and how the identified risks fit into the whole process of managing risks in purchasing and supply management. Even more important is the awareness and knowledge of the workers about the possibilities of risk during the purchasing process or procedures they are involved in every day.

Next you should have run through the list of risks identified in section 6.3.3, namely wrong or inadequate specification; requisitions received late; internal and/or external fraud; lack of suppliers; pricing; quality; continued availability; quantities and lead times; agreed procedures for inspections and returns to suppliers; internal errors; information systems; and processes and disasters. In your discussion of each of the phases and the possible risks, you could have encouraged your department to identify as many as possible examples of risk that a pharmaceutical company would face in the purchasing and supply environment.

You should have explained that the purchasing and supply manager has two main options in risk management in purchasing and supply, as discussed in section 6.5.4 of the prescribed book. Firstly, he/she can employ risk control alternatives such as risk avoidance, risk assumption, risk elimination, risk reduction and risk transfer. Secondly, the purchasing and supply manager can manage the purchasing and supply function proactively by employing strategies to minimise

risks. These proactive strategies fall into three categories, namely behaviour-based strategies (mostly strategies which include supplier cooperation), buffer-oriented techniques (mainly revolving around inventory) and contingency plans.

You should also have also discussed the strategies available to proactively manage purchasing and supply risks, as suggested in section 6.5.5 – behaviour-based and buffer-orientated management techniques. The alternatives provided in the last category are not necessarily complete. You could have considered what other alternatives (techniques) you are aware of or employ in Ambo Pharmaceuticals (Pty) Ltd that were not mentioned in the prescribed book.

At the end of such a workshop your department should have not only a grasp of the academic definitions of purchasing and supply risks, but also a workable knowledge on how to apply these concepts within its own environment.

SUMMARY



Read the case study “Health care for truckers” at the end of chapter 6 in Hugo & Badenhorst-Weiss (2011).

Study unit 6 contained a lot of information to digest, and this information can have such a compelling effect on purchasing and supply managers that they want to incorporate all the suggestions within their own organisations immediately. This study unit provided a glimpse into the responsibilities of purchasing and supply in respect of corporate governance, social responsibilities, ethical conduct, environmental aspects and risks.

But sustainable purchasing initiatives may take a while to fully bed down. Before a sustainable purchasing mentality is developed, current purchasing practices and key stakeholders need to be understood. You can then continue to focus on a couple of products or services to achieve some quick gains, essentially to demonstrate that the policy works and to gain support and win over the sceptics.

Study unit 7 addresses quality management aspects, such as key performance indicators, for purchasing and supply management to consider.



ASSESSMENT

Revise chapter 6 in the prescribed book. Once you have done this, answer the following questions:

- (1) Briefly explain the role of purchasing and supply management in corporate governance.*
- (2) Identify and explain the social responsibilities of purchasing and supply management.*
- (3) Define business ethics.*
- (4) Write an essay in which you clarify purchasing and supply ethics and ethical conduct.*
- (5) Identify and explain possible areas of unethical conduct in purchasing and supply management.*
- (6) Describe a code of ethical conduct.*

- (7) Suggest a code of ethical conduct for: (1) a small fruit and vegetable shop owner and (2) the purchasing and supply department of a large industrial doorframe manufacturer.*
- (8) Explain the role of fraud in purchasing and supply management.*
- (9) Identify areas in environmental sustainability where purchasing and supply-chain management can make a contribution.*
- (10) Classify and describe the risks inherent in purchasing and supply management.*
- (11) Compile a list of purchasing and supply management risks.*
- (12) Identify and explain the possible origin of risks in the different phases of the purchasing process or procedure.*
- (13) Suggest and explain strategies to deal with or eliminate purchasing and supply risks.*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 6 in your prescribed book.

Study unit 7

THE MANAGEMENT OF QUALITY IN PURCHASING AND SUPPLY

CONTENTS

Aim

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7.2 Cost of quality

7.3 Purchasing and supply: QMSs

7.4 Purchasing and supply: technical elements of quality

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Summary

Assessment

AIM

The aim of this study unit is to outline quality management issues in the context of purchasing and supply.



LEARNING OUTCOMES

After working through this study unit, you should be able to do the following:

- Explain the concept of quality in relation to the supply function.
 - Analyse the multiple roles that purchasing has in ensuring internal service quality and supplier quality programmes.
 - Identify the costs associated with implementing a supplier quality programme.
 - Write a detailed report explaining the three QMSs (QMS): TQM, Six Sigma and ISO.
 - Suggest appropriate aids available to assist in quality decisions: standardisation, international standards, value analysis exercises and description of quality.
 - Design and implement a quality control programme for supply management.
-



KEY CONCEPTS

- internal service quality
- cost of quality
- prevention costs

- appraisal costs
 - failure costs
 - supplier quality management systems (QMS)
 - TQM
 - Six Sigma system of quality management
 - standardisation
 - ISO
 - value analysis
 - description of quality
 - quality assurance
 - control of quality
-



Study chapter 7 in Hugo & Badenhorst-Weiss (2011).

GETTING AN OVERVIEW

The application of QMS within the purchasing and supply context is increasingly being considered a prerequisite for competitiveness in the private sector and a guarantee of good governance in public-sector institutions. A QMS is the comprehensive set of procedures and working methods of an organisation which ensure that its outputs satisfy the customer's needs and which safeguard the overall interests of the organisation in line with its mandate, vision and mission. In the context of purchasing and supply, executives are responsible for the integrity of the purchasing process by putting in place effective purchasing QMSs that guarantee that the procured inputs (goods, works, services) conform to quality and effectiveness requirements and are conducive to achieving overall organisational objectives. A QMS consists of:

- **quality planning:** that part of quality management focused on setting quality objectives and specifying necessary operational processes and related resources to fulfil the quality objectives;
- **quality assurance:** that part of quality management focused on providing confidence that quality requirements will be fulfilled;
- **quality control:** that part of quality management focused on fulfilling quality requirements; and
- **quality improvement:** that part of quality management focused on increasing the ability to fulfil quality requirements.

The following vital quality issues in purchasing and supply management are addressed in this study unit: the quality concept in purchasing and supply management; supply management and internal service quality; different supplier QMS; standardisation; value analysis exercises as a supply manager; and quality control programmes.



Study the introduction to chapter 7 in Hugo & Badenhorst-Weiss (2011).

7.1 THE QUALITY CONCEPT IN PURCHASING AND SUPPLY MANAGEMENT



Study section 7.1 in Hugo & Badenhorst-Weiss (2011).

You will agree that when a business enterprise is ensuring a supply of products and/or services, it has to determine exactly what is required. In the discussion in the prescribed book, the first step is to determine the responsibility of purchasing and supply in the execution of the best possible quality management. Fundamentally, it is the task of the purchasing and supply management function to then ensure that the organisation obtains the best value for money in each purchasing transaction, ensuring the optimisation of value and cost. Value means purchasing products or services exactly suited to the purpose they have to serve.

Quality is an element of the value concept. Fundamentally, quality in business has a pragmatic interpretation as the suitability of a product or service for a specific purpose. Quality is a perceptual, conditional and somewhat subjective attribute and may be understood differently by different people. Consumers may focus on the specification quality of a product/service, or how it compares to competitors in the marketplace. Producers might measure the conformance quality, or degree to which the product/service was produced correctly.

The next step focuses on the impact of internal service quality on supply management. The quality of internal services relates to the quality of service that the purchasing and supply function delivers to internal customers (other functions) in the enterprise or institution. This internal service delivery will have an impact on the performance of internal customers. The prescribed book lists various reasons for the significance of internal quality service delivery in purchasing and supply management. Can you name them?

We then explore supply management and supplier quality management. Table 7.1 depicts the areas where supply management is involved in supplier quality management, the related tasks to be executed and the activities required to achieve enhanced quality. Make sure that you can reproduce this table.

7.2 COST OF QUALITY

We all know that the best way to communicate between the different functions of an organisation and top management is to use the universal language of money. The concept of studying cost of quality ensures that there is a vocabulary to communicate between the departments responsible for the implementation of QMSs and the organisation's managers.



Study section 7.2 in Hugo & Badenhorst-Weiss (2011).

This section covers the following:

- prevention costs
- appraisal costs
- failure costs (internally and externally)

7.3 PURCHASING AND SUPPLY: QUALITY MANAGEMENT SYSTEMS

An organisation's QMSs are perhaps more vital than a customer's perception of quality, because of the significant impact they have on every aspect of the business. Yet QMSs are constantly given substandard treatment, with manufacturing processes taking precedence in a crowded environment of scarce resources. QMSs form the structure of how an enterprise realises the products and services it manufactures, grounded in a process perspective. They are in effect vehicles for change. Let us take a closer look at TQM, the Six Sigma system of quality management and the QMS of the ISO.



Study section 7.3 in Hugo & Badenhorst-Weiss (2011).

7.3.1 TQM

After you have considered the basic elements pertaining to TQM in the prescribed book, do the following activity:



ACTIVITY 7.1

Sportec is an international manufacturer of sport equipment and clothing. John Hart, purchasing and supply manager of the international parent company, has been transferred to the South African subsidiary because Sportec (SA) is experiencing quality problems with purchasing and manufacturing. John has been specifically instructed to institute TQM at Sportec in South Africa.

What elements of the TQM approach, and which individuals, should John involve in instituting TQM?



Feedback

At its core, TQM is a management approach to long-term success through customer satisfaction. John should realise that in a TQM effort, all members of Sportec (SA) will have to participate in improving processes, products, services and the culture in which they work. As a result, John will have to instil a new attitude in staff to ensure that everybody in the enterprise, as well as its stakeholders beyond the borders of the enterprise, will make an effort to continually maintain and improve quality levels. They all need to become involved in constant quality enhancement so that Sportec (SA)'s entire supply chain will be geared to providing clients with better quality and value in the long term.



The methods for implementing this approach come from the teachings of such quality leaders as Philip B Crosby, W Edwards Deming, Armand V Feigenbaum, Kaoru Ishikawa and Joseph M Juran, and John would be wise to do extensive literature research in the subject before continuing. He can then start by sharing his knowledge with a core team, who will assist him in implementing TQM.

A way to understand the implementation of TQM is to study Deming's 14 points – a set of management practices to help companies increase their quality and productivity.

- (1) *Create constancy of purpose for improving products and services.*
- (2) *Adopt the new philosophy.*
- (3) *Cease dependence on inspection to achieve quality.*
- (4) *End the practice of awarding business on price alone; instead, minimize total cost by working with a single supplier.*
- (5) *Improve constantly and forever every process for planning, production and service.*
- (6) *Institute training on the job.*
- (7) *Adopt and institute leadership.*
- (8) *Drive out fear.*
- (9) *Break down barriers between staff areas.*
- (10) *Eliminate slogans, exhortations and targets for the workforce.*
- (11) *Eliminate numerical quotas for the workforce and numerical goals for management.*
- (12) *Remove barriers that rob people of pride of workmanship, and eliminate the annual rating or merit system.*
- (13) *Institute a vigorous program of education and self-improvement for everyone.*
- (14) *Put everybody in the company to work accomplishing the transformation.*

Source: <http://asq.org/learn-about-quality/totalqualitymanagement/overview/overview.html> (accessed on 20 October 2010).

Now John should be able to describe the following elements of this approach:

- *a definition*
- *key elements of TQM that are important to supply management*
- *impact of TQM on purchasing and supply*

Summarising this would be a good place for John to start. Can you assist him?

7.3.2 The Six Sigma system of quality management

When a Japanese firm took over a Motorola factory that manufactured Quasar television sets in the United States in the 1970s, they promptly set about making drastic changes in the way the factory operated. Under Japanese management, the factory was soon producing TV sets with one-twentieth the number of defects they had produced under Motorola management. They did this using the same workforce, technology and designs, making it clear that the problem was Motorola's management. Eventually, even Motorola's own executives had to admit "our quality stinks."

Finally, in the mid-1980s, Motorola decided to take quality seriously. Motorola's CEO at the time, Bob Galvin, started the company on the quality path known as Six Sigma and

became a business icon largely as a result of what he accomplished at Motorola. Today, Motorola is known worldwide as a quality leader and a profit leader. After Motorola won the Malcolm Baldrige National Quality Award in 1988, the secret of their success became public knowledge and the Six Sigma revolution was on. Today it's hotter than ever.

It would be a mistake to think that Six Sigma is about quality in the traditional sense. Quality, defined traditionally as conformance to internal requirements, has little to do with Six Sigma. Six Sigma is about helping the organisation make more money. To link this objective of Six Sigma with quality requires a new definition of quality. For Six Sigma purposes we define quality as the value added by a productive endeavour. Quality comes in two flavours: potential quality and actual quality. Potential quality is the known maximum possible value added per unit of input. Actual quality is the current value added per unit of input.

The difference between potential and actual quality is waste. Six Sigma focuses on improving quality (i.e. reducing waste) by helping organisations produce products and services better, faster and cheaper. In more traditional terms, Six Sigma focuses on defect prevention, cycle time reduction and cost savings. Unlike mindless cost-cutting programmes which reduce value and quality, Six Sigma identifies and eliminates costs which provide no value to customers: waste costs.

7.3.2.1 What is Six Sigma?

Six Sigma is a rigorous, focused and highly effective implementation of proven quality principles and techniques. Incorporating elements from the work of many quality pioneers, Six Sigma aims for virtually error-free business performance. Sigma, Σ , is a letter in the Greek alphabet used by statisticians to measure the variability in any process. A company's performance is measured by the sigma level of their business processes. Traditionally companies accepted three or four sigma performance levels as the norm, despite the fact that these processes created between 6 200 and 67 000 problems per million opportunities!

Source: <http://www.evancarmichael.com/Human-Resources/840/Six-Sigma-A-Case-study-in-Motorola.html> (accessed on 20 October 2010).

7.3.2.2 Implementation of Six Sigma



After over two decades of experience with quality improvement, there is now a solid body of scientific research on the experience of thousands of companies implementing major programmes such as Six Sigma. Researchers have found that successful deployment of Six Sigma involves focusing on a small number of high-leverage items. The steps required to successfully implement Six Sigma are well documented.

- **Step 1** – Successful performance improvement must begin with senior leadership. Start by providing senior leadership with training in the principles and tools they need to prepare their organisation for success. Using their newly acquired knowledge, senior leaders direct the development of a management infrastructure to support Six Sigma. Simultaneously, steps are taken to “soft-wire” the organisation and to cultivate an environment that supports innovation and creativity. This involves reducing levels of organisational hierarchy, removing procedural barriers to experimentation and change, and a variety of other changes designed to make it easier to try new things without fear of reprisal.
- **Step 2** – Systems are developed for establishing close communication with customers, employees and suppliers. This includes developing rigorous methods of obtaining and evaluating input from customers, employees and suppliers. Baseline studies are conducted to determine the starting point and to identify cultural, policy and procedural obstacles to success.
- **Step 3** – Training needs are rigorously assessed. Remedial skills education is provided to assure that all employees have adequate levels of literacy and numeracy. Top-to-bottom training is conducted in systems improvement tools, techniques and philosophies.
- **Step 4** – A framework for continuous process improvement is developed, along with a system of indicators for monitoring progress and success. Six Sigma metrics focus on the organisation’s strategic goals, drivers and key business processes.
- **Step 5** – Business processes to be improved are chosen by management, and by people with intimate process knowledge at all levels of the organisation. Six Sigma projects are conducted to improve business performance linked to measurable financial results. This requires knowledge of the organisation’s constraints.
- **Step 6** – Six Sigma projects are conducted by individual employees and teams, which are led by Green Belts and assisted by Black Belts.

Although the approach is simple, it is by no means easy. But the results justify the effort expended. Research has shown that firms that successfully implement Six Sigma perform better in virtually every business category, including return on sales, return on investment, employment growth and share price increase. When will you be ready to join the Six Sigma revolution?

Source: <http://www.evancarmichael.com/Human-Resources/840/Six-Sigma-A-Case-study-in-Motorola.html> (accessed on 20 October 2010).

7.3.3 Quality management systems (QMS) of the International Standards Organisation (ISO)

Keep the following key questions in mind, while working through this section in the prescribed book:

- What is a QMS?
- What are the two most significant requirements that a QMS must meet?
- Can you list the principles of a QMS?

7.4 PURCHASING AND SUPPLY: TECHNICAL ELEMENTS OF QUALITY

Mastering the technical elements of quality often means the difference between the success or failure of the quality management programme implemented within an organisation. It involves making a choice between available alternatives in order to achieve the predetermined objectives.



Study section 7.4 in Hugo & Badenhorst-Weiss (2011).

This section focuses on specific techniques available to an organisation that can assist with decisionmaking on quality. **Standardisation** is discussed first: the concept is defined, the advantages highlighted and the impact on purchasing decision explained.

We then focus on **international standards by the ISO**. In order to assist purchasers and suppliers who operate in the international market with *quality* issues, the ISO has developed internationally accepted quality standards and documented them in the ISO 9000 series of standards.

The ISO 9000 standards have been implemented by many South African businesses. Acceptance of these standards by South African businesses is driven by the South African Bureau of Standards (SABS), through which South African businesses become members of the ISO. South African businesses have realised that ISO 9000 standards afford them the opportunity to compete internationally.

You should also read the discussion in the prescribed book on the exciting ISO 14000 series, which relates to environmentally friendly manufacturing (ERM). This aspect will continue to gain importance as the global conversation focuses on sustainability.

Value analysis is then explored as an aid to making decisions on quality: the concept is defined, the procedure explained and the impact on purchasing decision identified.

Lastly, we focus on **the description of quality**. It is not sufficient for an enterprise simply to know what quality relating to their products or services is most appropriate. Employees of an enterprise must be able to describe the desired quality so accurately that all stakeholders will understand precisely what they want. A clear description of quality not only specifies the inherent characteristics of the product but also sets standards for inspection so that quality can be controlled.



ACTIVITY 7.2

How will John Hart explain the various methods of quality description to a newcomer in the purchasing function?



Feedback

He could have explained the existence and appropriateness of the following methods of quality description in the context of products used by Sportec (SA):

- *market grades*
- *brand names*
- *commercial standards*
- *inherent specified characteristics*
- *materials and manufacturing characteristics*
- *engineering drawings (blueprints)*
- *samples*
- *combinations of these methods*

Some of these methods apply more in certain situations than in others, depending on the situation in the supply market and the nature of the products or services involved. For instance, the quality of the materials that Sportec (SA) requires for sportswear may be described in terms of fabric and weaving methods – in other words, the method of describing materials and manufacturing characteristics. Remember, a clear description of quality can be used to promote uniformity when several suppliers of a specific product are used.

7.5 CONTROL OF QUALITY

Remember that incoming materials may influence the quality of finished products or services; and may cause production stoppages; damaged equipment and other raw materials used in the manufacturing process, as well as endanger the safety of production staff. Quality control is the process employed to ensure a certain level of quality in a product or service, and avoid the above-mentioned consequences that will impact negatively on an organisation's bottom line.

The basic goal of quality control is to ensure that the products, services or processes provided meet specific requirements and are dependable, satisfactory and fiscally sound. Essentially, quality control involves the examination of a product, service or process for certain minimum levels of quality. The goal of a quality control team is to identify products or services that do not meet a company's specified standards of quality. If a problem is identified, the job of a quality control team or professional may involve stopping production temporarily. Depending on the particular service or product, as well as the type of problem identified, production or implementation may not cease entirely.

Quality control may include whatever actions a business deems necessary to provide for the control and verification of certain characteristics of a product or service. The prescribed book covers the following activities:

- the general nature of quality control
- recording the performance
- sample inspection
- reporting and explaining deviations
- taking corrective action

Usually, it is not the job of a quality control team or professional to correct quality issues. Typically, other individuals are involved in the process of discovering the causes of quality issues and fixing them. Once such problems are overcome, the product, service or process continues production or implementation as usual.



Study section 7.5 in Hugo & Badenhorst-Weiss (2011).



ACTIVITY 7.3

Because of the quality problems at Sportec (SA), John Hart obviously has to pay attention to quality control. The question is: Should the entire quality control process be redesigned and the existing inspection methods re-examined?

Indicate the steps to be followed in an effective quality control process for Sportec (SA).



Feedback

After studying quality control in the prescribed book, you should be able to give practical illustrations of the following steps:

- *setting standards*
- *observing actual performance*
- *explaining discrepancies*
- *taking corrective action*

Because quality control plays such vital role in business, every enterprise has to exercise it effectively. Enterprises therefore have to develop thorough processes of quality control and apply effective inspection methods to ensure good quality. John Hart of Sportec (SA) will have to evaluate the effectiveness of the entire quality control process and make sure that thorough inspection methods are applied.

SUMMARY

After studying the relevant parts in the prescribed book on this study unit, attempt the following comprehensive, integrated activity.



ACTIVITY 7.4

After his experience of the quality problems at Sportec (SA), John Hart decides to send a detailed quality management report to top management. He wants to explain the problems in detail and make recommendations on how to deal with them. John Hart asks you to assist him with the report. What would you include in the report?



Feedback

For this integrated activity you need to be thoroughly familiar with the entire study unit on quality management. It is logical that all the quality problems at Sportec (SA) need to be thoroughly investigated and described in the report. You should then indicate what steps could be taken to resolve the problems. In conclusion, you should summarise the proposals to make quality management at Sportec (SA) more effective.



Read and attempt to answer the three questions on the case study “Toyota South Africa (TSAM) – Recall of Vehicles” at the end of chapter 7 in Hugo & Badenhorst-Weiss (2011).

Toyota’s announcement of a technical fix for its sticky petrol pedals – which can lead to sudden acceleration problems – is not likely to bring a quick end to the company’s current recall nightmare. Having already halted sales and production of eight of its top-selling cars in the United States of America – and recalled more than 9 million cars worldwide – Toyota faces the prospect of losing billions of rands.

We cannot help but agree with Michael Conner that the Toyota brand, once almost synonymous with top quality, has taken a serious knock. Fixing the problem and ensuring that something like it doesn’t happen again will require an all-out effort, from the Toyota assembly line to the boardroom. Even then, there are no guarantees. Maintaining a good corporate reputation in the 21st century is a tricky business indeed.

Toyota’s case offers a number of valuable lessons for other business people and companies to consider, most of them related to the quality matters that we have discussed in this study unit. Toyota’s desire to supplant General Motors as the world’s number-one car-maker pushed it to the outer limits of quality management. The evidence that Toyota was expanding too much and too quickly started surfacing a couple of years ago. Not on the company’s bottom line, but on its car-quality ratings. That was realised in 2005 when Toyota recalled more cars and trucks than it sold.

One wonders if, when accepting management’s plan for aggressive growth, Toyota’s board of directors exercised appropriate diligence to ensure that growth could be achieved without betting the entire franchise. Did Toyota consider quality management in the purchasing and supply context and its impact on internal service quality and the external supplier base? Did the normally reputable company even consider the various quality management systems? Was quality control part of the discussion?

Maybe gaining market share is not worth the trade-off, as it is well known that your supply chain is only as strong as your weakest link. The reality is that auto companies make hardly any of their parts. They assemble cars from parts made by others. In this case, the offending petrol pedal assembly was made for Toyota by a company called CTS of Elkhardt, Indiana, USA.

The overall message is that quality management requires daily vigilance. We have now clearly seen that your reputation is at stake. Reputation can be easily lost – and Toyota’s reputation is indeed threatened – but it’s highly unlikely the company will collapse completely. And that may be one of the one of the biggest lessons for other companies as they study how Toyota emerges from this recall crisis. The reality is that Toyota is positioned for recovery about as well

as it could be – owing, in large measure, to the reputation for quality products and corporate responsibility it has developed over the last two decades. That reputation is a valuable asset, and one that Toyota will undoubtedly be citing and calling upon, in the weeks and months ahead.

Source: <http://business-ethics.com/2010/01/31/2123-toyota-recall-five-critical-lessons/> (accessed on 15 October 2010).

The next study unit explores important issues regarding price determination and cost analysis of purchased goods and services.



ASSESSMENT

Revise chapter 7 in the prescribed book. Once you have done this, answer the following questions:

- (1) Explain the concept of quality in relation to the supply function.*
- (2) Analyse the multiple roles that purchasing has in ensuring internal service quality and supplier quality programmes by writing an essay on the subject.*
- (3) Identify the costs associated with implementing a supplier quality programme.*
- (4) Write a detailed report explaining the three QMSs – TQM, the Six Sigma system and the ISO system.*
- (5) Suggest appropriate aids available to assist in quality decisions: standardisation, international standards, value analysis exercises and description of quality.*
- (6) Design and implement a quality control programme for supply management. Use an example to substantiate your answer. (Hint: The Toyota case is an excellent choice.)*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 7 in your prescribed book.

Study unit 8

PURCHASING PRICE DETERMINATION AND COST ANALYSIS

CONTENTS

Aim

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Key concepts

Getting an overview

- 8.1 The importance of purchasing prices
- 8.2 Cost elements
- 8.3 Behaviour of cost related to volumes
- 8.4 Different market forms and price determination
- 8.5 Price determination for different types of product
- 8.6 Price analysis to determine prices
- 8.7 Cost analysis as a method of determining prices
- 8.8 Techniques assisting in price and cost analysis

Summary

Assessment

AIM

The aim of this study unit is to clarify the interface between purchasing price and purchasing costs.



LEARNING OUTCOMES

After working through this study unit, you should be able to do the following:

- Distinguish between the elements of value and the way prices can influence the purchased value.
- Define the concepts “the right price” and “a competitive price.”
- List and define various cost elements.
- Indicate the behaviour of cost related to volumes.
- Explain the interface between different market forms and price determination.
- Explain price determination for different types of product.
- Clarify price analysis as a method to determine a fair price.
- Differentiate between the various approaches to determining prices.
- Clarify cost analysis as method to determine a fair price.
- Explain the learning curve as a price and cost analysis tool.
- Explain the principles of break-even analysis.
- Briefly describe hedging of prices.



Key concepts

- price
 - value
 - the right price
 - the competitive price
 - cost elements
 - direct cost of materials
 - direct labour costs
 - indirect costs
 - profit mark-up
 - total fixed costs
 - total variable costs
 - semi-variable costs
 - pure (perfect) competition
 - oligopoly
 - monopoly
 - price determination for different types of product
 - price analysis
 - collecting information for determining prices
 - supplier pricing models
 - price volume model
 - market penetration model
 - market skimming model
 - revenue pricing model
 - promotional pricing model
 - market price level
 - price determination by prevailing market prices
 - price determination by competition in the market
 - price determination by means of negotiation
 - cost analysis
 - supplier cost-based pricing models
 - cost mark-up pricing model
 - margin pricing model
 - rate-of-return pricing model
 - collaborative cost management
 - target pricing
 - cost saving sharing pricing
 - cost/price analysis techniques
 - learning curve
 - break-even analysis
 - hedging prices
-



Study chapter 8 in Hugo & Badenhorst-Weiss (2011), including all figures and tables.

GETTING AN OVERVIEW

Price is something we all consider on a daily basis. Whether we are buying household items, cars or properties the price is often the determining factor in our decision-making process. For a bit of fun, read the following excerpt:



Lexus LFA supercar comes to SA

"Lexus on Wednesday announced its LFA supercar's global allocation of 500 units has been sold out. Global distribution for the most expensive Lexus yet is pencilled in for October this year. Retailing at \$375 000, LFA represents a quantum pricing leap into the unknown for Lexus and parent company Toyota.

Expensive. Worth it? The retail price may be outrageous, yet considering what's on offer you realise that even at such stratospheric retail Lexus is probably losing money on the LFA. Its technical specifications read like a racing team's Christmas shopping list. A Carbon Fibre Reinforced Plastic (CFRP) monocoque bodyshell hosts one of the most advanced naturally aspirated engines ever passed through road car emission control. Displacing 4.8l amongst ten cylinders and fed via a trick Yamaha cylinder head, the mostly titanium LFA V10 produces 412kW at 8 700r/min. Rear-wheel drive in configuration, LFA's power delivery is managed by a six-speed (single clutch) transaxle transmission.

Lexus claims the LFA's V10 spins its crank with such urgency a conventional analogue tachometer was too inaccurate and lagging, therefore the LFA makes do with a digitised TFT display. This really is as trick a production supercar as you could ever wish to own. An inverted triangle exhaust grouping shows off the LFA's dynamic billing. Performance figures tally 0–100km/h in 3.7 seconds and a top speed beyond 320km/h ...

Traditionalists will question whether the purchase price is in any way justifiable, considering the lack of a performance heritage behind the Lexus badge."

Source: http://www.wheels24.co.za/News/General_News/LFA-supercar-will-come-to-SA-20100603 (accessed on 22 October 2010).

What an extraordinary car! But at a price of \$375 000, it is no wonder that there are only five of these cars allocated to the South African market, where other luxury vehicles are readily available at the fraction of the cost of the Lexus.

In the same fashion, price is often the determining factor when buying organisations select suppliers and award contracts. However, this does not happen in isolation. Buyers can only operate effectively in any market if they have enough information about, and experience of, the approaches to price determination, the market in which they have to operate, and the type of product they deal with.



Study the introduction to chapter 8 in Hugo & Badenhorst-Weiss (2011).

8.1 THE IMPORTANCE OF PURCHASING PRICES



Study section 8.1 in Hugo & Badenhorst-Weiss (2011).

Remember that we determined in the previous study unit that quality is an element of value. Well, so is price. Price determination is therefore a key purchasing and supply activity, but must be seen as part of the total value package as explained in section 8.1.1 of the prescribed book.

You should also be aware of the differences between determining a “right” and a “competitive” price as explained in section 8.1.2 and 8.1.3.



ACTIVITY 8.1

A prominent businessman, Gary Zenz, decides to buy himself a new suit. He does not have much time to shop around, but would like to buy a good suit. After visiting two outfitters he realises that suits are very expensive. He now has to decide where to buy the suit and weighs up the factors of price and quality. He has difficulty coming to a decision.

- (1) How should Gary Zenz decide between quality and price (value package)?
 - (2) How many outfitters should he go to before making the decision to buy?
 - (3) How do you think the two outfitters that Gary Zenz visited determined their final prices?
-



Feedback

After studying the relevant sections in the prescribed book, you should be able to help Gary Zenz to apply the following three approaches: (1) the best-value approach (2) the reasonable price approach and (3) the competitive price approach.

Remember, there are various factors that influence price determination. In Gary Zenz’s case, for example, price and quality factors may be equally important to him, so he may first decide how much he is prepared to pay and then select the best (quality) suit for that price. In industrial purchasing, however, one first has to determine the “right” quality level before looking for the best price.

Obviously it is sound business practice to consider several suppliers, especially in the case of expensive products or services.

In this case it would have been wise if Gary Zenz had used brand names (e.g. Carducci or Man About Town) to establish which quality in which price lines he is willing to purchase. It would also be wise to compare the prices of the same brands at various outfitters to determine where he will get the best value package (taking style into consideration).

8.2 COST ELEMENTS

Any good buyer who wants to obtain an optimal value package for her/his enterprise must know the various methods that suppliers use to determine prices. One of the main aspects of importance is the cost of the supplier to manufacture the product or deliver the service. The relationship between cost and price, and the behaviour of cost in relation to volumes, are important factors which a purchaser needs to understand. In this manner, he/she will be able to determine whether the supplier is asking a fair price and what his/her chances are of negotiating a lower price.



Study section 8.2 in Hugo & Badenhorst-Weiss (2011).

This section includes:

- direct costs of materials
- direct labour costs
- indirect costs
- profit mark-up

8.3 BEHAVIOUR OF COST RELATED TO VOLUMES

The costs that a supplier incurs are also related to the volume of production. The buyer must be aware of the impact of smaller or larger volumes on the various cost elements, since this information may prove to be valuable in negotiating the ultimate price and facilitate collaboration with the supplier in cost-reduction drives. In order to achieve the objective of understanding the behaviour of cost under volume changes, the following three cost categories may be used:

- total fixed costs
- total variable costs
- semivariable costs



Study section 8.3 in Hugo & Badenhorst-Weiss (2011).

8.4 DIFFERENT MARKET FORMS AND PRICE DETERMINATION

The other significant issue in price determination is the different market conditions or market forms in which suppliers are operating. This is discussed extensively in the prescribed book, focusing on the following market forms:

- pure (perfect) competitive market
- oligopoly
- monopoly and monopolistic (imperfect) competition



Study section 8.4 in Hugo & Badenhorst-Weiss (2011).



ACTIVITY 8.2

Info Technologies, a large international manufacturer of computers, wants to start operating in South Africa. Peter Maluleka, the new purchasing and supply manager, is responsible for purchasing a wide range of products.

- (1) Indicate what cost approach Peter Maluleka should adopt in order to determine the “right” prices by clearly identifying the cost categories.
- (2) Compare the various market situations or forms in which Peter has to make his purchases.



Feedback

After studying the relevant sections in the prescribed book you should be able to assist Peter Maluleka. Since effective price determination is one of the buyer’s most important activities, buyers need to have maximum information about suppliers’ cost structures. If buyers have enough information about these cost structures, they can negotiate effectively and evaluate tenders properly. Peter Maluleka, for example, needs to be familiar with the situation in the market and know the market forces that he has to deal with. Market situation (form) and market forces play a major role in determining the “right” prices.

8.5 PRICE DETERMINATION FOR DIFFERENT TYPES OF PRODUCT

It should be clear that as with the purchasing cycle, supply management and quality management, the methods of price determination vary from product to product. Buyers have to use the most effective method of price determination, depending on the product and market situation. They should therefore know how to determine the “right” price in each of the various product categories.



Study section 8.5 in Hugo & Badenhorst-Weiss (2011).



ACTIVITY 8.3

Peter Maluleka will be dealing with different product categories. He therefore wants to develop a clear framework with indications of how to act when dealing with the different categories. Complete the table below by inserting the missing product categories and indicating the practical implications of each category for Peter.

PRODUCT CATEGORY	PRICE DETERMINATION IMPLICATIONS
<ul style="list-style-type: none"> Raw materials 	Specialised skills required in this category. Commodity brokers must often be used. Peter Maluleka will regularly come up against fixed prices. Service is crucial and reliability (delivery times) and quality of supply can be negotiated.
<ul style="list-style-type: none"> Special items 	
<ul style="list-style-type: none"> 	
<ul style="list-style-type: none"> 	
<ul style="list-style-type: none"> 	
<ul style="list-style-type: none"> 	
<ul style="list-style-type: none"> 	



Feedback

After studying the relevant sections in the prescribed book, you should be able to identify the product categories and their implications for price determination. The table should make it clear that the more types of product a buyer has to purchase, the more complicated his/her task will be. So in order to purchase effectively and determine the "right" prices, it is necessary to know each type of product as well as the specific market situation.

8.6 PRICE ANALYSIS TO DETERMINE PRICES

The planning of prices is of cardinal importance to purchasing and supply management. This is particularly true since the global financial crises. Since buyers usually have little influence over prices on the market, they have to plan carefully, identify alternative suppliers and negotiate effectively.

Any buyer worthy of his/her job must be able to plan effectively. Important steps in the price analysis process include collecting essential information for determining prices, understanding supplier pricing models, setting objectives for price determination and

formulating a price policy and strategy based on prevailing market prices, competition in the market or negotiation.



Study section 8.6 in Hugo & Badenhorst-Weiss (2011).



ACTIVITY 8.4

The top management of Communica has sent Fatima Ebrahim an urgent memorandum, requesting her to do a price analysis. The request came because Communica's purchasing costs were continually increasing. Advise Fatima and explain the following:

- (1) the various steps in the price planning process
- (2) what exactly each step in the price planning process entails



Feedback

After studying the relevant sections in the prescribed book you should have identified the following steps of the price analysis process:

- *collecting essential information for determining prices*
 - *understanding supplier pricing models*
 - *setting objectives for price determination*
 - *formulating a price policy and strategy based on prevailing market prices, competition in the market or negotiation*
-

8.7 COST ANALYSIS AS A METHOD OF DETERMINING PRICES

Cost analysis is the second method available to purchasing and supply management in establishing whether suppliers are offering prices that comply with the prerequisites of a fair price. It is the process of analysing each individual cost element which together add up to the final price. This can be done using various techniques:

- Suppliers' cost-based pricing models (cost mark-up pricing model, margin pricing model and rate-of-return pricing model); or
- Collaborative cost management (target pricing and cost saving sharing pricing).



Study sections 8.7 in Hugo & Badenhorst-Weiss (2011).

8.8 TECHNIQUES ASSISTING IN PRICE AND COST ANALYSIS

Purchasers can apply various aids to make decisions on prices (e.g. the learning curve, break-even analysis and hedging prices). The use of these aids requires a great deal of research to collect essential data on the market and on suppliers.



Study section 8.8 in Hugo & Badenhorst-Weiss (2011).



ACTIVITY 8.5

After a series of cost increases, Fatima Ebrahim realises the importance of cost/price analysis. Her study of the subject indicates that certain aids are essential for proper cost/price analysis.

- (1) Explain how these aids can help Fatima to plan prices.
- (2) Indicate what the aids to price planning entail.



Feedback

After studying the relevant sections in the prescribed book, you should be able to help Fatima Ebrahim to use the following three planning aids:

- *the learning curve*
- *break-even analysis*
- *hedging of prices*

These aids in cost/price analysis are powerful mechanisms that can greatly enhance the cost/price analysis process. They require a great deal of research (data collection) to be applied in practice.

SUMMARY

Fixing the purchasing price of any product or service can be founded within a price or cost analysis subject to current market conditions. Read the following excerpt from an article published in the China Daily on 13 October 2010. Can you identify any key concepts that were discussed in this study unit?



China raises purchasing price for wheat

China will increase the minimum government purchasing price for wheat in 2011, the National Development and Reform Commission (NDRC) said on Tuesday. The government will pay a minimum of 95 yuan (\$14) for every 50 kilograms of white wheat, and 93 yuan for red and mixed wheat. That's an increase of 5 yuan for white wheat and 7 for both the red and mixed varieties.

The move will encourage farmers to plant more wheat in order to stabilise the domestic market in the face of a fluctuating global environment and to ease to inflation expectations, said analysts. "Recent soaring global wheat prices have fueled the expectation of a price hike in the domestic market," said Cheng Guoqiang, deputy director of the Institute of Market Economy at the Development Research Center of the State Council.

The wheat price will rise along with the increased purchasing price, but it will set a benchmark for the domestic market and will maintain a stable pace, he said. "Mild and controllable" prices will help ease inflation expectations, Cheng said. Rising grain prices are regarded as a major contributor to inflation. Global wheat prices surged recently as a drought hit Russia, the world's third largest exporter, and floods damaged crops in Canada.

Earlier this month, the United States Department of Agriculture reduced its forecast for world wheat production, saying that it may decline to 641.44 million tons, from a September forecast of 643.01 million. However, China is likely to see a bumper harvest, said Agricultural Minister Han Changfu during an inspection tour in Hebei province on Monday.

To date, 55 million hectares of farmland have produced yields accounting for 71.3 per cent of the country's harvest. The remaining land is also likely to produce good yields, according to Han.

China has maintained relatively high wheat stockpiles, helping to ensure food supplies and ease pressures on grain prices, said analysts. Although wheat prices have increased rapidly internationally, there will only be a very limited impact on the domestic market because imports, such as rice and wheat, account for less than 1 per cent of consumption, said Zhang Xiaoqiang, vice-minister of the NDRC, in a recent interview.

Since 2006, the minimum government purchasing price for agricultural commodities has been raised during the sowing season to encourage farmers to plant more crops. The year-on-year growth rate for the government's minimum purchasing price has remained at around 8 per cent for three consecutive years, said Cheng.

Source: <http://english.peopledaily.com.cn/90001/90778/90862/7164345.html#> (accessed on 23 October 2010).

We can see from the article that one product's purchasing price can be of importance not only locally, but globally. The impact of the market conditions in Russia and Canada influenced the price and production decisions made in China. China's government determined the right and competitive price by increasing the minimum purchasing price of wheat in order to stimulate local wheat production and stabilise the domestic market in a fluctuating global environment.

It would have been important to take into account all the cost elements, and the behaviour of planting and storing the wheat in terms of the larger and smaller volumes yielded. The market forms that played a role here would have impacted the Chinese government's decision. Wheat is categorised as a raw material, and this type of product requires the skills of commodity specialists or commodity brokers.

The Chinese government took note of price analysis as a basis of price determination by collecting information from across the nation and the globe. Then, understanding the major supplier pricing model, they set objectives and used prevailing market prices as a basis of their decision.

What a good example of how the spokes of price determination work!



ASSESSMENT

Revise chapter 8 in the prescribed book. Once you have done this, answer the following questions:

- (1) Write a report in which you distinguish between the elements of value and the way prices can influence the purchased value.*
- (2) Define the concepts "the right price" and "a competitive price".*
- (3) List and define various cost elements involved in price determination.*
- (4) Outline the behaviour of cost related to volumes.*
- (5) Explain the interface between different market forms and price determination.*
- (6) Explain price determination for different types of products.*
- (7) Clarify price analysis as method to determine a fair price.*
- (8) Differentiate between the various approaches for determining prices.*
- (9) Clarify cost analysis as method of determining a fair price.*
- (10) Explain the learning curve as a price and cost analysis tool.*
- (11) Explain the principles of break-even analysis.*
- (12) Briefly describe hedging of prices.*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 8 in your prescribed book.

Study unit 9

PURCHASING QUANTITY AND INVENTORY MANAGEMENT

CONTENTS

Aim

Learning outcomes

Key concepts

Getting an overview

9.1 The role and economic importance of inventory management

9.2 Basic inventory concepts

9.3 Inventory planning and control

9.4 Symptoms of poor inventory management

Summary

Assessment

AIM

The aim of this study unit is to explain the significance of inventory management in a lean supply context.



LEARNING OUTCOMES

After you have studied this study unit, you should be able to do the following:

- Briefly explain efficient inventory management in a lean supply context.
 - Describe the reasons for holding inventory.
 - Illustrate the importance of keeping inventory to a minimum within a business enterprise.
 - List and define the various categories of inventory.
 - Analyse the different cost elements of holding inventory.
 - Outline the ABC classification of inventory.
 - Write a report explaining the most significant aspects of the various methods and techniques of inventory planning and control, focusing on both independent and dependent demand items.
 - Describe the symptoms of poor inventory management.
-



KEY CONCEPTS

- quantity and inventory management
- lean supply context
- inventory holding

- dependent demand
 - independent demand
 - most economic ordering quantity (EOQ)
 - re-order point (ROP)
 - materials requirement planning (MRP)
 - second-generation materials requirement planning (MRP II)
 - enterprise resource planning (ERP)
 - distribution resource planning (DRP)
 - just-in-time (JIT) purchasing
-



Study chapter 9 in Hugo & Badenhorst-Weiss (2011), including all figures and tables.

GETTING AN OVERVIEW

Consider the following elementary problems in practical inventory situations. As part of the purchasing and supply team, can you do something about them?

- Tasty Bread, a bakery, has no inventory control and regularly replenishes its stocks too late, and sometimes even has to stop production because it does not have enough flour in stock. This means that the bakery loses clients and sales automatically drop.
- Mr Sibanda, an entrepreneur, also does not control his inventory, so he often buys too much stock. As a result, once again Sibanda General Store currently has more blankets in stock than it needs. Because the enterprise has invested its money in blankets, there is not enough money to buy the other products that clients want right now.
- Cape Town Cycle Warehouse sells bicycles and spare parts through its depot in Epping Industrial Area and through its website. But because of outdated technology, the organisation is finding it hard to operate efficiently as a result of badly calculated stock levels. This limits its ability to respond rapidly to customer trends and manufacturers' special offers.

Buying the right quantity, and optimally managing inventory, is undoubtedly a key activity in purchasing and materials management in a vast range of situations. Inventory is all the products or services that an enterprise needs in order to provide their products or render their services to their customers. One aspect remains clear: it doesn't matter what type of organisation you are, in which industry, operating in which country ... you cannot sell what you do not have. A customer (either internal to the processes of or external to the organisation) wants to know if items are in stock, start the transaction, obtain the items and carry on with their own business.

It is important to determine quantities effectively and efficiently, because competence in this task ensures that materials and services can be supplied continuously, allowing the organisation to proceed with internal processes in order to achieve maximum customer satisfaction. This study unit will help you determine quantities by explaining: the efficient management of inventories in a lean supply context; the reasons for holding inventory;

the importance of keeping inventory to a minimum within a business enterprise; the various categories of inventory; the different cost elements of holding inventory; the ABC classification of inventory; the most significant aspects of inventory planning and control, focusing on independent and dependent demand items; and the symptoms of poor inventory management.



Study the introduction to chapter 9 in Hugo & Badenhorst-Weiss (2011).

9.1 THE ROLE AND ECONOMIC IMPORTANCE OF INVENTORY MANAGEMENT



ACTIVITY 9.1

At the start of this section, it is important to determine what the best practices in inventory management are. In other words, what do most organisations strive to achieve when managing their inventories?



Feedback

In almost every endeavour it is difficult to determine what constitutes “best practice”. Businesses around the world spend millions of dollars on software and advisory services, but often don’t know whether they are “best practice” or just somewhere in the pack.

Many companies will say, “Why does it matter just as long as you keep getting better?” The stark reality is that inventory requires the investment of capital. The items need to be purchased and stored and this ties up cash. Tying up working capital can be a significant burden for many companies; if this capital is freed up, it can provide significant cash resources that can be used more productively.

For many companies the key issue is availability, and as long as they have an item when it is required they care little about the cash investment. However, this approach cannot be financially justified on any level. This is because the excess inventory investment that this approach generates provides little or no value to the business. The excess is invested in inventory that does not move or becomes obsolete.

World-wide best-practice inventory management demands that the complete management system is optimised, not just the inventory. It is in this field that best practice can be both easily identified and readily achieved.

The five levels of the world’s best-practice inventory management are:

- **Level 1 – Ad hoc:** Purchases are made on an “as needed” basis. At this level little control is necessary as inventory is expensed when purchased and used immediately. While this may seem to reduce the cash investment, it may not reduce the total cash expenditure. This approach is only viable if the items are available instantly and the cost of a “stock out” is negligible.
- **Level 2 – Storage:** Inventory is expensed when purchased and stored for use but not strictly controlled. This is similar to Level 1 except that items are stored because of the cost of a stock out. This approach appears to solve one problem, but it raises two others.

Firstly, total expenditure is likely to increase as items are purchased in “economic quantities”. Secondly, without controls there is little opportunity for review and development.

- **Level 3 – Capitalisation:** *Inventory is capitalised and subject to some level of control, either manual or software-based. This approach is by far the most popular as it appears to provide the required mix of availability and control. Unfortunately, most organisations use their software solely for counting and accounting. There is a strong reliance on human calculation of inventory requirements, but often little review of outcomes. The result is likely to be good availability, but a significant overinvestment in inventory and high levels of obsolescence.*
- **Level 4 – Software optimisation:** *Inventory is capitalised and stock levels are optimised based on a risk/return algorithm. This is the basis of most software solutions. Most software packages incorporate the ability to automatically adjust the required stock levels based on the history of demand and supply. However, very few companies actually use this feature because they know that they cannot trust the results. This is due not to a software flaw but because the supply and demand may not represent typical usage.*
- **Level 5 – System optimisation:** *Inventory management minimises the overall cash investment without an increase in risk. This is world’s best practice. At this level, all the factors that influence the actual inventory investment are regularly reviewed. This review is manageable because it is limited to the “vital few” items that have a real impact on the level of investment. Inventory levels are adjusted to take account of changing needs, and this minimises the likelihood of obsolete inventory.*

*Any company that already has the software required for Level 3 can achieve Level 5 – world’s best practice. What is needed is the knowhow, policy development, measures and reporting required to take a company to Level 5, **not more software**. Once these key issues are addressed, a true management system can be implemented. Software only goes to Level 4: it is the management system that provides the bridge to Level 5.*

Source: <http://www.inventorymanagement.com/20076/worlds-best-practice-inventory.html> (accessed on 21 October 2010).



Study section 9.1 in Hugo & Badenhorst-Weiss (2011).

The reasons for the increasing importance of the purchasing and supply function were listed in section 1.3.1 of both the study guide and the prescribed book. Do you remember them? The same reasons necessitate the role of inventory management to change. Increasingly, inventories are seen as unnecessary, and organisations are moving to eliminate them. To many purchasing and supply managers, overstocked warehouses represent missed opportunities and, as seen in activity 9.1, wasted capital.

Inventory has become such an abomination that organisations regularly risk shutting down their assembly lines in order to hold less of it. But rather than being eliminated, however, inventory has been pushed down into the lower reaches of the supply chain – from manufacturers to top-tier suppliers to lower-tier suppliers. There are various good reasons (outlined in the prescribed book) why organisations still consider holding inventory as important:

- Sufficient inventory ensures that production and marketing is continuous.
- It can lead to cost savings and hedging against price uncertainties.
- Inventory provides protection against supply uncertainties.
- It can lower purchasing costs.

However, it is also important to manage inventory so that the substantial capital investment is kept to a minimum. This is discussed in section 9.2.2 of the prescribed book.

9.2 BASIC INVENTORY CONCEPTS

It seems that inventory is important to enterprises and it can probably never be eliminated completely. We therefore need to analyse the nature and scope of inventory in more detail.



Study section 9.2 in Hugo & Badenhorst-Weiss (2011).

9.2.1 Categories of inventory

Inventory can be classified in various ways. For the purpose of this study unit, the following four categories are the most important:

CATEGORY	EXAMPLE
1 Production inventories	raw materials, materials and components which the enterprise's production process requires for reprocessing
2 Maintenance inventories	materials that support the manufacturing process but are not necessarily incorporated into the finished product, e.g. lightbulbs, cleaning materials, protective clothing
3 Processing inventories	semifinished products which are stored between the various production stages
4 Final product inventories	finished products ready for dispatch to their respective destinations

To function effectively, an enterprise needs adequate inventory in all these categories.

9.2.2 Inventory costs

Remember: An enterprise always strives to carry adequate inventory at minimum cost.

When deciding what inventory to carry and what inventory levels an enterprise can maintain economically, we need to know about the various components of inventory costs. Note, however, that it is often extremely difficult to calculate the exact value of

inventory costs. Effective inventory management, then, requires a thorough knowledge of total inventory costs. The following table gives the different elements with practical examples of each:

1 Inventory-holding or carrying costs	<ul style="list-style-type: none"> ● storage facilities ● warehouse management ● inventory insurance premiums ● depreciation or obsolescence because of change ● handling costs
2 Ordering costs	<p>These costs derive from the preparation and issue of orders to suppliers:</p> <ul style="list-style-type: none"> ● administrative salaries ● post and telephone ● computer time
3 Cost of inventory shortages (stock out costs)	<p>These costs, e.g. losses due to cancelled orders and customer goodwill forfeited, are difficult to quantify.</p> <ul style="list-style-type: none"> ● higher transport costs (airfreight or express deliveries) ● additional administrative costs

9.2.3 ABC classification of inventory

The ABC classification of inventory is also known as the Pareto analysis.

This is discussed in your prescribed book, and we urge you to take the time to understand this important tool in purchasing and supply management. It is addressed under the following sections:

- Inventory catalogue
- ABC analysis

9.3 INVENTORY PLANNING AND CONTROL

We have established that business owners pay close attention to inventory as it usually represents a large business expense. They will also ensure that they execute the management tasks associated with inventory to the best of their ability: *inventory planning* includes creating forecasts to determine how much inventory should be on hand to meet consumer demand, and *inventory control* is the process by which managers count and maintain inventory items in the business.

Business owners usually create internal policies and procedures for inventory planning and control. Managers and employees must follow these policies and procedures when handling the organisation's inventory. Policies and procedures outline who can order

inventory, how inventory flows through the company, accounting policies for valuing inventory and procedures to deal with obsolete goods.

Inventory planning and control usually distinguishes between independent demand items and demand items.



Study section 9.3 in Hugo & Badenhorst-Weiss (2011).

9.3.1 Planning and control for independent demand items

Independent demand is any demand for a product that is not connected to the demand for another product, such as finished goods. This is discussed in your prescribed book under three headings: inventory timing, inventory quantity and response-based techniques.

9.3.2 Planning and control for dependent demand items

Now we turn our attention to the planning and control of those items in a time-based supply chain which is dependent on demand for finished products. The requirements planning and the JIT system are addressed in this section.

- **Material requirements planning system**

What does this system entail? It means using a computer to optimally reconcile the supply of production materials and the problems arising from production plans and schedules. Clearly an MRP system cannot be introduced unless the interdependence of materials flow and production planning and scheduling is recognised. As a result the materials management approach presents an ideal opportunity for implementing an MRP system.

What is the MRP system? In its purest form, it is a needs-oriented system whose primary aim is to function at zero inventory level and which controls the inflow of materials so as to synchronise with the time-scheduling of production programmes.

First study the complete section on MRP in the prescribed book, and then do the following activity:



ACTIVITY 9.2

As the purchasing specialist at Kabana Foundry you have to judge the feasibility of an MRP system for the enterprise. Bear the following points in mind:

Kabana Foundry's top management is not at all convinced that an MRP system will provide the answer to their inventory problems. They are doubtful about the possible impact of Kabana's unstable labour force on the system. Because of this problem the data required for the MRP system may occasionally be either late or inaccurate, or both. Nevertheless Kabana Foundry has no doubt that it must reduce its investment in inventory. They also foresee a considerable expansion of business in the long term and realise that they have to explore new alternatives with regard to inventory control.



Feedback

An MRP system offers Kabana Foundry the following advantages:

- It leads to a reduction in all categories of inventory costs.
- It increases reliability of materials supply and continuity of production.
- Because of the requirements of the system, both inventory provision and the production system will have to be effectively planned and controlled, which is an additional advantage of implementing an MRP system.
- A major advantage is the greater reliability of the overall inventory system.
- Another asset is reliable service to clients and suppliers who keep their delivery promises.
- The system leads to a drastic reduction of inventory levels and the elimination of buffer inventories.

However, the following limitations should be noted:

- It applies only to inventory used in the production process.
- It requires accurate forecasting, which is not always possible.
- It may function less efficiently if the materials management function is broken up into different departments.
- It is expensive to maintain and sets certain preconditions that not all enterprises can fulfill.
- It requires considerable organisational discipline to run smoothly.

The basic aim of the MRP system is to try to minimise inventory investment through careful planning of the demand for finished products. Another technique with the same aim is the JIT system.

Now consider the sections in the prescribed book which discuss the new developments in MRP:

- Manufacturing resource planning (MRP II)
- Distribution resource planning (DRP)
- Enterprise resource planning (ERP)
- Just-in-time system (JIT)

9.4 SYMPTOMS OF POOR INVENTORY MANAGEMENT



Study section 9.4 in Hugo & Badenhorst-Weiss (2011).

Seven symptoms of poor inventory management are discussed in the prescribed book. Make sure that you can list and explain these aspects!

SUMMARY



Read the case study “Leather and Hide CC” at the end of chapter 9 in Hugo & Badenhorst-Weiss (2011). Ms Hills has no easy task ahead of her. If we look back at the information contained in the study unit, we can suggest that she

start Mr Abrahams off with the basics, such as familiarising him with the best practices in inventory management, explaining the reasons for holding inventory and the importance of keeping inventory to a minimum. She can then take him through the various categories of inventory, and the costs associated with these inventories. After this, they can research the various methods and techniques of inventory planning and control available to Mr Abrahams. They can then apply this information to his particular case, and determine the best inventory management strategy for Leather and Hide.



ASSESSMENT

Revise chapter 9 in the prescribed book. Once you have done this, answer the following questions:

- (1) Briefly explain efficient inventory management in a lean supply context.*
- (2) Describe the reasons for holding inventory.*
- (3) Illustrate the importance of keeping inventory to a minimum within a business enterprise.*
- (4) List and define the various categories of inventory.*
- (5) Write a report in which you analyse the different cost elements of holding inventory.*
- (6) Outline the ABC classification of inventory.*
- (7) Write a report explaining the most significant aspects of the various methods and techniques of inventory planning and control, focusing on both independent and dependent demand items.*
- (8) Compile a checklist of the symptoms of poor inventory management.*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 9 in your prescribed book.

Topic 4

APPLICATION FIELDS IN PURCHASING AND SUPPLY MANAGEMENT

CONTENTS

Study unit 10: Purchasing capital equipment

Study unit 11: Purchasing services

Study unit 12: Purchasing from small businesses: a focus on black economic empowerment

TOPIC AIM

The aim of topic 4 is to familiarise you with a number of application fields in purchasing and supply management.

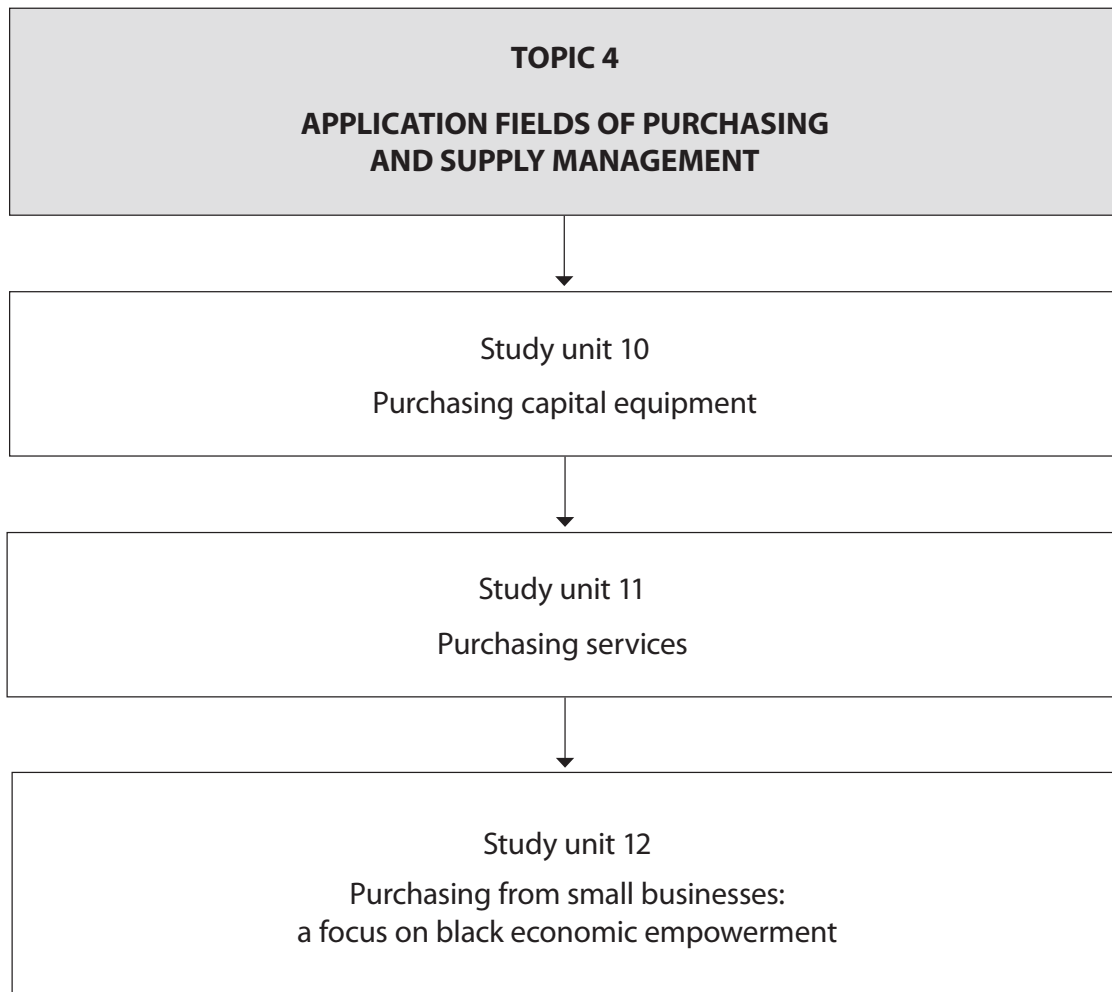


TOPIC LEARNING OUTCOMES

After studying this topic, you should be able to do the following:

- Define the term “capital equipment”.
- Classify capital equipment and provide examples of each category.
- Explain the characteristics of capital equipment.
- Discuss the size and scope of the procurement team when purchasing capital equipment.
- Explain the role of purchasing and supply management in the procurement of capital equipment.
- Explain the factors to be considered when purchasing capital equipment.
- Explain the principle and methodology of the quantitative assessment of capital equipment.
- Explain the procurement of used capital equipment.
- Discuss leasing as an option for acquiring capital equipment.
- Explain why the purchasing of services has become so important.
- Explain the nature of services and the implications for the purchasing process.
- Suggest a phased approach for services procurement.
- Discuss the key features of buying professional services.
- Illustrate and explain the role of supply management in acquiring transportation.
- Explain why outsourcing services is part of the responsibilities of supply management.
- Define small business.
- Justify the use of small suppliers from a global point of view in the face of government pressure and initiatives.

- Justify the use of small suppliers from a South African point of view in the face of government pressure and initiatives.
 - Justify the use of small suppliers from a business-related perspective.
 - Clarify the challenges encountered by the roleplayers in the disadvantages of small-business purchasing programmes.
 - Develop and implement a plan to manage a small-business purchasing programme, and substantiate your answer with an example.
 - Explain the most significant assessments of the inbound transport of purchased materials.
 - Outline the intricacies related to the storage of material within an organisation.
 - Analyse the importance and objectives of materials handling.
 - Briefly discuss the importance of packaging within the purchasing and supply context.
 - Write a report clarifying the most significant aspects of the removal of waste materials.
-



Study unit 10

PURCHASING CAPITAL EQUIPMENT

CONTENTS

Aim

Study unit learning outcomes

Key concepts

Getting an overview

- 10.1 Acquiring capital equipment
- 10.2 Classifying capital equipment
- 10.3 Characteristics of purchasing capital equipment
- 10.4 Size and scope of the capital equipment team
- 10.5 The role of the purchasing and supply management department in procuring capital equipment
- 10.6 Factors to be considered in purchasing capital equipment
- 10.7 Procuring used capital equipment
- 10.8 Capital equipment and leasing

Summary

Assessment

AIM

The aim of this study unit is to distinguish between the nature and scope of procuring capital equipment as compared to purchasing other goods and services.



STUDY UNIT LEARNING OUTCOMES

After working through this study unit, you should be able to:

- Define the term “capital equipment”.
 - Classify capital equipment and provide examples of each category.
 - Explain the characteristics of capital equipment.
 - Discuss the size and scope of the procurement team when purchasing capital equipment.
 - Explain the role of purchasing and supply management in procuring capital equipment.
 - Explain the factors to be considered when purchasing capital equipment.
 - Explain the principle and methodology of the quantitative assessment of capital equipment.
 - Explain the procurement of used capital equipment.
 - Discuss leasing as an option for acquiring capital equipment.
-



KEY CONCEPTS

- acquiring capital equipment
 - classification of capital goods
 - characteristics of purchasing capital equipment
 - large expenditure
 - nonrecurring expenditures
 - specialised and technical in nature
 - size and scope of the capital equipment team
 - role of purchasing and supply management in procuring capital equipment
 - provision of information
 - evaluation and selection of suppliers
 - negotiating with suppliers and contractual conditions
 - coordinating and administering the purchase
 - specific purchased
 - factors to be considered in purchasing capital equipment
 - qualitative considerations
 - quantitative assessment
 - payback period method
 - net present value method
 - internal rate of return method
 - used capital equipment
 - leasing capital equipment
 - types of leasing
 - deciding between leasing and purchasing
 - merits of leasing
-



Study chapter 15 of Hugo & Badenhorst-Weiss (2011), including all figures and diagrams.

GETTING AN OVERVIEW

We regard it as extremely important that you not only understand the theory behind the concepts we explain to you, but also recognise these concepts within real events that occur in the business arena. Once you grasp the academic aspects of capital equipment, you should be able to evaluate the following report with discernment.

Contract awarded for circulating fluidised bed steam generators

By Karishma Thakurdin

Global engineering and construction contractor and power equipment supplier Foster Wheeler reports that a subsidiary of its Global Power Group has been awarded a contract by engineering company Daewoo Engineering for the design and supply of two circulating fluidised-bed (CFB) steam generators for PT Merak Energi.

PT Merak Energi Indonesia is part of a joint venture company that plans to build a coal-fired power plant in Serang, Banten. Its head office will be in Jakarta. The project will cost around \$60 million, including \$2,5 million in equity and the rest in loan capital. The power plant will have the capacity to generate 120 MW of power and 438 000 t of hot steam.

The project, which is located in the Banten province, on the western part of Java Island, in Indonesia, will see the commercial operation of the new steam generators scheduled for the third quarter of 2012.

Foster Wheeler will design and supply the two 60-MWe CFB steam generators and auxiliary equipment, and provide site advisory services for the project. The CFB steam generators will be designed to burn local coal.

"We are pleased to have an opportunity to again demonstrate Foster Wheeler's state-of-the-art CFB technology in Indonesia," says Foster Wheeler Power Group Asia CEO Mark Garvey. "Our CFB technology has proven itself an excellent choice for the clean combustion of coal and other solid fuels."

"We look forward to a successful project, our first milestone collaboration with Foster Wheeler, and hope there will be additional opportunities in the near future," says Merak Energi Indonesia president and director Lokita Prasetya.

Foster Wheeler is delivering technically advanced, reliable facilities and equipment. The company employs about 13 000 talented professionals with specialised expertise dedicated to serving its clients through one of its two primary business groups. The company's Global Engineering & Construction Group designs and constructs processing facilities for the upstream oil and gas, liquefied natural gas and gas-to-liquids, refining, chemicals and petrochemicals, power, environmental, pharmaceuticals, biotechnology and healthcare industries.

The company's Global Power Group is a leader in combustion and steam generation technology that designs, manufactures and erects steam generating and auxiliary equipment for power stations and industrial facilities and also provides a wide range of after-market services. The company is based in Zug, Switzerland, and its operational headquarters office is in Geneva, Switzerland.

Source: <http://www.engineeringnews.co.za/article/contract-awarded-for-circulating-fluidised-bed-steam-generators-2010-09-17>

What did you notice in the article? Did you see that this contract was awarded in a global arena, as discussed in the previous study unit? Did you notice that PT Merak Energi was the buying organisation, and Foster Wheeler the supplier? Did you notice that the project is based in Indonesia at Banten, Java Island, with the head office located in Jakarta, but that the holding company (Global Power Group) is located in Zug, Switzerland? Did you see that Foster Wheeler will not only supply the steam generators, but also provide site advisory services? Did you observe that the project involves a large capital outlay (\$60 000 000)?

Purchasing capital equipment differs considerably from purchasing other goods and services. The emphasis is on purchasing equipment which is used to produce goods or render services.

This study unit focuses on acquiring capital equipment; classifying capital goods by identifying examples thereof; the characteristics of capital equipment; the size and scope of the capital equipment procurement team; and the role of the purchasing and materials function in the purchasing of capital goods. It also explores the factors to be considered when purchasing capital equipment, procuring used capital equipment and capital equipment and leasing.



Study the introduction to chapter 15 of Hugo & Badenhorst-Weiss (2011).

10.1 ACQUIRING CAPITAL EQUIPMENT

As illustrated in the article, capital equipment suppliers must deliver technically advanced, reliable facilities and equipment, and employ talented professionals with specialised expertise who are dedicated to serving their clients, in order to gain mutual competitive advantage.

The prescribed book briefly discusses the acquisition of capital equipment, emphasising its nature (long-term), extent (investment) and its importance from a cost point of view.



Study section 15.1 of Hugo & Badenhorst-Weiss (2011).

10.2 CLASSIFYING CAPITAL EQUIPMENT

Capital equipment includes all equipment that is directly used in the manufacturing process (physical transformation process) and/or the overall running of the enterprise.



Study section 15.2 of Hugo & Badenhorst-Weiss (2011).

Make sure you understand what is meant by capital equipment before you do the following activity:



Activity 10.1

You want to start your own enterprise, under the name of Tiny Tots, which will design and manufacture an exclusive range of kiddies' clothes. To test the product in the market, you decide to put a sample of each range up for sale at the weekly flea market in town for one week.

Make a list of what you regard as essential requirements to manufacture the Tiny Tots products and sell the finished products at the flea market.



Feedback

Did you think of the following? A sewing machine, an overlocker, a work table, fabric, buttons, thread, patterns and a steel rail on which to hang the clothes at the flea market.

You already know the term “production inventory” (chapter 9 in the prescribed book). Study the list carefully and indicate which of these requirements you regard as production inventory. (To refresh your memory: production inventory consists of the raw materials, materials and components an enterprise must reprocess in its production process).

In the case of Tiny Tots children’s wear, fabric, thread, buttons, needles and patterns will be classified as production inventory. What about the other items on the list? They are what we call capital goods. Unlike production materials, capital goods do not form part of the finished product, but are used to manufacture or produce products.

In a manufacturing enterprise you may find the following examples of capital goods: lathes, printing presses, automatic drills, auxiliary equipment like fork cranes, trucks and even administrative auxiliary equipment like office furniture, computers and printers. These goods will be entered as investments on the asset side of the balance sheet. In the case of Tiny Tots, capital goods seem to be rather simple, but are not less important for the type of organisation involved. They include a sewing machine, an overlocker and a work table.

10.3 CHARACTERISTICS OF PURCHASING CAPITAL EQUIPMENT

So, what have you learned so far? You know that capital equipment is defined as an article of nonexpendable, tangible personal property having an anticipated useful life of one year or more and having a considerable unit acquisition cost.



Study section 15.3 of Hugo & Badenhorst-Weiss (2011).

After familiarising yourself with the special characteristics of purchasing capital equipment, try the following activity:



Activity 10.2

Give practical examples of the following characteristics of capital equipment:

- large expenditure
- nonrecurring expenditures
- specialised and technical nature



Feedback

- *Large expenditure. The purchase of fork cranes, trucks, cars and other capital goods is extremely expensive.*

- *Nonrecurring expenditures.* Items like office equipment usually have a long lifespan, so they are purchased at irregular intervals.
- *Specialised and technical nature.* When a photocopier is purchased it has to meet the requirements of all departments, from marketing to production.

Were you able to think of any other characteristics, and practical examples to explain them?

10.4 SIZE AND SCOPE OF THE CAPITAL EQUIPMENT TEAM

The acquisition of capital equipment can often mean the difference between success and failure for a business enterprise. The capital equipment team therefore has an enormous responsibility to provide sustained competitive advantage by effectively meeting the capital equipment need.

They do so by:

- ensuring that the necessary specification is well formulated in terms of cost, environmental responsibility, technology, responsiveness, assurance of supply and quality
- selecting, managing and developing suppliers to be part of the buying organisation's continuous improvement situation and environment
- conducting the negotiations and awarding the business, strongly driven by the supplier's technology capability, financial stability and commitment
- managing the installation and maintenance of the equipment



Study section 15.4 of Hugo & Badenhorst-Weiss (2011).

10.5 THE ROLE OF THE PURCHASING AND SUPPLY MANAGEMENT DEPARTMENT IN PROCURING CAPITAL EQUIPMENT

Purchasing and supply management does not play a dominant role in purchasing capital goods, but can make important inputs in some areas. Purchasing and supply managers usually form part of the team which makes recommendations on these types of acquisition. In purchasing capital goods the role of the purchasing and supply management department is mostly supportive, mainly in the areas of advice and supplier relations. So this department concentrates on cost savings (to reduce investment) which, because of the nature and magnitude of the cost of capital goods purchases, are of vital importance.



Study section 15.5 of Hugo & Badenhorst-Weiss (2011).



Activity 10.3

In your opinion, what role does the purchasing and supply manager play in negotiations for the purchase of capital goods in XYZ (Pty) Ltd? In this enterprise the purchasing and supply manager is one of the line managers, along with the other functional area managers who all report directly to top management.



Feedback

The purchasing and supply management department's role in the purchasing of capital goods is largely supportive, especially in the form of advice and in the field of supplier relations. However, one can identify the special areas where their contribution will be vital. According to the prescribed book, these areas of impact are:

- provision of information
 - evaluation of suppliers and/or tenders
 - negotiations with suppliers
 - coordinating and administering the purchase
 - specific purchase
-

10.6 FACTORS TO BE CONSIDERED IN PURCHASING CAPITAL EQUIPMENT

As the world slowly emerges from one of the toughest recessions in recent history, all business enterprises are searching for ways to invest wisely in capital equipment that positively impacts customer satisfaction and the bottom line. It isn't easy, though, considering a global push to reduce costs and improve outcomes. Regardless of your exact circumstances, you can probably relate to feeling the pinch when it comes to capital equipment purchasing. Now more than ever it is important to make smart decisions during this process in order to save money in the long run.



Study section 15.6 of Hugo & Badenhorst-Weiss (2011).

There are various qualitative and quantitative considerations when purchasing capital goods. Qualitative factors, which are not easily transformed into monetary terms, include the following:

- the reliability of the equipment
- the flexibility of the equipment
- space requirements
- the safety of the equipment
- the effect on the quality of end-products
- the durability of the equipment
- the preferences of different departments

Quantitative factors entail the numerical prediction of the performance of the equipment under consideration. This performance relates to the return on the capital invested in the equipment. The quantitative evaluation of capital equipment can be done by means of:

- the payback period method
- the net present value (NPV) method
- the internal rate of return (IRR) method

Make sure you are able to distinguish between qualitative and quantitative measures, and then do activity 10.4.



Activity 10.4

As the newly appointed purchasing manager of Photofax (Pty) Ltd, you have to buy two new photocopiers for the enterprise. What qualitative factors will influence your choice?



Feedback

Did you consider the following?

- the reliability of the equipment
- its adaptability
- space requirements
- the safety of the equipment
- the quality of the photocopies
- technical and economic lifespan
- maintenance

Last but not least: did you consider the preferences of all the departments in the enterprise? Marketing may want colour photocopies, whereas production may need a photocopier with better magnifying/reduction options. All these factors, which vary from one department to the next, should be considered when purchasing capital goods. Since none of these factors are quantifiable, they are called qualitative considerations in the purchase of capital goods.

10.7 PROCURING USED CAPITAL EQUIPMENT

Obtaining the most value for your organisation does not always require acquiring new capital equipment. An organisation can consider purchasing or leasing pre-owned capital equipment because of cost, return on investment, life cycle, compatibility or operational considerations. The prescribed book lists the precautions to take when considering this choice.



Study section 15.7 of Hugo & Badenhorst-Weiss (2011).

10.8 CAPITAL EQUIPMENT AND LEASING

Is your company's current overriding goal to make its balance sheet look better, polish its income statement or improve its tax situation? These issues will influence its next equipment investment: whether to buy capital equipment, or lease. During the global financial crisis, investment in new equipment has been weak globally because businesses of all sizes have deferred upgrading in favour of making do with existing infrastructure. Similarly, businesses have curtailed expansion plans, seeking instead to preserve profitability or protect their financial position in the face of weak demand for products and services, thus squeezing more out of their existing workers and equipment.

This has the obvious effect of additional wear and tear on existing equipment, hastening its ultimate demise. When combined with the effort to postpone new equipment purchases, it makes it highly likely that the global economy is in a condition of pent-up demand for equipment for both replacement and expansion needs. The renewed increase in equipment investment has favorable ramifications for an economic recovery. But many businesses are opting to lease capital equipment rather than owning it.



Study section 15.8 of Hugo & Badenhorst-Weiss (2011).

This section covers aspects such as:

- types of leasing
- the basis for deciding between leasing and purchasing
- a practical illustration of the choice between leasing and buying
- the relative merits of leasing (including the advantages and disadvantages)



Activity 10.5

Mpumalanga Enterprises urgently needs a casting furnace for production. But since they are a new enterprise that has only been in operation for a short time, they cannot be sure that the demand for cast iron will continue to grow. They currently have a cash-flow problem and also anticipate tax problems. As an experienced buyer, what would you recommend to Mpumalanga Enterprises? Is leasing an option?



Feedback

There are several possible methods, but considering Mpumalanga Enterprises' problems of cash flow and tax, leasing would seem to be a shrewd solution to both problems. Leasing involves the use of a specific fixed asset such as machinery or equipment (e.g. a casting furnace) without actually obtaining ownership of it. The asset remains the property of the lessor, but for its use the lessee pays a regular fixed sum, normally in advance, for a fixed period.

SUMMARY



Please go back to the beginning of this study unit and read the article entitled *Contract awarded for circulating fluidised bed steam generators* by Karishma Thakurdin again.

At first, you would have noticed that many aspects of international purchasing and global sourcing, as discussed in the previous study unit, were covered in the article. Now, using your increased understanding of the acquisition of capital equipment, we can add to those observations.

To summarise: this contract was awarded in a global arena where PT Merak Engineering was the buying organisation and Foster Wheeler the supplier. The project is based in Indonesia at Banten, Java Island, with the head office located in Jakarta, but the holding company (Global Power Group) is located in Zug, Switzerland. Foster Wheeler will not only supply the steam generators, but also provide site advisory services. And as an initial indication that this transaction was concerned with acquiring capital goods, the project involves a large capital outlay of \$60 000 000.

We can now confirm that this is in fact an acquisition of capital equipment based on facts that we understood regarding the nature, classification and special characteristics of purchasing capital equipment. The two circulating fluidised steam generators will be acquired at a considerable investment for long-term use to burn local coal. The purchase involves Foster Wheeler's state-of-the-art technology, delivered by a reliable supplier employing vast numbers of professionals with specialised expertise dedicated to serving its clients.

We can assume that the purchasing and supply management department has an advisory role in purchasing capital equipment focusing on cost reduction and supplier relationship management, and that PT Merak Energi had to take special factors into consideration when purchasing the steam generators, and selecting Foster Wheeler to supply them. We can also assume that PT Merak Energi evaluated their ownership and leasing options carefully, before deciding on spending the \$600 000 000 in equity and loan capital.

The next study unit will help you explore the uniqueness of purchasing services.



ASSESSMENT

Revise chapter 15 in the prescribed book. Once you have done this, answer the following questions:

- (1) Define the term "capital equipment".*
- (2) Classify capital equipment and provide examples of each category.*
- (3) Explain the characteristics of capital equipment.*
- (4) Discuss the size and scope of the procurement team when purchasing capital equipment.*
- (5) Explain the role of purchasing and supply management in the procurement of capital equipment.*
- (6) Explain the factors to be considered when purchasing capital equipment.*
- (7) Explain the principle and methodology of the quantitative assessment of capital equipment.*

- (8) *Explain the procurement of used capital equipment.*
- (9) *Discuss leasing as an option for acquiring capital equipment.*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 15 in your prescribed book.

Study unit 11

PURCHASING SERVICES

CONTENTS

Aim

Study unit learning outcomes

Key concepts

Getting an overview

11.1 Importance of services procurement

11.2 The nature of services: differences between buying services and goods

11.3 Purchasing of services: guidelines and activities

11.4 Purchasing professional services

11.5 Purchasing consultancy services

11.6 Purchasing transport services

Summary

Assessment

AIM

The aim of this study unit is to emphasise the peculiarities associated with purchasing services.



STUDY UNIT LEARNING OUTCOMES

After working through this study unit, you should be able to do the following:

- Explain why the purchasing of services has become so important.
 - Explain the nature of services and the implications for the purchasing process.
 - Suggest a phased approach for services procurement.
 - Discuss the key features of buying professional services.
 - Illustrate and explain the role of supply management in the acquisition of transportation.
 - Explain why outsourcing services is part of the responsibilities of supply management.
-



KEY CONCEPTS

- services procurement
- deregulation of previously government-controlled services
- reduce cost
- e-procurement
- outsourcing

- services are intangible
 - services are heterogeneous
 - simultaneity in services production
 - perishability of services
 - entry into the market
 - guidelines for services procurement
 - clearly defined scope
 - suitable organisational structure
 - allocate sources to supply management relative to the importance of services buying
 - develop a supplier selection procedure
 - performance measurement system for service delivery
 - core activities in services procurement
 - statement of work
 - service-level agreements
 - policy of compliance
 - contract administration
 - purchasing professional services
 - purchasing consultancy services
 - purchasing transport services
-



Study chapter 16 of Hugo & Badenhorst-Weiss (2011), including all figures and diagrams.

GETTING AN OVERVIEW

This module has so far focused on the purchasing and supply issues relating to tangible economic goods. A service is the intangible equivalent of a tangible economic good. Service provision is often an economic activity in which the buyer does not generally, except by exclusive contract, obtain exclusive ownership of the thing purchased. The benefits of such a service, if priced, are held to be self-evident in view of the buyer's willingness to pay for it.

By composing and orchestrating the appropriate level of resources, skill, ingenuity, and experience required to effect specific benefits for service consumers, service providers participate in an economy without the restrictions of carrying stock (inventory) or the need to concern themselves with bulky raw materials. On the other hand, their investment in expertise does require consistent service marketing and upgrading in the face of competition which has equally few physical restrictions. Many so-called services, however, require large physical structures and equipment, and consume large amounts of resources, such as transportation services and the military.

The fact is that buying services differs in many respects from acquiring goods and must be addressed as a separate matter. This study unit focuses on the importance of services procurement; the nature of services; differences between buying services and goods; the

procurement of services; guidelines and activities; and the purchasing of professional services, consultancy services and transport services.



Study the introduction to chapter 16 of Hugo & Badenhorst-Weiss (2011).



Activity 11.1

Define the term “services” in your own words, and give an example to substantiate your answer.



Feedback

The prescribed book defines a service as a process consisting of a series of more or less intangible activities that often take place in interaction between the customer and employees and/or physical resources or goods and/or systems of the service provider, which are provided as solutions to customer problems.

The following is an incomplete list of service industries, grouped into rough sectors. Parenthetical notations indicate how specific occupations and organisations can be regarded as service industries to the extent they provide an intangible service, as opposed to a tangible good.

- *business functions (that apply to all organisations in general)*
 - *consulting*
 - *customer service*
 - *human resources administrators (providing services such as ensuring that employees are paid accurately)*
- *childcare*
- *cleaning, repair and maintenance services*
 - *janitors (who provide cleaning services)*
 - *gardeners*
 - *mechanics*
- *construction*
 - *carpentry*
 - *electricians (offering the service of creating safe and effective wiring)*
 - *plumbing*
- *death care*
 - *coroners (who provide the service of identifying cadavers and determining time and cause of death)*
 - *funeral homes (who prepare corpses for public display, cremation or burial)*
- *dispute resolution and prevention services*
 - *arbitration*
 - *courts of law (who perform the service of dispute resolution backed by the power of the state)*
 - *diplomacy*

- incarceration (provides the service of keeping criminals out of society)
- law enforcement (provides the service of identifying and apprehending criminals)
- lawyers (who perform the services of advocacy and decisionmaking in many dispute resolution and prevention processes)
- mediation
- military (performs the service of protecting the state in disputes with other states)
- negotiation (not really a service, unless one party is negotiating on behalf of another)
- education (institutions offering the services of teaching and access to information)
 - library
 - museum
 - school
- entertainment (when provided live or within a highly specialised facility)
 - gambling
 - movie theatres (providing the service of showing a movie on a big screen)
 - performing arts productions
 - television
- fabric care
 - drycleaning
 - self-service laundry (offering the service of automated fabric cleaning)
- financial services
 - accountancy
 - banks and building societies (offering lending services and safekeeping of money and valuables)
 - real estate
 - stock brokerages
 - tax preparation
- food service industry
- personal grooming
 - hairdressing
 - manicurist / pedicurist
 - body hair removal
 - dental hygienist
- health care (all healthcare professions provide services)
- hospitality industry
- information services
 - data processing
 - database services
 - interpreting
 - translation
- risk management
 - insurance
 - security
- social services

- social work
- transport
- public utility
 - electric power
 - natural gas
 - telecommunications
 - waste management
 - water industry

Source: [http://en.wikipedia.org/wiki/Service_\(economics\)](http://en.wikipedia.org/wiki/Service_(economics)) (accessed on 23 October 2010).

11.1 IMPORTANCE OF SERVICES PROCUREMENT

Various reasons for the increasing importance of services procurement are discussed in the prescribed book, starting with the fact that the service industry is by far the fastest-growing industry in the world.



Study section 16.1 of Hugo & Badenhorst-Weiss (2011).

Can you recall the other five reasons discussed in this section of the prescribed book?

11.2 THE NATURE OF SERVICES: DIFFERENCES BETWEEN BUYING SERVICES AND GOODS

This is an area that still requires a vast amount of research. Some research studies suggest that the processes of purchasing services and goods are identical, but to buyers the differences are real and obvious.



Study section 16.2 of Hugo & Badenhorst-Weiss (2011).



Activity 11.2

Kevin Naidoo is the purchasing and supply manager of Sawubona Bottling in Ladysmith, KwaZulu-Natal. A trip to the local grocery store and a walk down the beverage aisle will reveal dozens of varieties of bottled water produced by this company. Bottled water, often called drinking water, is usually bottled at the source and sealed by the organisation in safe drinking containers.

Bottling water starts at the source. As mentioned above, there are several sources of water: protected underground springs, wells and municipal supplies. The next step is to filter

the water through multibarrier sources, which could include source protections, source monitoring, reverse osmosis, ultraviolet light, distillation, micron filtration and ozonation. Water bottlers may use one or more of those processes. Then they fill the bottle and cap it. Sawubona Bottling uses quite a number of services, and Kevin Naidoo asks you to compile a report in which you identify the characteristics of services.



Feedback

These characteristics are discussed in the above-mentioned section of the prescribed book, and include:

- *services are intangible*
- *services are heterogeneous*
- *simultaneity in services production*
- *services are perishable*
- *entry into the market*

An additional characteristic is

- *Inseparability. The service provider is indispensable for service delivery, as he must generate and render the service promptly to the requesting service consumer. In many cases, the service delivery is executed automatically but in preparation the service provider must assign resources and systems and actively maintain appropriate service delivery readiness and capabilities. Additionally, the service consumer is inseparable from service delivery because he/she is involved in it from the initial request up to consuming the benefits rendered.*
-

11.3 PURCHASING OF SERVICES: GUIDELINES AND ACTIVITIES

If you're not purchasing services yet, you probably will in the future so don't disregard this section! There are unique pitfalls to purchasing services, such as not having services finished by the date you expect, having a problematic "customer review" or not getting a good response from your supplier. You may just sidestep these drawbacks by understanding the following guidelines for purchasing services as discussed in the prescribed book:

- have a clearly defined scope
- establish a suitable organisational structure
- allocate resources to supply management relative to the importance of services buying
- develop a procedure for supplier selection and supply base
- develop a performance measurement system for service delivery

The core activities in services procurement are:

- Phase 1 – Data collection (sourcing process; deciding on a procurement structure; drafting the statement of work (SOW))
- Phase 2 – Actual procurement (negotiations, contract development (service-level agreements) and performance instruments)
- Phase 3 – Implementation phase (a policy of compliance and contract administration)



11.4 PURCHASING PROFESSIONAL SERVICES

Earlier in the module we established that more and more organisations are focusing on their core competencies, and outsourcing or subcontracting the other activities. It therefore stands to reason that the purchasing of professional services is also on the increase, because a large number of smaller organisations are specialising in certain activities that are normally regarded as nonessential by larger buying organisations.



11.5 PURCHASING CONSULTANCY SERVICES

We have all heard our fair share of jokes about consultants, but in truth they are laughing all the way to the bank! Consultants generally specialise in a particular area. They may be good at solving problems or doing research or exploring alternatives. Consultants usually work on contract – they sell their knowledge or services for a fee. Professional consultants can bring new ideas to projects, and your organisation can often learn from working with them.

How do consultants work? The two general approaches are the knowledge approach and the people approach. It's important to choose a consultant who uses an approach that fits with how you want the job done. If a consulting job doesn't work out for the client, the problem could be that the wrong consultant was chosen. One of the problems may be that the consultant's approach might not have been suited to the job.

- The knowledge approach: Consultants who use this approach work for you – not with you. Hire an expert if you just want to get a job done as quickly as possible and there's no need to involve the community. This approach is suitable for straightforward, technical jobs such as designing a computerised accounting system or membership database.
- The people approach: Consultants using the people approach tend to work with you, not just for you. Communities are leaning toward hiring consultants who use this style. The reason is that when a consultant works with you and the community, you have a chance to learn something. If you hire a people-type consultant, he/she will probably work with the people in the organisation to decide what research should be done and then train them to do the work.

In summary, the approaches used by consultants have a great impact on the purchasing decision: use the knowledge approach for one-time technical jobs that one or two consultants can do efficiently working alone, and use the people approach when the organisation should become involved in a project that affects it in whole or in part.

Source: <http://www.omafr.gov.on.ca/english/rural/facts/98-053.htm> (accessed on 23 October 2010).



You can familiarise yourself with the following areas within the procurement of consultancy services:

- purchasing legal services
- purchasing advertising
- purchasing temporary personnel services

11.6 PURCHASING TRANSPORT SERVICES

Transport services are the means of moving physical goods and labour within and across countries. The transport sector impacts directly on the cost of trade, both internally and externally. A less costly and efficient transport system increases opportunities for trade and specialisation, which in turn will improve the welfare of South Africans.

Purchasing such transport services can lead to the increased competitive advantage or the failure of an organisation, as it is often the determining factor in the proficiency in cost management. The acquisition of this service is discussed in the prescribed book under the following headings:

- considerations in purchasing transport services
- decisions regarding mode of transport
- decisions regarding carrier selection



Activity 11.3

In activity 11.2 we established that Sawubona Bottling in Ladysmith, KwaZulu-Natal delivers dozens of varieties of bottled water produced by this company to various retail outlets. Often, the retailers will enter into a contract with a transport company to carry the bottled water from the bottling company to the retail stores. It is significant to note that these products are also distributed internationally. Outline the impact of purchasing transport services on retailers such as these.



Feedback

These retail businesses may blame lost profits on soaring fuel costs, but they can also point the finger at themselves for managing their transport carriers poorly, according to a benchmark report by the Supply Chain Consortium. The survey, which polled 100 retailers and retail suppliers, found that nearly one-third were off-target concerning their carrier transport rates.

For example, 82% of ocean shippers report that their rates are better than other shippers with similar volume and service requirements. Because only 50% of shippers can realistically have better-than-average rates, this means 32% of those asked were overly optimistic about their sourcing successes.

The retailers should take on board the following tips in order to bid, negotiate and manage their carrier bases more effectively:

- *Bid methodologies should be flexible and offer carriers the opportunity to propose solutions that best fit their capabilities and network.*
- *Collect the data carriers need to aggressively bid on your freight. Leverage the characteristics of your freight that are attractive to carriers.*
- *Build trust relationships with carriers. For incumbent carriers, measure performance in an open and equitable fashion.*
- *Understand that shippers achieve higher levels of service and better supply-chain integration by focusing on core carrier programmes.*
- *Keep in mind that ocean and air transportation pose unique challenges for developing trust in carrier relationships.*

Source: <http://tradeinservices.mofcom.gov.cn/en/f/2008-01-30/23235.shtml> (accessed on 25 October 2010).

SUMMARY



Read the case study “Purchasing catering services for Nuclear Research Africa” at the end of chapter 16 in Hugo & Badenhorst-Weiss (2011), and attempt to answer the questions.

Purchasing services of various types affords supply management the opportunity to develop new applications for existing skills, to develop new skills for applications previously unknown to purchasing and supply management and to prove conclusively that purchasing and supply management is a functional area that has adapted well to the challenges of a global environment.

Clearly, much research is still required before service buying can be fully understood. At the same time it is obvious that training in new skills and the ability to break out of the functional silo of purchasing and supply management are absolute prerequisites if purchasing and supply experts are to play a role in purchasing services.

There is no doubt that change in the domestic and global business environment, which emphasised the importance of the service-oriented economy, now affords purchasing and supply management an opportunity to play an increasingly important role in the overall strategy of business organisations.

Another important strategy business organisations employ to improve the local economy is purchasing from small business. We take a closer look at this phenomenon in the next study unit.



ASSESSMENT

Revise chapter 16 in the prescribed book. Once you have done this, answer the following questions:

- (1) Define the term “small business” in your own words.*
- (2) Explain why the purchasing of services has become so important.*
- (3) Explain the nature of services and the implications for the purchasing process.*
- (4) Suggest a phased approach for services procurement.*
- (5) Discuss the key features of buying professional services.*
- (6) Illustrate and explain the role of supply management in the acquisition of transportation.*
- (7) Explain why outsourcing services is part of the responsibilities of supply management.*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 16 in your prescribed book.

Study unit 12

PURCHASING FROM SMALL BUSINESSES: A FOCUS ON BLACK ECONOMIC EMPOWERMENT

CONTENTS

Aim

Study unit learning outcomes

Key concepts

Getting an overview

12.1 Defining small business

12.2 Justification for purchasing from disadvantaged small businesses

12.3 Problems with disadvantaged small business purchasing programmes

12.4 Implementing a corporate small business purchasing programme

Summary

Assessment

AIM

The aim of this study unit is to target purchasing from small businesses with a focus on black economic empowerment.



STUDY UNIT LEARNING OUTCOMES

After working through this study unit, you should be able to do the following:

- Define small business.
- Justify the use of small suppliers from a global point of view in the face of government pressure and initiatives.
- Justify the use of small suppliers from a South African point of view in the face of government pressure and initiatives.
- Justify the use of small suppliers from a business-related perspective.
- Clarify the challenges encountered by the roleplayers in the disadvantaged small business purchasing programmes.
- Develop and implement a plan to manage a small business purchasing programme (substantiate your answer with an example).



KEY CONCEPTS

- small and medium businesses
- targeted procurement
- black economic empowerment (BEE)

- broad-based black economic empowerment (BBBEEE)
- Black Economic Empowerment Sector Charter
- National Small Business Amendment Act 26 of 2003
- disadvantaged small businesses
- small business purchasing programmes
- global overview of small business
- South African history of government initiatives and pressures
- social adjustments and changing demographics
- supply management paradigms
- management attitude
- problems with disadvantaged small business purchasing programmes
- communication
- availability of information and suppliers
- transaction costs
- conflicting policies influencing the purchaser
- objections and attitudes of purchasers
- financial instability
- lack of experience
- cost
- location
- welfare perception
- risk
- dependency
- reverse discrimination
- tracing and development
- poor performance
- implementing a corporate small business purchasing programme
- goal and mission of the organisation
- origin of the idea and purpose of the programme
- systematic approach to implementing a corporate small business purchasing programme
- senior management commitment
- planning
- Black Economic Empowerment Legislative Network
- the Constitution
- Preferential Procurement Policy Framework Act 5 of 2000
- Competition Act
- National Small Business Act 102 of 1996
- Employment Equity Act
- Skills Development Act
- Broad-Based Black Economic Empowerment Act 53 of 2003
- Codes of Good Practice
- Competitive Supplier Development Programme (CSDP)
- establish objectives
- formulate policy
- plan resources
- orientation of staff
- quotation of suppliers
- organisation of the small business purchasing programme
- publicity
- supplier selection
- control of small suppliers



GETTING AN OVERVIEW

Larger, financially strong enterprises operating within South Africa no longer have a choice concerning their involvement in the development of the country's disadvantaged communities.

Few South African purchasing and supply experts will not have heard about one of the best possible ways of achieving this objective – to purchase from small businesses in disadvantaged communities. However, purchasing from such enterprises may be complicated for the enterprise doing the purchasing and for the buyer in particular. This is not a decision and strategy that can be applied and immediately pay dividends. It requires careful planning, research, adjustment of procedures and, especially, changes in traditional ways of thinking in the enterprise.



Several of South Africa's large organisations are already on board with this initiative, and have been for some time. Read this statement published on Telkom's Website in 2003:

Telkom is considering having an independent impact study conducted on its Black Economic Empowerment initiative to ensure that it adequately addresses the company's strategic approach to BEE. Telkom's BEE strategy is aimed at empowering the larger demographics of South Africa, thereby creating a market for Telkom to trade in. ... Since it started actively measuring its BEE spend on black suppliers as a percentage of procurement spend targeted at 6% in 1997, Telkom has seen an increase in its actual BEE spend as a measure of total procurement spend to 24% in the financial year ending March 2003.

This represents close to R19 billion which Telkom has spent to meet its empowerment objective since 1997. ... Craddock said Telkom had provided various channels to black suppliers to take advantage of business opportunities in Telkom. These include accessing opportunities through set aside businesses and tender information, which is posted in the weekly Telkom Tender bulletin.

"Telkom encourages black suppliers to assess their core business to enable them to have a more focused approach when coming to Telkom to discuss business opportunities," said Craddock. This puts Telkom in a stronger position to identify opportunities that reside with some of its more traditional and significant suppliers that have contracted BEE commitment plans with Telkom.

Through these BEE commitment plans, Telkom will endeavour to introduce black suppliers to its traditional and significant suppliers for possible business ventures. "These commitment plans include, among others, addressing issues of equity ownership, affirmative procurement and sub-contracting," said Craddock. "Telkom's 'Business Eco-system' is designed as a value added proposition for long-term sustainability that collectively draws from opportunities within Telkom and its diverse supplier base," said Craddock. As part of its business eco-system, Telkom

believes that without corporate and private customers, Telkom does not have a market, and without big business like Telkom, there will be no facilitation.

"Without significant and traditional suppliers, there will be no catalyst to support transformation, and without black SME's and larger black suppliers, there will be no transformation. Addressing BEE requires an all-inclusive approach," said Craddock.

Telkom recognises that without enablers in the form of capacity building initiatives such as set aside business for black suppliers, price preferences and training that is aimed at assuring transformation in the areas of fiscal discipline, commercial competence and business acumen, there is no means to assure transformation.

Source: http://www.telkom.co.za/common/aboutus/mediacentre/pressrelease/articles/article_598.html (accessed on 20 October 2010).

The purpose of this study unit is to provide background on the contemporary purchasing and supply management question of purchasing from small businesses, justifying the action from a global point of view in the face of government pressure and initiatives; a South African point of view in the face of government pressure and initiatives; and from a business-related perspective. We will then clarify the challenges encountered by the role players in the disadvantaged small business purchasing programmes, and develop and implement a plan to manage a small business purchasing programme.



Study the introduction to chapter 17 of Hugo & Badenhorst-Weiss (2011).

12.1 DEFINING SMALL BUSINESS

The prescribed book includes the definition used in the National Small Business Amendment Act 26 of 2003. Do you agree with the definition?



Study section 17.1 of Hugo & Badenhorst-Weiss (2011).

12.2 JUSTIFICATION FOR PURCHASING FROM DISADVANTAGED SMALL BUSINESSES



Study section 17.2 of Hugo & Badenhorst-Weiss (2011).

12.2.1 Global overview

Buying from small business in order to obtain a certain economic or social objective is a global phenomenon, although perhaps not as regulated in other countries as is currently the case in South Africa.

12.2.2 South Africa: history of government initiatives and pressures

The focus now shifts to South Africa and the guiding role that the government, as the largest spender in the country, plays in ensuring supplier development through the employment of preferential procurement practices. Although you will not be examined on this it is important to understand the development of the Competitive Supplier Development Programme (CSDP).



Background to the Competitive Supplier Development Programme (CSDP) – For 15 to 20 years, from 1985, there was extremely limited capital investment by Eskom and Transnet. In the absence of sustained national demand, there was a virtual collapse of supplier industries relevant to energy, rail and port infrastructure. ...

Given this context, when Eskom and Transnet announced their first major capital investment programmes in 2004/5, the Department of Public Enterprises (DPE), with the Industrial Development Corporation (IDC), modeled the impact of the build programme on the national economy and on manufacturing, in particular.

This modeling exercise, which was shared across government and industry, suggested that, given existing industry capacity and capability, about 40% of the build programme would need to be imported. This created both a security-of-supply problem for the state-owned enterprises particularly in the context of a then overheated global market, and a balance of payments problem at a macroeconomic level.

The existing policy to leverage procurement, the National Industrial Participation Programme (NIPP), was comprehensively reviewed. The NIPP is a programme whereby, when any goods worth over \$10-million are imported as part of public-sector procurement, the supplier is obligated to invest in South Africa or procure for export the equivalent of 30% of the value of the imports. The obligation takes the form of a contract between the supplier and the Department of Trade and Industry (DTI).

Some of these contracts are entered into before and some of them are entered into after the tender has been awarded by the purchasing public-sector organisation. There is direct national industrial participation where the supplier has to invest or procure from the industry in which the goods are supplied and there is indirect national industrial participation where the supplier has to invest in any industry other than where the goods are supplied.

Should the supplier fail to fulfill this obligation, then the supplier is subject to a penalty of 5% of the 30% obligation, that is, 1,5% of the value of the imported goods. Consequently, the real force behind the NIPP is one of moral suasion, as the penalty of 1,5% of the value of the imported component of the deal is not particularly meaningful (and is often built into the price given by suppliers as a risk mitigation mechanism).

The NIPP was found to be an inappropriate instrument to achieve state-owned enterprises supplier development aims because of the following reasons:

- *The key challenge is to make the procuring organisation both responsible and accountable for developing suppliers and decreasing imports. The NIPP, which is a contract between the DTI and the supplier, effectively absolved the procuring organisation of any responsibility for importing on the grounds that fulfillment of NIPP requirements would make the import acceptable.*

- The DPE wanted suppliers to compete with respect to who could make the best industrial development proposal as part of what differentiated them in the tender, rather than as a separate process that happens between the supplier and the DTI – competition, the DPE believed, would result in better proposals.
- The DPE wanted the process to result in the strengthening of the state-owned enterprises supply chain in areas of strategic importance to the State-owned enterprises. The NIPP, as it currently stands, is indirect and, consequently, prevents suppliers from investing in the supply chain directly relevant to the tender.
- The DPE wanted to accelerate the development of the national supply chain by making national supplier development an integral aspect of the tender, hence the resulting contractual obligation with significant penalties should the supplier fail to deliver – in the NIPP, the supplier has seven years to fulfill the obligation, with an effective 1,5% of the imported content as a penalty for non-fulfillment.
- The DPE's analysis of successful fast-industrialised countries, such as Korea, suggested that they focused on effective and direct procurement leverage (alongside other industry development and, in some cases, protective measures), rather than industrial participation programmes. Consequently, we wanted to put focus on learning to procure developmentally and effectively, rather than having substitute measures that distracted from this goal.

The DPE embarked on a process to design a tailor-made strategy to develop national suppliers and decrease imports. The strategy development process took the form of numerous workshops, interviews and surveys with suppliers and with the state-owned enterprises, as well as research into international comparators. The University of the Witwatersrand and independent consultants also conducted research and provided their own assessments of the state of supplier industries and areas for localisation.

The research found the following:

- Price premiums for “local content” needed to be used extremely carefully, as they would push up Eskom’s and Transnet’s prices for energy or logistics (thus crowding out investment among their customers) as well as result in local suppliers inflating prices because they could, not because it reflected the true costs of production.
- As a rule, where capacity and capabilities existed in South Africa, the state-owned enterprises were overwhelmingly procuring nationally. On those occasions where this did not happen, it was a result of bad communication or historical conflicts between state-owned enterprises and national suppliers, unnecessarily restrictive technical specifications and quality problems with national producers.
- Much of the opportunity for leveraging procurement was identified in the area of intermediate manufacturing capabilities, where local suppliers would invest in the required capability, provided they were given some demand certainty. This required the state-owned enterprises to procure differently in both leveraging relationships with original-equipment manufacturers (OEMs) to access technologies, processes and additional markets and establishing longer-term relationships with national suppliers.
- An additional opportunity was identified for leveraging procurement in the development of more advanced manufacturing capabilities. However, because of the risk profile associated with these investments, a range of coordinated government investments in skills, technologies and infrastructure would be required, alongside a stable demand platform to make investments in these capabilities viable. Consequently, the state-owned enterprises could not be held singularly accountable for the development of advanced capabilities.

It was in this context that the CSDP was developed, with the aim of promoting investment in, and enhancing the competitiveness of, state-owned enterprises supplier industries. Core to the programme was making the State-owned enterprises accountable for the way they procured – consequently, the first pillar of the programme was to require that the state-owned

enterprises produce a strategic Supplier Development Plan (SDP) based on a bottom-up analysis of expenditure, the state of the national supplier industry and where opportunities for industry development are located. The plan needed to embody targets for increasing investment and national value-add as a portion of the procurement programme. As is the case with all business plans produced by state-owned enterprises, they could be held responsible for delivery, as the targets were based on a management assessment of what is achievable. In contrast, it is not possible to hold an organisation accountable for an imposed, top-down target that is not necessarily based on detailed data and rigorous analysis. Both Eskom and Transnet developed and published detailed SDPs during 2008. The focus of Eskom's plan is on the development of intermediate industrial capabilities, as the bulk of shallow-capability-related requirements are already being procured in South Africa and intermediate capabilities is where strategic procurement can have the most impact.

While the CSDP is still in its early stages of development, significant progress has been made at Eskom, with over R1-billion having been invested in local equipment manufacturing capacity, 2 000 artisans and 125 specialists being trained by turbine and boiler suppliers at Medupi and Kusile, permanent specialist training facilities being established, and a range of additional investments being negotiated with other suppliers of plant and equipment, such as switchgear and cabling.

It is important to appreciate that, during the period of minimal investment, between 1985 and 2004, the state-owned enterprises all but lost their capacity for complex capital procurement – assuming the experience of procuring capital goods during the apartheid era provided any value to procuring during a non-sanctions era. How capital procurements are structured and scoped will profoundly impact on the contribution of national industry, not just to the manufacture of the initial system, but also to its ongoing maintenance. In order to build its capability, so that it could optimally implement a supplier development programme, Transnet launched a comprehensive procurement capability building programme. Core to the programme is an ambitious procurement skills development programme that is being run in partnership with the Chartered Institute of Procurement, in the UK. Currently, 235 learners are registered in courses under the programme, while 12 people have already achieved a fast-tracked globally recognised honours degree in procurement from the programme.

In addition, Transnet launched the Rail and Harbour Supplier Association to facilitate structured communication between the state-owned enterprises and its supplier community. Through the association, and in partnership with the United Nations Industrial Development Organisation, Transnet has also established a benchmarking programme of its top 20 tier-2 South African suppliers and the top 60 tier-3 suppliers. The aim is to enhance the competitiveness of these suppliers and position them as key components of Transnet's OEM supply chain. So far, 18 suppliers have been benchmarked. Transnet's SDP has identified port equipment and rolling stock as the key focus areas. The locomotive procurement, for example, has been designed to optimise the participation of national suppliers throughout the life cycle of the equipment – concrete information will be available once the tender is awarded in the coming two months.

Transnet's revenues have been significantly affected by the drastic downturn in international trade associated with the global financial crisis. This has resulted in activities being cut back and a concurrent lower-level demand for spare parts. In the short term, Transnet is working with the IDC to provide a rescue package to key suppliers where required, on the back of a Transnet commitment to procure from these suppliers as soon as revenues recover.

In conclusion, procurement planning and execution are the key transmission mechanisms that translate government and state-owned enterprises expenditure into an attractive and sustainable investment climate for suppliers. Unless we build national procurement capability

in state-owned enterprises, government and the private sector, we will not achieve a stable national demand platform on which an export-orientated manufacturing sector can emerge. No offset programme, indirect or otherwise, can substitute for this.

State-owned enterprises investments make up less than half of all government capital investment. Yet, at this point, through the CSDP, the state-owned enterprises are the only organs of government that are being encouraged and held accountable for developing their national supply chains and decreasing imports. This does not mean that the performance of the state-owned enterprises in this regard is remotely adequate – while some progress has been made, the State-owned enterprises have just embarked on a long journey of learning what world-class procurement and supplier development mean. Yet many parts of government have not even left the station. A range of procurements are taking place, such as the Gautrain and the Rapid Passenger Transit System, around which significant investment can be leveraged and capabilities built. In addition, it is in the interests of the private sector to develop its national supply chain – outside the automotive sector, there is limited commitment from the private sector to do this. Surely, it is time for a national campaign to remedy this situation.

Source: <http://www.polity.org.za/article/xxxx-2009-05-29> (accessed on 25 October 2010).

12.2.3 Business-related considerations

Business-related considerations to be taken into account when a buying organisation purposefully focuses their spending on small businesses are covered under three sub-headings in your prescribed text:

- social adjustments and changing demographics
- supply chain paradigms
- management attitude

Of course, another important reason is the rationalisation of the enterprise's activities and the outsourcing of noncore functions or processes to other enterprises, mostly small businesses.



Activity 12.1

Why should purchasing from small businesses not be regarded only as a social responsibility?



Feedback

The reason is simply that the purchase of requirements from small businesses should be for commercial reasons. In the long term, no business can afford to support ineffective suppliers.

12.3 PROBLEMS WITH DISADVANTAGED SMALL BUSINESS PURCHASING PROGRAMMES

Unfortunately, small business purchasing programmes often fail because various problems are experienced. A purchasing enterprise must be aware of possible problems and anticipate them in the planning and implementation of their proposed plans:

- communication with small suppliers
- availability of information and small suppliers
- transaction costs
- conflicting policies influencing the purchaser
- objections and attitudes of purchasers (including financial instability, lack of experience, cost, location, welfare perception, risk, dependency, reverse discrimination, tracing and development and poor performance)



Study section 17.3 of Hugo & Badenhorst-Weiss (2011).

Ensure that you understand the problems explained in this section. Knowing what you are up against can lead to a better considered plan and great chance of successful implementation.



Activity 12.2

Discuss in detail the problems an enterprise may experience when purchasing from disadvantaged suppliers.



Feedback

In the first part of the activity, you were required to make a comprehensive summary of section 17.3 in your prescribed book. This type of question could be worth 20 marks in the examination.

12.4 IMPLEMENTING A CORPORATE SMALL BUSINESS PURCHASING PROGRAMME



Study section 17.4 of Hugo & Badenhorst-Weiss (2011).

South African organisations have become increasingly aware of current legislation concerning BEEs. It is common knowledge that in that in order to conduct business with “organs of the state”, organisations need to comply with their procurement policies. One of the ways in which this can be achieved is for the supply company to have a Small Business Purchasing Policy and programme incorporating elements of the Broad-Based

Black Economic Empowerment concept. As a result many leading companies in South Africa have included a programme for purchasing from small businesses as a key issue in their strategic planning process.

As purchasing from small business enterprises goes hand in hand with so many problems and changes in the enterprise, it is important to tackle and implement it systematically. The prescribed book proposes a systematic programme. The following steps are suggested and depicted schematically in Figure 17.2:

- the organisation's goal and mission
- the origin of the idea and the purpose of the small business purchasing programme
- top management's commitment
- the planning of the programme, which includes analysing BEE legislation, BEE status of all current and new suppliers and identifying suitable products and services, establishing objectives, formulating the policy and planning resources
- the orientation of staff and suppliers
- organisation of the small business purchasing programme
- the publicity surrounding the programme
- the selection of small suppliers, including obtaining sources of information, identifying possible small suppliers, assessing possible small suppliers, maintaining supplier relations and developing small suppliers
- control of small suppliers



Activity 12.3

Carefully explain each of the steps when implementing a corporate disadvantaged small business purchasing programme. Use an example to substantiate your answer.



Feedback

You will find the theoretical part of the answer in section 17.4 and Figure 17.2 in the prescribed book. Now that you have the outline of your answer, read the following article and incorporate the relevant sections as a practical view to the successful execution and completion of small business development and purchasing programmes.

Effective tool for change

By Sven Lünsche

Eskom's procurement policy sets the standard for the public sector and many private-sector companies – Eskom's black economic empowerment (BEE) strategy and affirmative procurement spending is the most powerful among the country's public-sector corporations. Over the past seven years the utility has spend more than R27bn with BEE companies, much of this with 9 000 small and medium-sized enterprises (SMEs). Last year affirmative procurement totaled R7,9bn.

Some of the world's largest industrial companies have been persuaded to sell part of their SA operations' equity to BEE firms to remain suppliers to Eskom. These include Germany's Siemens; ABB, a Swiss-Swedish engineering group; and France's Alstom. Eskom's procurement spending is an effective tool for change.

Yet this programme started out with a small R500 000 initiative in 1994, with the aim of giving a few black women the contract to make half of Eskom's protective clothing. "It was a slog," recalls Eskom commercial GM Reuben Mamorare, who was involved in setting up the programme, and who now oversees the utility's procurement spending.

He faced resistance from some Eskom managers, who were worried about the quality of the clothing delivered by the black suppliers. Eskom's traditional contractors were obviously not pleased and bought up most of the material from the material suppliers to make it difficult for the black operators to meet schedules. "We kept intervening for more than nine months to get the programme to work. But it was a learning experience and four of the original seven suppliers have expanded and are still operating," says Mamorare. Crucially, he had the backing of the Eskom council and senior management, particularly then-CEO Allan Morgan.

In 1995 the programme was formalised under the corporate commercial division, with the aim of developing and supporting emerging black entrepreneurs. Eskom's electrification programme presented the next opportunity for Mamorare and his team to implement the strategy. Eskom was given the task of connecting 1,75m homes in five years, so with subcontractor ABB it trained and established teams of residents in villages and townships to implement house connections. Eskom also began encouraging some of the subcontractors who supplied the electrical equipment to team up with black partners.

Mamorare approached all Eskom divisions to explain the benefits of the programme. "It wasn't easy because many of the white managers at the time were conservative and reluctant to change old processes. However, after some early resistance they bought into it and are now committed to the programme," he says.

Eskom's affirmative procurement policy has become increasingly sophisticated and now sets the standard for the public sector and many private-sector companies. In 1995 Eskom spent R15m with BEE suppliers; today that figure is about R8bn. Mamorare says that in the 2004 financial year Eskom spent 52% of its discretionary spending – spending on all contracts excluding those on primary energy (coal, water and nuclear fuel) – with BEE companies; 60% of affirmative spending is with SMEs. This amounts to more than R5bn of the discretionary spending bill. In addition 38% of all coal – worth about R2,5bn – is now procured from black-owned coal miners such as Eyesizwe.

Eskom's procurement policies have been widened to promote black women entrepreneurs, with almost R800m having been spent in 2004 to facilitate their participation in the programme. "Along with our effort to help SMEs, we have a strong bias towards black women-owned businesses," says Mamorare.

With a supplier base of more than 40 000 companies – of which about half are active suppliers – Eskom has had to introduce mechanisms and processes to ensure that no fronting takes place and that vendors meet small-business and BEE criteria. They must provide Eskom with a statement of their empowerment performance on ownership, control, employee statistics and their own procurement using a points system. Eskom often compels contractors to use black subcontractors.

"All vendors must meet our criteria and we do random checking to ensure they have given the correct information," Mamorare says. Many of the vendor requirements used by Eskom have formed the basis of government's balanced scorecard approach, he says.

SMEs are defined as companies with a turnover of less than R25m, and Eskom insists that they are at least 50% owned by black firms or individuals who actively participate in the running of the company. Eskom provides these companies with supplier support, including tendering

guidelines, special payment terms and price matching. Eskom insists that larger firms have a BEE ownership of at least 10%, a strong black management presence, extensive socioeconomic programmes and that they procure goods from black suppliers.

The initiative has affected Eskom's SA supplier base as well as multinationals, says BusinessMap consultant Fiona Thomson. In an assessment of Eskom's procurement policies in 2003, Thomson says the dominance of Eskom in the energy industry compelled large global engineering firms to meet the utility's BEE standards.

In 2002 ABB sold 20% of its SA operation to black women's group Wiphold as a strategy to win public-sector contracts. France's Alstom went further, selling 42% of its R2bn-plus SA business to two empowerment groups. Siemens, previously part-owned by the Industrial Development Corp, has sold a 26% stake to BEE companies. However, Mamorare says Eskom assisted these large groups to meet the BEE criteria because it would have been impossible to substitute the products and services of these multinationals with local ones. "Almost 60% of our discretionary spend is with these large industrial companies and with most of them we have had a successful long-term partnership. Substituting them was not in our interests and would have led to significantly higher costs," he says.

Source: <http://free.financialmail.co.za/projects05/topempowerment/stories/zzjbee.htm> (accessed on 25 October 2010).

SUMMARY



Read the case study "De Beers Consolidated Mines" at the end of chapter 17 in Hugo & Badenhorst-Weiss (2011).

Successful purchasing from small businesses with the focus on black economic empowerment is only possible if: buyers in large enterprises take the initiative and identify and consider different possibilities; buyers anticipate the problems that are often experienced in purchasing from small businesses; and it is carefully planned and systematically implemented in the form of a small business purchasing programme.

This study unit provided you with the knowledge to adhere to the above principles when planning and implementing a small business purchasing programme with the particular focus on black economic empowerment.



ASSESSMENT

Revise chapter 17 in the prescribed book. Once you have done this, do the following questions:

- (1) Define the term "small business" in your own words.
- (2) Justify the use of small suppliers from a global point of view in the face of government pressure and initiatives, and from a business-related perspective.
- (3) Briefly explain the problems that organisations face with small disadvantaged business purchasing programmes.

- (4) *Illustrate the implementation process of a small business purchasing programme. Use an example to justify your answer.*

For your own enrichment, ensure that you also attempt the self-evaluation and multiple-choice questions at the end of chapter 17 in your prescribed book.

This brings us to the end of the contents of the module, Purchasing (MNP2601). We hope you found the module interesting and informative. We urge you to keep up to date by consulting websites containing information on the subject and discussing burning issues with experts in the field. Good luck with your purchasing and supply endeavours!
