ABC Inventory: What Is It And Is It The Right Approach For My Company?



Like a lot of professionals, you probably already know that inventory optimization is a useful aid in capturing both savings and value for your business.

But not all methodologies are created equal, and for businesses focused on maximizing performance of their most valuable goods (and customers!), *ABC Inventory Analysis and Management* can provide the perfect solution.

While it is not without its challenges, ABC inventory control can be powerfully beneficial for those willing to learn its capabilities and limits.

What is ABC Inventory Analysis and Management?

As the name implies, ABC Inventory Analysis and Management is a tripart inventory control system. Also known as *selective inventory control*, or SIC, ABC analysis is built around the Pareto Principle—sometimes called "The 80/20 Rule"—which states that 80% of a company's profits and production are

generated by 20% of its activities.

By extension, it can be argued that 80% of the *annual consumption value* (the total value of a specific item consumed over a specific time period, usually a year) represented by a company's inventory is held by 20% of the items therein.

Like many other technologies evolving to embrace the potential offered by digital transformation and big data, ABC inventory management is data driven.

It relies on accurate, complete, and transparent data for transactions of all kinds to drive the analysis used to identify not just the value and number of items in your inventory, but the time, labor, and other resources dedicated to them.

In the ABC analysis model, goods are broken into three groups: A items, B items, and C items. Merchandise is categorized based on its performance relevant to specific company goals, such as profitability, market share growth, etc.

A, B, and C each have their own specific roles to play:

- **A items** have a high annual consumption value, and are few in number. This classification is for items essential to the continued health and growth of the company.
- **B items** have moderate annual consumption value, and are moderate in quantity. These items are also of moderate importance.
- **C items** have low annual consumption value, and are numerous. These items are relatively unimportant compared to the other two classes, but still merit analysis and tracking.

Applying the Pareto Principle, class A goods account for about 20% of the items in inventory, but 75% of its total annual consumption value, while the remaining 80% is split between class B and class C items (e.g., 30% for B and 50% for C), which account for 15% and 10% of total annual consumption value, respectively.

CATEGORY	PERCENTAGE OF ANNUAL CONSUMPTION VALUE	PERCENTAGE OF PHYSICAL INVENTORY
Category A	75%	20%
Category B	15%	30%

Category C	10%	50%

These values are not fixed, of course—no two businesses, even in the same market, have identical inventories—but provide a useful rule of thumb when evaluating your inventory control needs.

They should add up to 100%, but fluctuations are normal, particularly for businesses offering products with volatile market performance.

High-value class A items will require more frequent evaluation and highly accurate, tightly monitored inventory management compared to their less valuable, and profitable, brethren.

ABC classification allows a company to focus its attention and efforts on the most profitable products across all business processes, including production, inventory management, marketing, and sales, as well as customer resource management (CRM) and customer service.

Companies may also apply ABC analysis to their supply chain and customer base to achieve further optimization yields.

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Pros and Cons of ABC Inventory Analysis and Management

Before you can take full advantage of ABC analysis, it's crucial to identify and understand the scope of its capabilities, and the potential challenges you may face when implementing an ABC approach.

It's important to keep in mind that many of the "cons" are limitations imposed by implementing the ABC approach with obsolete or last-gen technologies.

Choosing a purpose-built inventory optimization solution, or a comprehensive procurement solution such as PLANERGY that features built-in support for ABC

analysis, will remove much of the frustration and difficulty that might otherwise discourage those considering an ABC classification and analysis approach.

PROS	CONS

● Integrates well with cycle counting systems (e.g., A class items are counted monthly, B class items are counted quarterly, and C class items annually). ● Accurate and tight control over high-value assets means greater availability and higher profits with lower costs and reduced stock loss. ● Identifying and managing low-value class B and class C items allows for more accurate safety stock levels and fewer stock-outs. This also increases production efficiency, reduces cycle times, and boosts customer satisfaction. ● Greater transparency reduces wasted resources, minimizes inventory turnover, and frees working capital by lowering carrying costs and preventing buildup of both excess and obsolete stock. ● More strategic pricing, demand forecasting, decision-making, and overall stocking thanks to complete visibility of performance across the entire product life cycle (i.e., launch, growth, maturity, decline, recovery, etc.) ● Analytics can be applied to both supply chain management and customer service optimization to identify and prioritize top-performing vendors and high-value customers for additional savings and greater profits.	● Requires investment of labor, time, and resources to achieve optimal results through frequent cycle counts at differing intervals. (Ameliorated through the use of automated inventory management and optimization software.) ● Is mutually exclusive with other inventory management systems. ● Does not conform to Generally Accepted Accounting Principles (GAAP), and may require an additional cost management system run concurrently with ABC analysis. (Ameliorated through integration with accounting software.) ● Products falling into multiple categories or spiking in value due to shortages or market trends can create bottlenecks and inaccuracies if using manual processes. (Ameliorated through automation, data centralization, analytics, and process optimization.)

Putting ABC Analysis to Work

To illustrate how you might apply an ABC inventory analysis and management system to achieve your own goals, let's consider the following example:

Company X has two goals:

1. Obtain total data transparency for its best-selling products.
2. Increase eCommerce sales for all its highest-performing products.

Using ABC analysis, the company examines sales over time and discovers Blue Widgets and Green Doodads account for nearly 85% of annual consumption value while occupying just 15% and 5% of physical inventory, respectively.

The company also applies ABC Analysis to identify those customers who make the lion's share of their purchases through the company's website.

Using shared data from their CRM and sales software, they identify what percentage of those sales are triggered by email campaigns, targeted social media campaigns, and referral codes from other customers.

It finds that online customers are responding most strongly to the referral program and social media efforts.

Consequently, the company classifies both the Blue Widget and Green Doodad as category A goods. It positions them as its flagship products and increases their profile on its website.

It also dedicates more marketing and advertising spend to promoting them through targeted social media campaigns, and develops a dedicated referral program with incentives for frequent referrers.

It tracks inventory levels and demand for both products closely to ensure optimal availability and customer happiness while keeping stock levels under control.

As a result, online sales of both products grow by 18% and 30% in the next quarter, and the number of both new and returning digital customers grows by 8%.

Inventory optimization reduces costs and improves efficiency, raising profits

further. The following quarter, the company repeats the process, and makes adjustments as necessary.

Master Your ABCs to Maximize Your ROI

It may sound elementary, but a little abecedarian analysis can help you slash costs, reduce inefficiencies, and build more value from your inventory management.

Those willing to invest the time, resources, and labor necessary to support successful ABC inventory analysis and management—and take advantage of the software tools that complement its data-driven processes—can achieve greater transparency, streamline their processes, and leverage actionable insights to optimize their inventory workflows, profitability, and overall efficiency.

What's your goal today?

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