**CHAPTER 8 PURCHASING PRICE DETERMINATION AND COST ANALYSIS PG133**

**LEARNING OUTCOME 1- EXPLAIN WHY PURCHASE PRICES ARE IMPORTANT**

Purchase prices are important because they 1) act as an element of value, the difference between the benefits the customer perceives minus the total cost to acquire those benefits. 2) Determining the right price, a right price is a price that is fair and reasonable to both the buyer and the seller or supplier and in general a fair price should be in reasonable proportion to the total costs of the supplier and include a provision for profit, the price should be determined by the supplier and the buyer in a collaborative effort in finding the required value and the price must be determined by active competition in a competitive market. 3)Competitive prices-purchasing price shld also be competitive to allow long term profitability

**LEARNING OUTCOME 2 – DISCUSS THE VARIOUS COST ELEMENTS**

**Costs –are refers to an average cost for raw material over a long period of time ,direct labour costs and estimated volume of production over a period of time on which the distribution overhead is based. There are two main types of costs which are DIRECT COSTS which normally constitute the major proportion of a product and are tied directly to the production of a product and INDIRECT COSTS which are those costs which are indirectly tied to the level of operations eg the office lease payments and staff salaries**

**1-direct costs of materials – they are consumed or converted during the production process. Direct materials are easily identified in the final product.**

**2-direct labour costs – generally some products/services are generally labour intensive unlike others and issues like labour hours and wage rate are of importance.The purchasing function is to determine the number and nature of labour hours needed to manufacture a product.**

**3 –indirect costs – (also known as overheads) these are costs of a product that are not direct labour or materials eg electricity, cleaning materials**

**4-profit mark up – the profit mark up is not a cost element for the supplier but for the purchaser which the purchaser should understand very well. The purchaser shld understand the production costs incurred by the supplier, the risk run by the supplier,the quantity purchased , the technological skills involved and the balance between supply and demand factors in a particular market all of which will constitute the supplier mark up price.**

**LEARNING OUTCOME 3 BRIEFLY EXPLAIN THE BEHAVIOUR OF COST RELATED TO VOLUMES**

**it is important that the purchaser understands how the various costs elements change in relation to larger or smaller volumes since this info will help in negotiating the ultimate price. There are 3 categories of costs which are 1)TOTAL FIXED COSTS – they remain the same no matter how many products are manufactured or marketed during a certain period 2)TOTAL VARIABLE COSTS-they increase as total production quantities increase but the cost per product remain the same no matter how many products are produced eg direct labour costs and direct materials cost 3)SEMI VARIABLE COSTS –they have both fixed and variable elements**

**LEARNING OUTCOME 4 DIFFERENTIATE BETWEEN THE DIFFERENT MARKET FORMS**

|  |  |  |  |
| --- | --- | --- | --- |
| **Sellers active in the market (suppliers)** | **Buyers active in the market (purchasers)** | | |
| **Many** | **Few** | **One** |
| Many | Pure Competition | Oligopoly | Monopsony |
| Few | Oligopoly | Oligopsonistic Oligopoly | Quasi-monopoly |
| One | Monopoly | Quasi-monopoly | Bilateral monopoly |

**LEARNING OUTCOME 5 EXPLAIN PRICE DETERMINATION FOR DIFFERENT TYPES OF PRODUCTS**

**The type of purchase or the type of product being purchased determine the price. Pricing method should therefore be adopted to the following product categories**

**RAW MATERIALS- such copper,wheat and crude oil which are bought on world commodity markets and require special skills of commodity purchasers or commodity brokers,Usually prices are fixed in these markets 2)SPECIAL ITEMS these items are specific to an organisation’s activities and are of non repetitive nature eg equipment 3)STANDARD PRODUCTION ITEMS – they constitute majority of items purchased by most purchasing divisions and there is use of catalogoues and published prices. 4) ITEMS OF SMALL VALUE – Items in this category have such small comparative value that the expenditure of any particular effort to check the price prior to purchase is not justified. 5) CAPITAL GOODS – price determination for capital goods is a complicated process and is usually performed by management team since it has major financial implications for the firm. 6)SERVICES - if it is a general type of service such as catering or cleaning,quotations must be submitted and tenders too. 7)ITEMS FOR RESALE – Prices are largely influenced by what prices the market will be willing to buy . unique purchasing and pricing methods are used by shops like pick and pay**

**LEARNING OUTCOME 6 EXPLAIN A PRICE ANALYSIS TO DETERMINE PRICE**

**Price analysis is a process and these are the steps**

1. **COLLECTION OF INFO TO DETERMINE PURCHASE PRICE**

**Price analysis is the process of comparing supplier prices against external price benchmarks without direct knowledge of the supplier’s cost .there is use of the price lists, catalogues to compare supplier price and this approach does not take into account the production and manufacturing costs by the supplier. The purchase must be sure that the comparison is valid by ensuring that other variables excluding price are similar. Examples of other comparison or benchmarks are competing tenders, quotations or offers, existing and stable market prices,historical data or reliable trends, published prices or indices for various branches of industry,gvt regulated prices, value analysis.**

**There are various sources of collecting information for determining purchasing prices which are published price lists, printed catalogues and electronic catalogues,quotations,commodity exchanges, price indices, record keeping,EDI,internet connections**

**2.UNDERSTANDING PRICE METHODS**

**Still in an attempt to determine prices, it is important to understand SUPPLIER PRICING MODELS which are 1)PRICE VOLUME MODEL- The price is as important a variable as the price because an increased volume may imply that the direct costs is spread over more units so that the costs per unit maybe reduced. The pricing model is therefore the basis for quantity discounts offered to the purchaser. 2) MARKET PENETRATION MODEL – THE aim behind this is to maximise profits by capturing a large share of the market as soon as possible. 3) MARKET SKIMMING MODEL –here prices are set to achieve a high profit on each unit as much as possible. this works on perceived superior products 4)REVENUE PRICING MODEL –this model is to obtain sufficient revenue thru sales to cover costs rather than to make profit. 5)PROMOTIONAL PRICING MODEL –this model attracts sales even if it means selling at below costs incurred 6)MARKET PRICE LEVEL –the suppliers use this strategy if there is keen competition and numerous similar products that compete on the market therefore use of product differentiation is important to maintain a competitive advantage.**

**3. SETTING OBJECTIVE FOR PRICE DETERMINATION**

**1) Budget objectives set cost/price objectives related to two variables namely the expected quantities of materials required by the enterprise and the prices of these materials.2.Cost reduction strategies these are internal initiatives of reducing costs eg value analysis, process improvements, standardisation,automation and better financing 3.Price indices as objectives for price determination price indices are important for commodities such as metals, wool and cotton for developed countries.**

**4. DIFFERENT APPROACHES FOR DETERMINING PRICES (this question was also in 2005 paper!)**

**Generally prices are determined according to 1)PREVAILING MARKET PRICES –used for standard production articles and certain raw materials and prices are published regularly 2)PRICE DETERMINATION BY MEANS OF COMPETITION IN THE MARKET –used for specialised products and tendering process is used. 3) NEGOTIATION is done for high transactions of high monetary values and tendering is not present!**

**LEARNING OUTCOME 8 DISTINGUISH BETWEEN COST ANALYSIS AND PRICE ANALYSIS**

**PRICE ANALYSIS- is the process of comparing supplier prices against external price benchmarks without direct knowledge of the supplier’s cost. COST ANALYSIS –is the process of analysing each individual cost element that together adds to the final price.the purchaser endeavours to gain detailed insight and understanding of the cost structures of the supplier(pg143).the process of understanding the individual cost elements can be done by using various techniques which are supplier’s cost based pricing model 1)COST MARK UP 2)MARGIN PRICING 3)RATE OF RETURN PRICING OR 4)COLLABORATIVE COST MANAGEMENT(target costing and cost saving sharing pricing)**

**LEARNING OUTCOME EXPLAIN THE VARIOUS TECHNIQUES IN COST AND PRICE ANALYSIS**

**Purchasers can use various aids to make decisions on prices and the use of such aids requires a great deal of research to collect essential data on the market and on suppliers; THE VARIOUS TECHNIQUES ARE**

**1. THE LEARNING CURVE – is an empirical relationship between the number of units produced and the number of units produced and the number of labour hours required to produce them. The learning curve is a graphic presentation of the influence of the learning process on the number of hours required to manufacture specific quantities of a product.**

**2. BREAK EVEN ANALYSIS – the breakeven point is where the total cost curve intersects the revenue curve.**

**TOTAL REVENUE = VARIABLE COST + FIXED COST**

**3. HEDGING PRICES –There are basically two types of hedging which are 1) CURRENCY MARKETS 2)COMMODITY MARKETS with the aim of both protecting the firm against risks**