

ABC Analysis – The Complete Guide

The Ultimate Guide to Inventory Classification:

ABC Analysis



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heavily to the overall profit without costing much when it comes to the seller's resources.

Category B products are less critical than Category A products and more critical than Category C products. So stay in the middle. This category, in particular, holds the potential to either get moved into category A if the sales are good, or can even slip down to category C.

Category C items are marginally valuable. These products will help you to continually run your business, with a fixed and steady income, but don't individually contribute much value to either the seller or to the business.

Example 1: ABC Analysis in Customer Segmentation

ABC analysis can also be performed for the customer or client base to understand the market and strategize your business plans. ABC analysis for customers can be based on four primary metrics: **revenue potential, support costs, sales revenue, and contribution margin.**



Only the high paying customers are welcomed!

Implementing the ABC Analysis for Customers

Implementation of ABC analysis for your customers can start by creating charts based on the four different categories that are classified above. Once the charts are prepared, compare them, especially the sales revenue and contribution margin charts. Rank your customers and categorize them into A, B, and C.

Your most valuable customers will be in **Category A**. Now, as these customers are the ones that will bring in a lot of revenue and make up a crucial portion of the contribution margin, ideally, they will be close to the limit in terms of revenue potential.

Another set of customers, lesser value, but ones that cannot be neglected, fall in **Category B**. These customers are loyal ones and they will spend a good amount of money with you at regular intervals. However, you can never expect them to be spending much.

The rest of the customers are automatically included in **Category C**. Here, the customers are the ones which turn up once in a while and make a purchase. On the other hand, this can also include frequent customers which make a lot of small purchases. These customers will definitely spend money on your storefront, but will never make much of an impact on your sales and profit. These are customers with less potential.

The sales figures alone can be very misleading when it comes to analyzing your customers. Seeing a customer who makes a purchase once or twice a week for a small amount can certainly goof you up into thinking that they are valuable when they are actually not.

Instead of the sales figures, drive your perspective more towards the actionable data. This will enable you to take actual decisions that will boost your revenue.

Example 2: ABC Analysis in Inventory Management

Lisa has a business of sweaters, and over time, her business has achieved tremendous success. Lisa, in search for varieties and additions to her sweater inventory, has filled in 180 types of sweaters instead of just 50 types. She now realizes that this business is seasonal, and she has already invested a lot. After thorough research on how the problem mentioned above can be streamlined, Lisa implemented the ABC inventory categorization in her business model.

She was finally able to allow her business to visualize those areas wherein more profit was expected.



Now, as Lisa already had too many options to organize into three categories: Category A, B, and C, depending on their selling ratio, price, demand, etc.

Category A – The sweaters that fall under this category are the ones that are most important to the company. They can either be the ones that are highly in demand, the ones that are generating the most revenue, or the ones falling under the hottest trend for the season.

Category B – These sweaters are essential to the company, but not as much as the ones in category A. A smaller market or lesser comparative demand are some of the reasons. For example, Christmas sweaters are mostly sold during the season and not very much before or after that. But yes, during the seasons, the sales do go up. Lisa can neither neglect such sweaters, nor can she make much profit when not in season. Hence, category B.

Category C – This category includes the products that are neither in category A nor category B. Lisa doesn't wish to put in more effort to sell off these sweaters as they are not of high value to the company.

Odd sizing, color combinations, patterns can be the possible reasons for Lisa to put these sweaters in category C.

Why Use ABC Analysis?

There are 6 reasons why a business should opt for ABC analysis...

#1 End-of-life management

When it comes to a product, there is always a lifespan: launch, growth, maturity, and decline. The moment a product reaches the maturity stage, it might get declined sooner or later, but for sure. The entire lifespan of the product depends on customer demands. ABC inventory analysis helps a seller to analyze the customer demand for a particular category of product and then manage the stocks accordingly. The maturity and decline period for every product is different. More customer demand, the chances of declination are pushed further. Lesser the market, sooner will it be declined.

#2 Supplier Negotiation

When it's all about getting the category A products sourced, it is understood that 70-80% of the money is about to be invested in those suppliers. Negotiation is always a must. There are chances when a supplier might make a nod to your offer, but do not back off. You can still make offers like reducing the down payment, providing free shipping, etc. Try to make it win-win for both yourself as well as the supplier, and there are chances that you might just win the deal. Saving more on category A products can bring more profits to your business.

#3 Inventory Optimization

Inventory optimization is the most crucial reason why ABC inventory analysis is preferred by many businesses. to organize and segregate the products in the inventory as per their revenue and importance. The products are also categorized as per their demands amongst the customer base.

#4 Strategic Pricing

The ABC analysis of the inventory also brings in much more value to the company when the prices for the products are set strategically. With ABC analysis, the company will easily be able to strategize the costs of the products and then accordingly align them into different categories. More the demand for a product, the wider will be the chances to increase the rates by the seller.

#5 Resource Allocation

While the process of resource allocation is done, category A is highly monitored. If it is noticed that the product from category A is not performing well or is no longer desired by the customers, it can be moved to a lower category i.e., either category B or category C.

#6 Customer Service Levels

Several factors can affect a product's value or importance – item cost, quantity sold, and margin set. There is no need for unnecessarily crowding your warehouse with the product that has a low margin and is also not sold frequently. In such cases, the ABC inventory analysis lets the planners set service levels based on the product classification. This further makes the supply chain smoother, carrying no additional safety stocks.

How is ABC analysis done?

Again, there are six steps to understand how ABC analysis is done...

#1 Identify what needs to be analyzed and define the success criteria.

ABC is mainly to be done to achieve two primary goals – to make sure that the supplier rate is as competitive as possible (let that be in exchange for any facility that you are providing) and to increase the cash flow by having the perfect items in the list that your customers need.

#2 Collect the data from your inventory that has been analyzed.

Before you begin to analyze, collect some data that is already available through any accounting tool, related to the annual spending. This can include all the ordering costs, carrying costs, etc. if at all, they are readily available.

#3 Sort your inventory in the decreasing order of impact.

Rank the items present in your inventory from the ones costing the most to the least.

#4 Calculate the accumulated impact.

Here, you need to list down all the items in a spreadsheet and calculate the cumulative impact they had on your business. This will be done by dividing the items and their annual costs. This later is added to the cumulative total of the percentage spent annually.

#5 Divide your inventory into buying classes.

Now, you need to bring the 'Pareto Principle' into action. Not to differentiate the products with the 80/20 rule exactly, but with the principle. You will have to negotiate your contracts with the suppliers, strategize the product prices, ensure the availability of valuable products, etc.

#6 Analyze the categories and decide accordingly.

The products with the highest revenue generation will remain on the top, whereas the ones with a lower revenue dropdown. There are only 'vital few' products that can be the money makers for you, whereas the 'trivial few' will drop down in the list.

You need to continually keep on monitoring the pricing and the selling performance of the products to make sure that their positions are adequate.

Industrial Application of ABC Analysis

When it comes to supply chain and **warehouse management**, ABC inventory analysis is majorly used for the stock count cycles. For example, category A products will be counted quarterly, as they are much more relevant and valuable, category B products can be counted twice a year, and in a similar fashion, category C products can be counted once in a year.

Stock counting not merely helps you analyze your highly valued items but also helps you to understand how frequently they need to be replenished. The process of replenishment can also be called reordering, which depends on the category of products, as per their own decided controls.

Category C items should never be reordered in the same way as category B. This will unnecessarily tie up your money. Most of the wholesalers and distributors do not put this into practice and unfortunately, get a large number of working capital tied up in unhealthy inventories and products.

ABC inventory analysis isn't mandatory for businesses to apply in their supply chain management, but is highly recommended to avoid future unwanted errors and losses.

Conclusion

There is no such threshold for determining which products will go into which category, the company needs to decide the limit for each category if they want to interpret the data that is meaningful to their business.