

8.6: Contract Manufacturing

Learning Objectives

After reading this section, students should be able to ...

1. define contract manufacturing
2. explain the advantages and disadvantages of contract manufacturing

In contract manufacturing, a hiring firm makes an agreement with the contract manufacturer to produce and ship the hiring firm's goods.

A contract manufacturer ("CM") is a manufacturer that enters into a contract with a firm to produce components or products for that firm. It is a form of outsourcing. In a contract manufacturing business model, the hiring firm approaches the contract manufacturer with a design or formula. The contract manufacturer will quote the parts based on processes, labor, tooling, and material costs. Typically a hiring firm will request quotes from multiple CMs. After the bidding process is complete, the hiring firm will select a source, and then, for the agreed-upon price, the CM acts as the hiring firm's factory, producing and shipping units of the design on behalf of the hiring firm.

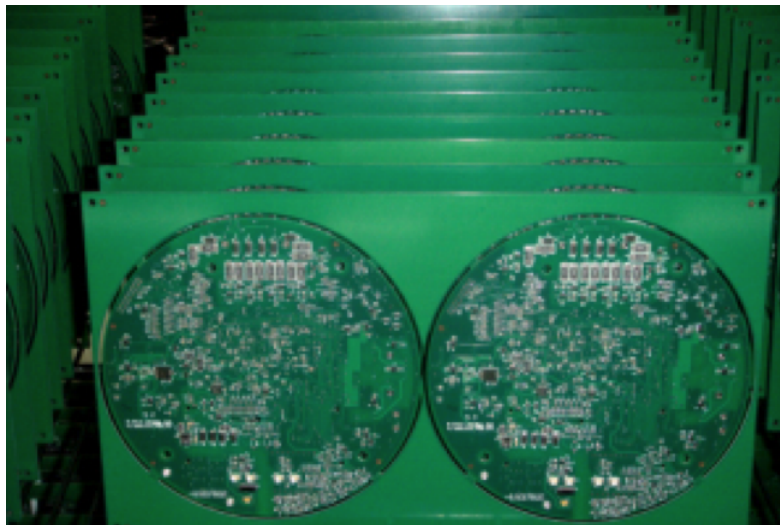


Figure 8.6.1: Printed circuit boards. (CC BY-SA: JayHand: https://en.Wikipedia.org/wiki/Electr...cuit_Board.jpg).

Benefits

Contract manufacturing offers a number of benefits:

- **Cost Savings:** Companies save on their capital costs because they do not have to pay for a facility and the equipment needed for production. They can also save on labor costs such as wages, training, and benefits. Some companies may look to contract manufacture in low-cost countries, such as China, to benefit from the low cost of labor.
- **Mutual Benefit to Contract Site:** A contract between the manufacturer and the company it is producing for may last several years. The manufacturer will know that it will have a steady flow of business at least until that contract expires.
- **Advanced Skills:** Companies can take advantage of skills that they may not possess, but the contract manufacturer does. The contract manufacturer is likely to have relationships formed with raw material suppliers or methods of efficiency within their production.
- **Quality:** Contract Manufacturers are likely to have their own methods of quality control in place that help them to detect counterfeit or damaged materials early.
- **Focus:** Companies can focus on their core competencies better if they can hand off base production to an outside company.
- **Economies of Scale:** Contract Manufacturers have multiple customers that they produce for. Because they are servicing multiple customers, they can offer reduced costs in acquiring raw materials by benefiting from economies of scale. The more units there are in one shipment, the less expensive the price per unit will be.

Risks

Balanced against the above benefits of contract manufacturing are a number of risks:

- **Lack of Control:** When a company signs the contract allowing another company to produce their product, they lose a significant amount of control over that product. They can only suggest strategies to the contract manufacturer; they cannot force them to implement those strategies.
- **Relationships:** It is imperative that the company forms a good relationship with its contract manufacturer. The company must keep in mind that the manufacturer has other customers. They cannot force them to produce their product before a competitor's. Most companies mitigate this risk by working cohesively with the manufacturer and awarding good performance with additional business.
- **Quality:** When entering into a contract, companies must make sure that the manufacturer's standards are congruent with their own. They should evaluate the methods in which they test products to make sure they are of good quality. The company has to ensure the contract manufacturer has suppliers that also meet these standards.
- **Intellectual Property Loss:** When entering into a contract, a company is divulging their formulas or technologies. This is why it is important that a company not give out any of its core competencies to contract manufacturers. It is very easy for an employee to download such information from a computer and steal it. The recent increase in intellectual property loss has corporate and government officials struggling to improve security. Usually, it comes down to the integrity of the employees.
- **Outsourcing Risks:** Although outsourcing to low-cost countries has become very popular, it does bring along risks such as language barriers, cultural differences, and long lead times. This could make the management of contract manufacturers more difficult, expensive, and time-consuming.
- **Capacity Constraints:** If a company does not make up a large portion of the contract manufacturer's business, they may find that they are de-prioritized over other companies during high production periods. Thus, they may not obtain the product they need when they need it.
- **Loss of Flexibility and Responsiveness:** Without direct control over the manufacturing facility, the company will lose some of its ability to respond to disruptions in the supply chain. It may also hurt their ability to respond to demand fluctuations, risking their customer service levels.

? KEY POINTS

- A hiring firm may enter a contract with a contract manufacturer (CM) to produce components or final products on behalf of the hiring firm for some agreed-upon price.
- There are many benefits to contract manufacturing, and companies are finding many reasons why they should be outsourcing their production to other companies.
- Production outside of the company does come with many risks attached. Companies must first identify their core competencies before deciding about contract manufacture.

Terms

- *Contract manufacturing:* Business model in which a firm hires a contract manufacturer to produce components or final products based on the hiring firm's design. A business model where a firm hires another firm to produce components or products.

Source

The above content was adapted from Boundless Business. Authored by: Boundless. Provided by: Boundless. Located at: <https://www.boundless.com/business/>. License: CC BY-SA: Attribution-ShareAlike under a Creative Commons Attribution-NonCommercial-ShareAlike License.

Image of Circuit Boards. Authored by: JayHand. Located at: https://en.Wikipedia.org/wiki/Electr...cuit_Board.jpg. License: CC BY-SA: Attribution-ShareAlike

This page titled [8.6: Contract Manufacturing](#) is shared under a [CC BY-NC-SA 4.0](#) license and was authored, remixed, and/or curated by [Babu John-Mariadoss](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- **7.6: Contract Manufacturing** by [Babu John-Mariadoss](#) is licensed [CC BY-NC-SA 4.0](#). Original source: <https://opentext.wsu.edu/cpim/>.