Contract Manufacturing and Electronics Manufacturing Services – Excess and Obsolete Inventory

By Rosemary Coates

Many companies outsource some or all of their manufacturing to contract manufacturers (CMs). This is particularly true in companies where electronics are involved or where new products with untested demand are being introduced. But outsourcing to a contract manufacturer can be a minefield, especially as it relates to inventory management.

Contract Manufacturers are typically experts in manufacturing and can quickly integrate your products into their manufacturing lines. These companies are excellent at assembly and repeatable production and are the kinds of factories you often see in photographs where hundreds of young women are bent over assembly tables. These factories are typically modern and efficient but earn relatively small margins on their operations.

Manufacturing Services for Profit

The contract manufacturer (in electronics, they are called Electronics Manufacturing Services or EMS) is in the business of providing manufacturing services for a profit. To accomplish this, they must profitably manufacture goods to a customer's demand schedule – a process difficult to achieve in a low-margin business. Because of the relatively low margins as compared to other businesses, CMs and EMS providers are continuously looking for ways to reduce costs and become more efficient.

Aggregated Raw Materials Demand

One of the strategies employed by EMSs and other contract manufacturers is to aggregate demand for raw materials and parts across multiple customers, then purchase raw materials and parts in bulk to fill that aggregated production demand. Parts for one customer's project then become part of a pool of inventory that has been purchased in bulk for multiple customers.

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Another common process is to purchase long-lead-time items well in advance of the production schedule to assure all of the materials are ready when production starts. If not purchased in advance, this may result in parts shortages and a delay in the production line. However, if there are changes to planned production or changes in customer demand, purchasing parts too far in advance may result in excess or obsolete inventory. This is a particularly acute problem in electronics manufacturing where certain parts may have a short shelf life before becoming obsolete.

Minimum Order Quantities

Often, minimum order quantities have to be purchased from suppliers that only sell in standard quantities or in bulk that cannot be broken down into smaller packages. For example, a contract manufacturer may only need 20 pieces of an individual part to produce a finished product, but the minimum order quantity (MOQ) is 100. In this hypothetical, the EMS, and eventually the EMS' customer ends up paying for the full 100, unless some other demand is identified. MOQs often become a point of contention between the contract manufacturer and its customer, trying to determine who is responsible to pay for the excess.

Excess and Obsolete Inventory

These kinds of inventory situations typically result in excess and obsolete (E&O) items. Inventory becomes obsolete when there is no current or future demand for the parts. To further complicate matters, many parts, particularly electronics, have a shelf-life – usually 2-3 years. If parts are not consumed in production within that time, they become unusable. It is this E&O inventory that often ends up in a dispute between the contract manufacturer and the customer.

Inventory management is a complex world in contract manufacturing. If you need assistance in a case involving contract manufacturing, please reach out to me.

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