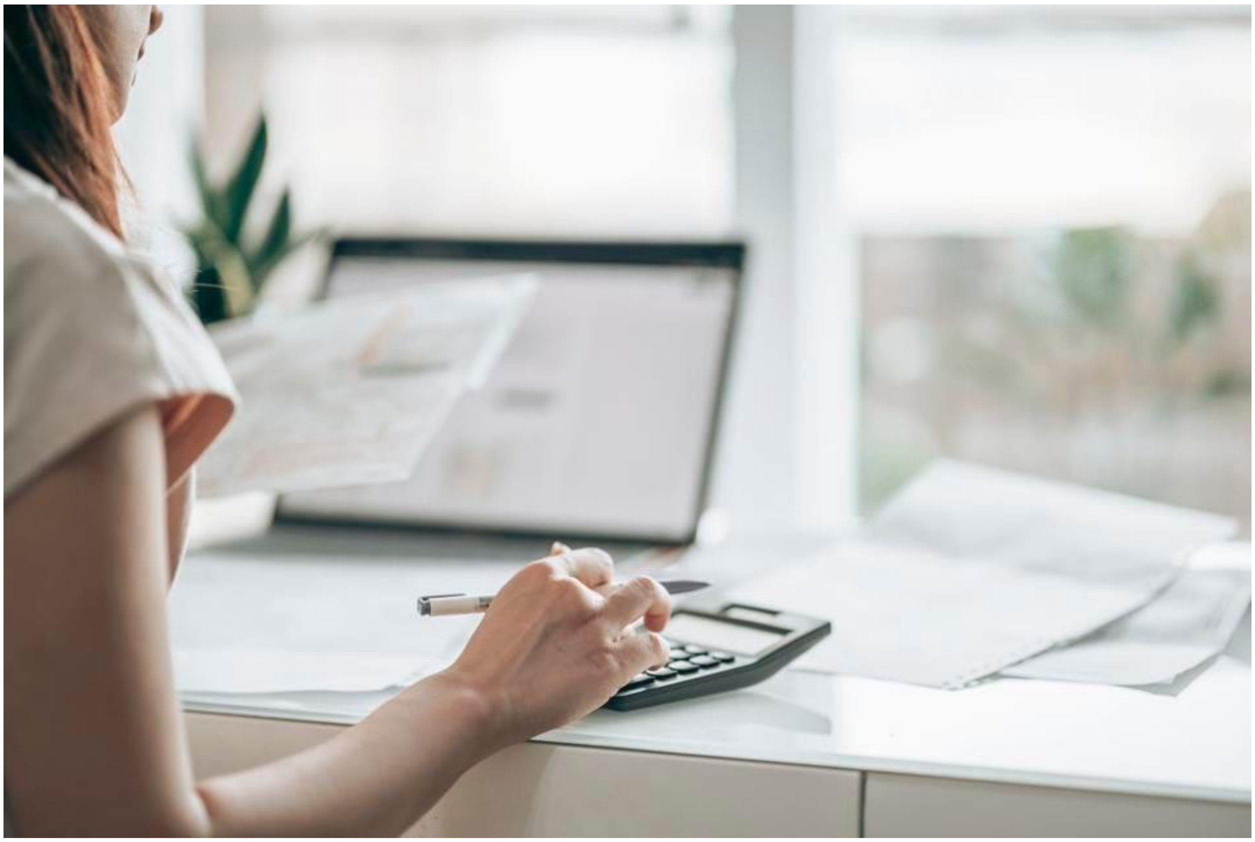
Why Contribution Margin Is an Ineffective Measure of Profitability

By Gregory Milano



“The perfect is the enemy of the good,” an aphorism often attributed to Voltaire, is frequently invoked by business leaders to avoid precisely measuring the granular profitability of products and services, distribution channels, customers and geographic regions. Instead, many aim to avoid arguments over how to allocate indirect costs and the costs of capital by measuring *contribution margin*.

Contribution margin indicates the extent to which product revenue exceeds its variable costs, and those who favor it often claim it reflects the *contribution* of each product to the bottom-line profit of the business. When asked why they do not allocate the remaining costs in the business, many say this approach ends up charging business unit or product managers for costs they don't control and instigates conflict and discontent, since everyone has a different view on how the indirect and fixed costs should be allocated.

It is true—calculating contribution margin is easier than allocating all costs to get to a true bottom-line profit per product, and so leaders across companies tend to accept this imperfect methodology. But is the easiest solution the best solution? Is contribution margin "good enough" to be the basis for the critically important task of allocating capital, innovation and marketing resources?

The Drawbacks

The primary reason for putting in the time and effort to determine a fully costed granular profit is to avoid the erroneous signals, and resulting flawed decisions, that contribution margin brings about. Some products tie up production capacity for longer periods per unit and should be charged a greater share of the associated fixed costs. But contribution margin ignores this, and product managers are only motivated to innovate new solutions to reduce production time when such costs are charged to the product.

Other products require a more complex sales process and should be assigned a greater sales force cost per transaction. Maybe the product is non-standard, and by charging for this higher sales cost, product managers would be motivated to bring the product in line with standards to simplify and shorten the selling process, or determine a higher price is warranted to offset the higher sales effort. With many common applications of contribution margin, there is no such motivation.

Theoretically, the use of production capacity and sales resources are variable costs and should be charged to contribution margin, but in practice they often are not. Additionally, it's hard to know what's fixed and what's variable. If we double the size of the business, will we need more HR staff? Will the salaries and overall compensation packages of the CEO and other executives rise?

I also often hear, "But I don't control those costs." Some seek to create an artificial world where managers are only accountable for things they control. This is an ineffective use of time since there are so many influences on a business that we do not control, but in the real world we want managers to properly react to them. Consider the inflation we have been dealing with; we do not control it but we must react to it, for example, in how we buy materials, consider salary increases and price products.

What's more, sometimes a lower contribution margin is seen as "less profitable, but still profitable," while fully allocated profits would show there is actually a loss. Herein lies one of the most common problems I've observed: the perpetuation of unprofitable activities that drag down overall profitability and success.

Fully allocated profits provide useful financial information on products and services, distribution channels, customers and geographic regions to know where to invest more or less. In many companies, the lion's share of value creation results from just a handful of products or business units, as suggested by the Pareto Principle, which is also known as the 80/20 rule. But because of the problems discussed above, we cannot rely on the signals provided by contribution margin to accurately classify the top and bottom 20% of our opportunities.

Embracing Granular Profit Insights

In my experience, the most profitable products, where reinvestment should be concentrated, will look great no matter how we do the cost allocations. And the least profitable ones, where we should restructure them to earn the right to grow, or harvest them by selling or shuttering them, will look bad under virtually any cost allocation methodology.

Indeed, this is how to get buy-in: Run multiple allocation scenarios and you'll likely see that the top performers tend to stay the best, and the bottom performers are always the worst. This information allows managers to align around the key opportunities for growth and restructuring, rather than debating the nuances and accuracy of the middle 60%.

To embrace granular profit insights, begin by gathering information, which often lies across different systems and departments and work through the allocations. The state-of-the-art in activity-based-costing has come a long way, and these methodologies can be applied thoughtfully to set up the algorithms in a suitable way. My colleagues and I advocate using an economic profit framework, which requires that you not only allocate costs but also the cost of the capital deployed. Working capital can often be assigned directly, and fixed assets can be keyed to the allocation of depreciation in the P&L.

Use the resulting insights to guide resource allocation to drive more growth in activities where more value is created, and vice versa. After going through the process in this way, I've found decisions become so clear that most managers seek to systematize the process to glean these granular insights on an ongoing basis.

I've found the companies that embrace such granular profit insights are likely to make better decisions on resource allocation, pricing and overall business management, which can lead to a managerial competitive advantage, stronger performance and higher total shareholder return.

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