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WHY CONTRIBUTION MARGINS MATTER

There are certain core financial ratios that any small business owner should understand in order to better manage their business – gross margin %, debt to assets, accounts receivable turnover, etc. One ratio that is often overlooked but proves to be immensely useful is the contribution margin. Understanding this concept is important because your contribution margin is what allows you to cover your fixed costs and generate a profit. Additionally, understanding your contribution margins will allow you to make better decisions as to where and how you sell your products.

Revenue minus variable expenses is the definition of a contribution margin. Whereas revenue less the input costs to produce a bottle of wine results in the gross margin, the calculation of the contribution margin factors in the additional costs to actually sell the product – the additional variable expenses. If the contribution margin does not exceed a company's fixed expenses, it does not make a profit. A company that has a contribution margin that is less than its fixed expenses incurs a loss.

As a small business owner, you are aware that there is a lot more to your business than just selling your product for more than it cost to produce. There are certain costs that are incurred regardless if you sell a product (fixed costs) and other costs that are incurred as part of selling your product (variable costs). To understand the concept of contribution margin, it is important to understand the differences between fixed and variable costs.

In order to be in business there are certain expenses that are required. These costs don't vary with the level of output of the business; they are recurring expenses that are also known as overhead. Common examples of fixed costs include rent, utilities, office supplies, permits, and insurance. Regardless of the amount of products sold, these costs are "fixed" in their nature and need to be covered by the business owner.

Variable expenses are costs that increase or decrease relative to the amount of product sold. Said another way, these are the costs that are incurred in order to complete the sale of the product. Examples of variable costs include broker commissions, shipping expenses, distribution allowance, shipping supplies, etc. As sales of products increase, these costs increase as well, hence the name "variable" expense.

With this basic understanding of fixed vs. variable costs and how they relate to contribution margins, an owner can now better evaluate sales opportunities. It is well known that certain sales channels (tasting room) have higher gross margins than others (distribution). While it does make sense to try and generate the highest gross margin possible it is equally important to understand the variable costs that are associated with completing the sale.

For instance, let's assume that you sell a bottle of wine via the tasting room for $30 and in distribution it is $15. Assuming a production cost of $10 per bottle, the gross margins by tasting room and distribution would be $20 and $5, respectively. At first glance, it seems obvious that you'd want to sell as much as possible through the tasting room in that the gross margin is much larger. However, in order to properly make that determination it is important to evaluate the additional variable costs incurred to complete the sale.

Let's assume that the variable costs incurred to sell the bottle in the tasting room were $18 (staffing, utilities, samples, etc.) while the variable costs to sell through distribution are $2. Once these costs are factored in, it appears that it is actually more profitable to sell your wine through distribution than through the tasting room in that the contribution margin is $3 per bottle as opposed to $2 per bottle. The extra $1 of contribution margin per bottle is that much more money you will have to cover the aforementioned fixed expenses.

Keep in mind that there are certain fixed costs that rely on the variable costs of selling product in a certain manner. An example would be if an owner spent considerable funds on retrofitting a tasting room only to close it a year later because sales didn't meet expectations. Without selling product through the tasting room this cost cannot be recovered and therefore adds that much more pressure to increase contribution margins in other channels. The same situation occurs if a long-term lease is signed and the owner cannot find someone to take it over, this is now a "sunk" cost that must be recovered through other sales channels.

The above is an example of why it is important to understand the concept of contribution margins. Business owners who assume that a higher gross margin is better for their business may find themselves in financial difficulty because they aren't considering the additional costs to complete the sale. If nothing else, understanding contribution margins will allow you to justify why one sales channel is worth focusing on relative to another. As always, if you'd like any assistance in evaluating your contribution margins please feel free to give us a call.