

Contribution Margin

In business we hear the terms “top line growth” and “bottom line growth”, and what these are referring to is Sales (top line) and Earnings (bottom line). A very common error in business is the focus of management on the top line, rewarding sales staff for bringing in revenue, but with no analysis or visibility into whether this is profitable revenue or not (i.e., whether it is contributing to or taking away from the bottom line). This is not good, because stock valuations are based on bottom line growth, and the objective of management should be to grow the return for shareholders. When analyzing sales, the measure to use instead of revenue is **contribution margin**, which is defined as:

$$\begin{array}{r} \text{Sales} \\ - \text{Cost of Goods Sold} \\ - \text{Sales Commissions} \\ - \text{Shipping Expenses} \\ \hline = \text{Contribution Margin} \end{array}$$

Since items below the contribution line are fixed expenses, the decision of whether to make a sale or not should be dependent solely on the contribution margin, with a single dollar of contribution helping to pay then for the fixed expenses that lay below this line. The only caveat to this is that your capacity utilization must be below 100%. If you are already constrained on capacity, then contribution margin should be used to select the sales that are accepted or rejected – accepting those that provide the most contribution to your company.

Sales commissions should be tied to the contribution that they bring to the company, not the revenue. Contribution margin can also be used to optimize product portfolios / lines, identifying what the profitable and unprofitable products are. Contribution margin can also be used to optimize the customer base, with customers who purchase lower contributing products being less desirable than customers who purchase higher contributing products.

Lower contributing products, customers, and sales staff are all prime candidates for elimination or restructuring. And highly contributing products, customers, and sales staff are all prime candidates for protecting, growing, and rewarding.