

Most favored nation pricing Are your suppliers holding up their end of the bargain?



In the current economic environment, when companies are under tremendous profit pressure, vendor pricing should be given high consideration as a path towards cost reduction. When companies have the leverage to do so, they routinely negotiate the inclusion of a most favored nation (MFN) provision in their supplier contracts. Although MFN may sound like it relates to international trade relations, in this context it is intended to provide for a company to receive pricing equal to or better than other customers.

MFN clauses can be found in many industries. Manufacturers use them to protect the pricing of purchases of raw materials and components, and healthcare payers include them in contracts with care providers. Many other businesses use MFN provisions in licensing and royalty agreements. Companies that depend on outsourcing use these provisions to help get the most favored price from their vendors.

Today's business environment underscores the current value of MFN clauses. As pricing pressure increases, controlling the cost of supplies and services becomes even more critical. Tight credit markets are raising the cost of borrowing for inventories, and commodity prices, while dipping recently, have been trending upward for years. Inflation threats still loom.

Amidst these conditions, having an MFN clause that keeps supply costs in line with, or in some cases better than, those of competitors can be an important factor in a company's financial performance and ability to compete. While overpaying for a single product component may not in itself appear significant, the cost variance may lead to a huge loss on the finished products.

Too often, MFN provisions are underutilized, or even forgotten. Attorneys may perfunctorily add boilerplate MFN language to a contract and not communicate with the appropriate business unit managers. Meanwhile, in many cases no one is assigned responsibility to monitor supplier compliance and the effects of changing marketplace conditions. The procurement department may not even know the clause exists, or it may only be reviewed when the time comes to renew the contract. Such oversights can be costly for large companies that may be overpaying suppliers by thousands or even millions of dollars.

Companies may avoid such significant losses and gain better control of their pricing by understanding the factors that can cause supplier pricing to stray from MFN terms and by identifying red flags that can indicate overpayments. Armed with this information, companies can then take steps to strengthen MFN oversight, improve supplier compliance and cooperation, and possibly recoup overpayments. The result: higher profitability and better price controls throughout the supply chain.

Are you getting “the most favored” price?

One important tenet underlies MFN matters – it’s the buyer’s responsibility to make sure the MFN provision is being followed. Suppliers typically do not have systems in place, nor the motivation, to monitor their MFN compliance. In addition, suppliers don’t have a financial incentive to monitor MFN compliance. So it falls to the customer to assess compliance. But for companies with hundreds or even thousands of suppliers, this can be an overwhelming task.

Furthermore, there are many ways that suppliers may willfully or obliviously violate MFN terms. A supplier may offer new and potentially more significant customer volume discounts or add-ons. Separate divisions within the supplier organization may be providing different terms to different buyers in your company. Other customers may be receiving price breaks related to timely payments, which may not have been offered to your company. External factors, such as continuing commodity price adjustments, also can cause suppliers to lose control of their pricing schemes while competitors are actively renegotiating with the same vendor. Another challenge is the opacity of the prices and terms that exist between the vendor and its other customers.

So what can you do? MFN clauses may include a provision that allows the buyer to request a review of the supplier’s adherence to pricing terms by an independent party. Such provisions may also state that the vendor pay for the investigation if there are findings that indicate overpayment over a certain amount.

However, most companies don’t conduct regular compliance assessments. More often, they initiate an analysis only when something unusual happens, such as accidentally obtaining information that shows a supplier is favoring another customer. In other cases, companies are prompted to conduct a compliance assessment after they themselves have been the subject of one undertaken by another company.

When should you investigate?

A variety of circumstances can indicate the need to question a supplier’s MFN compliance and potentially conduct an investigation. Some of these conditions relate to the nature of the particular buyer-supplier contract. For example:

You have a long-term supplier contract — A supplier’s customer base inevitably changes over time. With any new customer, the supplier may be motivated to offer different terms, such as volume discounts for a large buyer. The longer your contract has been in place, the higher the potential turnover in the supplier’s customer base, which may increase the risk that someone else will receive a better price.

The contract includes formulaic price increases — The pricing formula laid out at the beginning of your contract may not be appropriate several years down the road due to changing market conditions. This may lead to inappropriate pricing unless the pricing formula is reexamined.

Your products involve some degree of customization — If a supplier is offering a standardized product to all potential purchasers, it will be less likely to vary pricing from customer to customer. When a product is somewhat specialized, there can be leeway or vagueness from the vendor’s perspective with respect to what would be considered a comparable product.

The MFN provisions are too broad — Some MFN clauses simply mandate that the supplier will not give more favorable terms to any customer than the terms offered to you. There is no definition of who the other customers are, whether they’re in the same industry, or whether they’re the same size as you. Or, other issues relating to how the provision is applied may be unclear. For example, if you’re purchasing a component containing a variety of parts, does the provision apply on a part-by-part basis or on the entire assembly? Broad, vague language can provide the supplier considerable leeway in MFN interpretation, which may work to the detriment of the buyer.

Marketplace conditions may also signal the need to take a look at your MFN status. For example:

A vendor signs a significant new customer — A trade publication announcement or market intelligence may indicate your supplier has won a large new account. Favorable pricing may be one reason the supplier was able to reel in that customer.

A competitor who uses the same suppliers consistently undercuts your prices — The prices you charge customers are a function of both fixed and variable costs, as well as your desired profits. If you've determined that your fixed costs – facilities, equipment, and administrative overhead – are in line with those of competitors, and your profit margins are comparable, the price difference is likely a function of variable costs – which includes what you're paying to suppliers for materials.

Commodity prices go down but your costs don't — Commodity prices can vary widely over time, surging for a period and then retreating. If suppliers pass along increased raw material costs, but don't adjust prices downward when those costs decline, an MFN investigation could be in order.

Your suppliers consolidate — A merger of suppliers can result in a loss of institutional knowledge regarding MFN obligations. In the consolidation process, the terms of thousands of contracts may be ignored or overlooked as people assume new duties.

You go through a merger — Just as with suppliers, a merger involving your company can result in new people having the responsibility to oversee contracts. They can be unfamiliar with the contract terms and pricing structure and may not even be aware of a MFN provision.

What should you do?

If signs point to the need for a review of MFN compliance, here are steps you can take to get the analysis headed in the right direction, which may help prevent future problems:

Understand your vendor relationships — Before engaging a third party to conduct an investigation, identify the people within your organization who deal with the suppliers. Create a map of who knows whom and what kinds of leverage and bargaining power they may have with the supplier. Also determine what types of information you'll want to obtain from the supplier through an investigation.

Conduct preliminary industry research — People within your organization can start the investigation of competitor-supplier relationships through research of articles, studies, and other information sources.

Bring in the consultants to conduct an investigation — Deloitte & Touche LLP can begin its investigation by conducting market analysis and conducting in-house interviews. If a further compliance review is warranted, the consultants can compare pricing and terms across your contracts and examine deals the supplier has signed with your competitors and other customers. This information will help you create a baseline from which to measure whether you're getting the deal you're entitled to from the vendor or whether you should seek to recover overpayments.

Enter into vendor dialogue and negotiation — Once the investigation is completed, the next step may be to start vendor discussions to restructure the deal, recoup overpayments, or both. You'll need to approach the negotiations carefully to avoid alienating a valuable supplier, while still recovering overcharges to which you're entitled. You may need to consider whether you can still trust the supplier based on the circumstances of the MFN breach. In the end, you'll want to be confident that you'll be paying what you should in the future if you continue the relationship.

Take action to keep it from happening again — Assigning a person or group to monitor MFN compliance is an important step in preventing a recurrence of the problem in the future. Whoever serves in this capacity can maintain communication with your sales organization regarding customer wins and losses, with buyers on procurement cost trends, and with finance on the health of profit margins. External information sources also can be monitored on an ongoing basis for possible threats.

Staying truly "most favored"

Companies should stay intensely focused on cost control as economic conditions continue to pressure profit margins. An MFN provision in supplier contracts can help maintain a cost structure that allows you to price your products and services competitively. But you have to use it. Stay alert for signs that you may not be getting the pricing you're entitled to. Conduct a supplier compliance review if warranted. And establish controls that will capitalize on your MFN provision. Doing these things can help you stay truly "most favored."

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