

ABC Classification in the New Century

There was a time when Pareto's Principle (known more commonly as the 80/20 rule) was considered to be a groundbreaking concept in business management. That 80% of a company's profit is typically derived from 20% of the product line will surprise few. As this concept was transcended by ABC classification, which found three groups (or often four, depending on the proponent) in its taxonomy, it became increasingly possible to classify items according to their contribution to the company and move away from the antiquated notion of equal treatment across the product line.

These theories have been implemented to great effect, leading to significant improvements in the bottom lines of many innovative companies that have chosen to base their methodology on solid management ideology. This time of economic downturn appears to be separating the proverbial men from the boys as inefficient business practises become increasingly exposed while lean enterprises continue to prosper.

The best news is the fact that ABC classification is still improving as a business concept. At present, simple ABC classification has been replaced by more customisable levels of analysis with additional levels of depth to deliver a more informed strategy. ABC classification has been revolutionised by the introduction of two variable analysis. While the simple classification provided only three categories, two variables allows for nine and, more importantly, distinct strategies for each.

The fundamental difference is that the old approach often failed to distinguish the distinct needs of different product lines. An expensive item with low sales may contribute the same level of profit as a cheap item with high sales. However, demand variability in the former could cause serious risks to the business while the latter is a safe bet. If you cross lead time variation with the level of contribution you can predict where problems with the supplier will lead to a significant loss in sales of high priority items.

The general trend is always the same: there are sweet spots where the bulk of your income is produced and problem points where great costs are incurred without significant return. However, these cases are rarely homogeneous. At times, both may be happening concurrently. The most effective method of isolating these regions in the product line is difficult, if not impossible, to say. In spite of this, certain approaches tend to yield positive results. ABC classification, especially when conducted with two variables, can provide useful insights into the way a business operates and which areas require more, or less, attention.

Ultimately, resources need to be used sparingly but there shouldn't be downsizing to the point of downgrading. The aim of lean business has always been to ensure spending is directed towards value-added labour. Some companies employ large IT departments that result only in higher levels of administrative expenditure while a small fraction is dedicated to value-added work. This is by no means a criticism of IT, it simply highlights the fact that a large department of specialists may need to be carefully assigned tasks as, left to their own devices, the specialised nature of their work may lead them away from value added work. A good employee wants to do their job to the best of their ability, not to the end that it creates the most wealth and incurs the least costs. When there is a disparity between these two endpoints problems can readily occur.

ABC analysis has become more popular as companies start to realise the importance of reducing unnecessary costs and focus on the value added tasks their employees can perform. The current economic climate calls for innovative thinking and appropriate business methodologies. Lean philosophy requires an organisational infrastructure built towards adaptation and classification can provide beneficial insight to reach such ends. Used as part of a greater apparatus of business intelligence solutions, six sigma and theory of constraints related thinking, creative technological solutions and a commitment to the principles of the lean ideology; it offers an invaluable aspect to an organisation's business practice.

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