Case study: rich manufacturing

Background Bhagat Incorporated has been the supplier of machine parts of Rich Manufacturing Company. Both companies have agreed upon purchase terms: Rich will purchase a minimum of 50, 000 parts from Bhagat, the price for one unit of machine part will be Bhagat's production costs and a cost-plus markup of $5. But due to internal conflicts, that is, the labor union negotiations, production costs of Bhagat increases by $3, which is a result of increase in labor costs due to these negotiations. Rich Manufacturing Company then faces the problem of higher price of machine parts, that being one component of its costs for its product. Because of this increase, its profitability can be affected.

1. Why do many firms use cost-plus pricing for supply contracts?

There are two primary reasons why firms use cost-plus pricing in their supply contracts: one, the market price of the product by the supplying firm, as input to a company's production is hard to determine and reliance on differences in market prices will result in abrupt changes in the customer-firm's cost structure; two, because the parts from a supplier is an input to the final output the firm is going to produce, the production is similar when the firm produces the parts on its own, only that it has to pay for a markup as part of the profit of the supplying firm.

A company contracts a supplying firm in order to produce an input it can otherwise make, but chooses not to in order to achieve efficiency and rid itself of capital considerations for producing it. By having the supplying firm produce an input to its final output, the company aims similar cost structure from its supplying firm as when it produces the input on its own, or better cost structure when it can save. Therefore, the company chooses to base the price on the production costs of supplier, plus a certain markup as payment for the services it will render. In this way, the firm can still maintain the cost-structure as when it produces the input on its own but just paying a certain markup, which will enable it to gauge its return on investment on the decision.

2. What potential problems do you envision with cost-plus pricing?

The cost-plus pricing in this situation seems to assume that Bhagat's production costs will remain the same from the time the contract has been agreed upon up to a certain time. The cost-plus pricing in this situation does not incorporate the changes that may incur in the production of Bhagat, which will in turn increase its production costs, thus increase the price of the machine parts.

The problem with this cost-plus pricing is that Rich Manufacturing Company does not have control over the costs of Bhagat's production. Any increase in Bhagat's production costs will be reflected in the price Rich Manufacturing Company in this scenario. The problem with this approach is that if any inefficiency in Bhagat's production sets in, the increase in production costs will be absorbed by Rich Manufacturing Company. This will in turn hurt its profitability if the costs (price of machine parts) turn out to be higher that when the cost has been agreed upon.

3. Should Gina contest the price increase? Explain.

Gina may raise this issue with Bhagat, but if it is stipulated in the contract that the price Rich Manufacturing Company has to pay to Bhagat is dependent upon the production costs, plus a certain markup, it will be as agreed upon. Rich Manufacturing Company assumes that no changes will be made in the production cost structure of Bhagat that is probably why it agrees to sign it. But if it is stipulated in the contract that the production costs Bhagat will use in order to price its product, plus a markup is the cost that it has currently been using during the time of the signing of the contract, then Gina has a legal claim. It may raise the issue, but in these kinds of situation, Rich Manufacturing Company does not have any control over the cost structure of Bhagat, which leads to difficult production consideration on Gina's parts. This sort of cost-plus pricing approach can better be utilized when the other company has control over the cost structure of the supplying company in order to protect its own profitability.

4. Is the increase more likely to be justified in the short run or the long run? Explain.

The increase in the price is likely justified in the long-run, when Rich Manufacturing Company is able to make certain changes in its own cost structure and selling decisions, in such a way that it can accept the increase without hurting its own profits. In the short-run, depending on the cost structure of Rich Manufacturing Company, it may even incur losses because of the abrupt increase in the prices of machine parts. While Rich Manufacturing Company may adjust the price of its own products in the long-run in the market, it may not be able to do it in the short-run. Increasing the price of its products in the short-run in order to absorb the abrupt increase in costs of the machine parts, may offend Rich Manufacturing Company's customers, which can result in sales losses.

5. How will a $3 increase in the price of machine parts affect Ginas own production decisions?

The $3 increase in the price of machine parts, if it orders 50, 000 units up to 100, 000 units from Bhagat, will result in an increase in $150, 000 to $300, 000 in cost outlays. This increase can make Gina think of either producing the input on its own rather than contracting an outside supplier, Bhagat to produce it for Rich Manufacturing Company.

This is the so-called make-or-buy decisions within companies. A company chooses to get a supplier only when buying exceeds the benefits of making an input on its own. In this case, if Rich Manufacturing Company can manufacture the inputs on its own and incur fewer costs than when it gets Bhagat as supplier to produce it, Gina may choose it for its production considerations. The control on costs will also be beneficial to Rich Manufacturing Company as compared to no control over Bhagat which may have abrupt production costs, which in turn hurts the profits of Rich Manufacturing.

Proposed Solution:

If Gina still wishes to continue using cost-plus pricing in its supply contracts, it should be careful as to the agreement she will draft with the other company in order to control the costs of producing the machine parts Rich Manufacturing Company will buy. Either she stipulates in the agreement that the current level of production costs will be used for cost-plus pricing, and no subsequent changes in the production cost structure of the supplying firm will be reflected in the price Rich Manufacturing Company will have to pay. Gina will then have a safety net and legal claim in order to control the production costs. If it can control the costs of producing the machine parts, it will definitely hurt the profitability of its own company because of the abrupt changes in the other firm’s production cost structures, such as the labor cost increase due to union negotiation. That way, Gina can still control the costs in relation to Rich Manufacturing Company’s own cost structure.