Special Contracts to Supply Cameras to Chain-Store Retailers

Explanations – Cause-Effect Relationships – Suggestions and Tips

Beginning in year 9, there is an opportunity to obtain special contracts from large chain-store camera retailers in each region to supply them with AC cameras at a discount price. The cameras to be supplied are the company's regular models, not a stripped-down or lower-quality version. The payoff for winning bidders is a contract to supply a large retailer in the region with a unit volume equal to 10% of your company's actual total unit sales volume in the region in the current decision round/year.

Chain retailers use a ***Value Index*** to determine which of the camera-makers' offers to accept. The Value Index is a composite of three factors: (1) the net wholesale price the retailer will pay after the price discount offered by the bidder, (2) the P/Q rating of the bidder's action cameras, and (3) the numbers of models in the bidder's line of cameras. Multi-store chain retailers consider the Value Index as the *best indicator* of how many action camera buyers they can attract to their stores, given the sales prices they can offer, the P/Q ratings of the cameras, and the number of models that buyers can choose from. Your company's Value Index appears as an on-screen calc as soon as you enter a percentage discount offer.

Why Do Chain Retailers Use a "Value Index" to Evaluate Offers? Chain retailers do not believe it is in their best interest to choose a winner simply based on "the lowest discounted price" because this would fail to account for better quality and greater model selection advantages of higher-priced cameras. Such a "price-only" procedure for selecting winners would restrict big retail chains to having special sales promotions that would only appeal to people shopping for low-end camera brands. Rather, chain retailers believe it is in their best interest to hold discount sales promotions to draw in people willing to consider a broad range of action camera brands if offered "a good deal."

Hence, they have constructed a "Value Index" that puts most all AC camera companies in position to compete for special order contracts. Their Value Index methodology enables a maker of high-performing, premium-quality cameras sold at premium prices to achieve a competitive Value Index score because its necessarily higher net price offer is justified by higher P/Q ratings (and perhaps a bigger selection of models). Likewise, the Value Index methodology makes it feasible for a camera-maker selling mid-priced cameras with mid-level P/Q ratings and 4-5 models to put together an offer with a Value Index that can be competitive with those of companies selling high-priced cameras or low-priced cameras, cameras with high P/Q ratings or low P/Q ratings, and a big selection of models or a small selection of models.

In the instance where two or more companies make offers with the same highest Value Index, the contract is awarded to the company with the highest prior-year image rating/brand reputation.

All interested camera-makers can make offers for these contracts—offers are taken in each of the four geographic regions. The number of offers that are accepted in each region depends on the number of companies in the industry:

- In industries with 5 or fewer companies, there is 1 special contract awarded in each region.
- In industries with 6-8 companies, there are 2 special contracts awarded in each region.
- In industries with 9-12 companies, there are 3 special contracts awarded in each region.

Special Note: In the Competitive Intelligence Report for each geographic region contains three lines of data (at the bottom of the AC Camera Segment data) relating to the Special Contract offers made by companies in the industry. The first line reports each company's discount price offer. The second line reports the Value Index associated with each company's offer. The third line shows the company or companies whose offers were accepted and the number of cameras they sold under the special contracts accepted by multi-store chain retailers. ***You will find this information very valuable in helping prepare your offers for special contracts.***

The Percentage Discount Offer

Enter a percentage discount for each geographic region where you wish to make an offer for a contract and observe the resulting Value Index. While bigger percentage discounts will produce a higher Value Index (which boosts your chance of winning a special contract), it will also result in a lower contribution margin and smaller gains in EPS, ROE, and cash flow (which reduces the payoff from winning a contract). So this tradeoff the basic problem you have to resolve, assuming you want to submit a offer in one or more regions.

What should the compromise be between making an aggressive offer (a big enough price discount to produce a Value index deemed high enough to give your company an excellent chance of being awarded a special contract) and making a conservative offer (so as not to leave money on the table with a Value Index bid of, say, 75 when a Value Index offer of 71 would have been high enough to beat the offers of rival companies)?

> ***Tip:*** *Ideally*, you want to submit an offer with a Value Index that is just high enough to win, yet that involves a price discount low enough to yield the biggest contribution margin and biggest gains in EPS, ROE, and cash flow. *Winning a contract that entails a bare-bones contribution margin merits nothing more than polite applause for keeping a rival company from winning a contract.*

Note that each time a percentage discount is entered, you are instantly able to see the resulting discount price offered to chain retailers on the line just below the decision entry field and also the resulting Value Index on the line labeled “Value Index of AC Camera Units Offered.”

> ***Important Rule:*** *The company Board of Directors strictly prohibits management from submitting an offer which is projected to result in a negative contribution margin and thus negatively impact the company’s EPS, ROE, cash flow, and overall performance. Any such offers will be automatically “disallowed” and not considered by chain retailers.*

Projected Outcomes

Each time you enter a percentage discount, the Projected Outcomes section in the bottom half of the page displays ***projections*** of:

- The incremental revenues your company will receive from winning a contract.
- The incremental costs that will be incurred from assembling and delivering the projected number of cameras to be supplied.
- The resulting “contribution margin” (defined as incremental revenues minus incremental costs).
- The incremental profitability—the projected gain in EPS, the projected percentage boost to ROE, and the projected increase in cash flow.

These projected outcomes of alternative price discounts provide you with the feedback needed to quickly search out a percentage discount for each region that produces an “attractive” Value Index offer and “attractive” increases in the company’s projected performance.

Incremental Revenue Projections. The projections of incremental revenues are adjusted for favorable (+) or unfavorable (-) exchange rate effects. The incremental revenues are calculated by multiplying the net price your company will receive (after taking into account the price discount offered and any exchange rate adjustments) by the projected number of cameras to be supplied (10% of your company’s projected camera sales volume in the region) should your company win the offer you submit.

> ***Note:*** Because all special contract agreements and transactions occur in the first three quarters of the year, 100% of special contract revenues are collected in the current year. Therefore, special contract sales have no impact on accounts receivable in the balance sheet at the end of the year.

Variable Production Costs and Delivery Costs Projections. Bear in mind that the cost consequences of winning a special contract from a large camera retailer involve only *the incremental costs* associated with:

- **Variable Production Costs**—(1) camera components, (2) the labor needed to assemble the cameras (assembly for some of the cameras ordered may have to be outsourced to nearby contract assemblers if the company lacks the needed in-house capacity).
- **Delivery Costs**—(1) shipping and (2) applicable import duties.

All other camera-related costs (for marketing, administration, maintenance, depreciation, PAT training, and so forth) are "fixed" in a total dollar expenditure sense (since they will not change up or down as a consequence of winning or not winning a special contract). *Because there is no guarantee that your company will be awarded a contract, it is a generally accepted accounting practice to always fully allocate all such "fixed costs" to the company's "regular" camera business.*

> ***Note:*** Because all special contract agreements and transactions occur in the first three quarters of the year, 100% of all associated costs are incurred in the current year. Therefore, special contract sales have no impact on accounts payable and in the balance sheet at the end of the year.

Contribution Margin Projections. Incremental revenues *minus* incremental costs *equals* the total dollar contribution your company is *projected* to earn on the special contract. These monies can then can be used for (1) the payment of any "fixed costs" (for depreciation, maintenance, administrative costs, interest payments, and so forth) which might not be fully covered by the company's "regular" sales of cameras (or drones) and (2) boosting profitability. The bigger the projected contribution margin earned on special contracts, the bigger the projected impact on your company's bottom line, EPS, ROE, and internal cash flows.

Assembly of Special Contract Units. If your company wins one or more special contracts, then the needed cameras will be assembled in the following order of priority:

1. Any workstation capacity left over after assembling regular camera orders will be used to assemble cameras to fulfill the special contracts won by the company. The labor costs for assembling these cameras at regular time will be the same as the labor costs for regular time assembly of cameras sold and shipped to camera retailers across the four geographic regions.
2. Any overtime assembly capacity left over after assembling regular camera orders will be used to assemble cameras to fulfill the special contracts won by the company. The labor costs for assembling these cameras at overtime will be the same as the labor costs for overtime assembly of cameras sold and shipped to camera retailers across the four geographic regions.
3. Once the company's in-house assembly capacity has been exhausted, all remaining cameras needed to fulfill the special contracts will be outsourced for assembly by nearby contract assemblers for an assembly price/cost of $50 per camera.

All such assembly costs are included in the projections of "Variable Production Costs."

Outsourcing the assembly of a big fraction of the cameras required to fill the special orders is highly likely when you are already using overtime to assemble cameras for "regular" sale to camera retailers across the world.

Including Special Contract Projections in the Overall Projections

At the very bottom of the page, you are given the option of checking a box to include all of the projected outcomes for special order contracts in the company's overall performance projections for the year.

Suggestion: It is recommended that you temporarily check all the boxes just to see what the company performance outcomes would be if your company wins all the offers it submits. Later, consider whether you want to uncheck the boxes for those offers you believe are less likely to be successful.

