

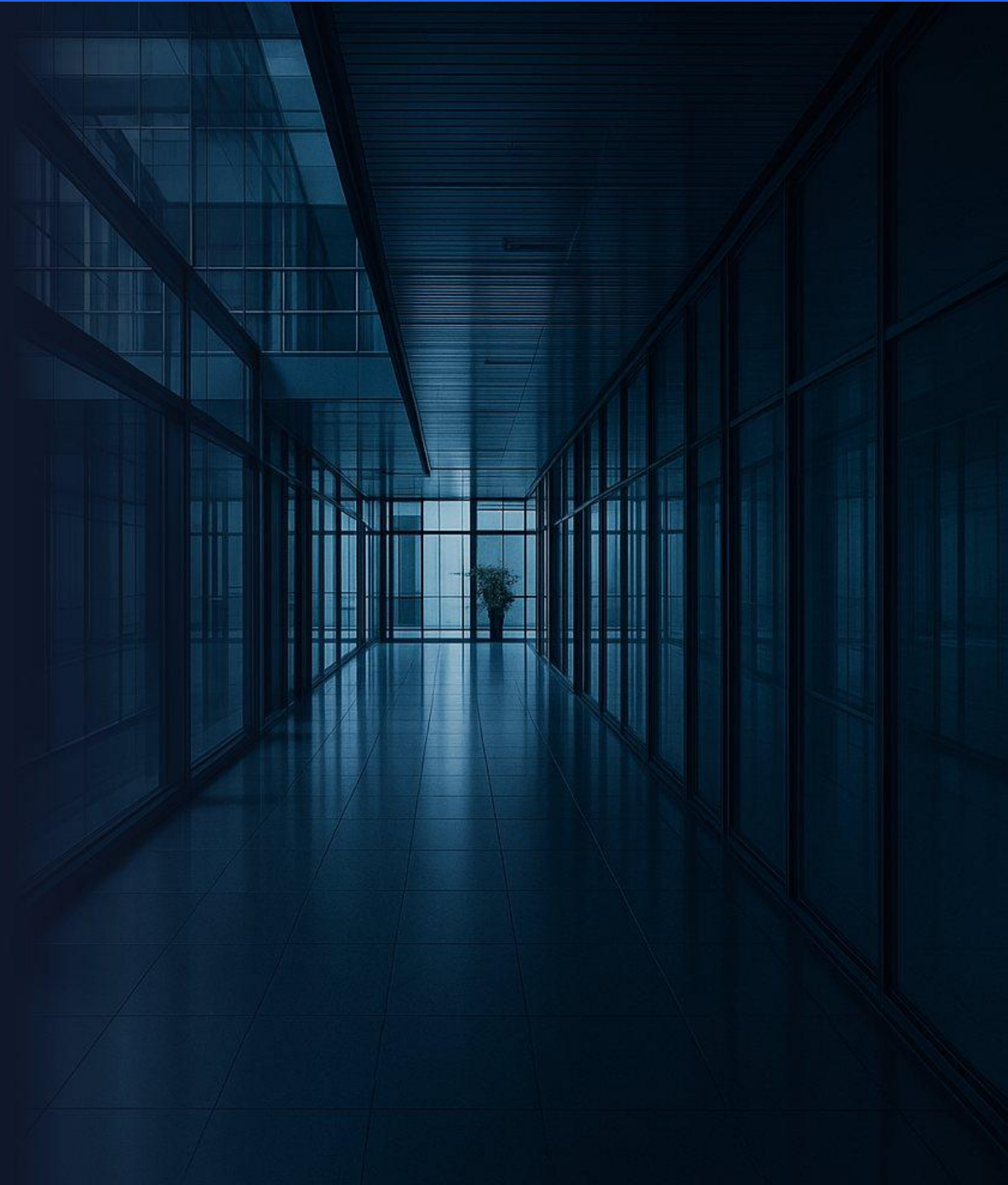
Allocate Costs, Explain Margin

How shared costs are assigned to the things that caused them, and how a margin movement is decomposed into reasons.

Theory session

Intermediate

Running case: LedgerLift



Where this session sits

1.1 established how costs enter the statements; 1.2 decides where they land

MODULE 1

Build Reliable Financial Foundations

MODULE 2

Manage Cash
and Uncertainty

MODULE 3

Choose and
Manage Funding

SESSIONS IN THIS MODULE

1.1

Read Statements Through Accruals

Connecting the three statements to the entries that create them

1.2

Allocate Costs, Explain Margin

Assigning shared costs and reconciling margin movement

YOU ARE HERE

1.3

Control the Monthly Finance Close

Catching errors before decisions are made on them

What this session explains

Making a margin number attributable, and a margin change explainable

01 Allocation is a causal claim

Assigning a shared cost asserts what drove it, and the assertion can be wrong.

02 Averages conceal variety

A blended margin hides which customers and products actually pay.

03 Contribution and operating margin answer different questions

One guides pricing and mix; the other judges the whole operation.

04 A margin movement decomposes

Price, volume, mix, and cost each contribute a quantifiable amount.

What a cost allocation asserts

Every allocation base is a hypothesis about causation

WORKING DEFINITION

Allocating a shared cost assigns it to the products, customers or jobs that caused it to be incurred — so the choice of allocation base is a claim about what drives the cost, not an accounting convenience.

1

Direct costs need no claim

They are traceable to one object. The difficulty begins only with costs shared across several.

2

The base should be the driver

If a cost rises with machine hours, allocating it on headcount produces a number with no decision value.

3

Arbitrary is not neutral

Spreading overhead evenly is itself a claim — that every unit consumes it equally — and it is usually false.

Cooper, R. & Kaplan, R. (1988). Measure costs right: make the right decisions. Harvard Business Review, 66(5), 96–103.

Traditional absorption and activity-based costing

The difference matters most where product or customer complexity varies

ABSORPTION

One or two broad bases

HOW IT WORKS

Overhead is pooled and spread on a volume measure — labour hours, machine hours, or revenue.

WHERE IT IS ADEQUATE

When products are similar and overhead is small relative to direct cost.

WHERE IT DISTORTS

High-volume simple products subsidise low-volume complex ones, invisibly.

ACTIVITY-BASED

Cost pools with their own drivers

HOW IT WORKS

Costs are pooled by activity — set-ups, deliveries, inspections — and each pool gets its own driver.

WHAT IT REVEALS

That complexity, not volume, drives much of overhead. Small awkward orders are often unprofitable.

THE COST

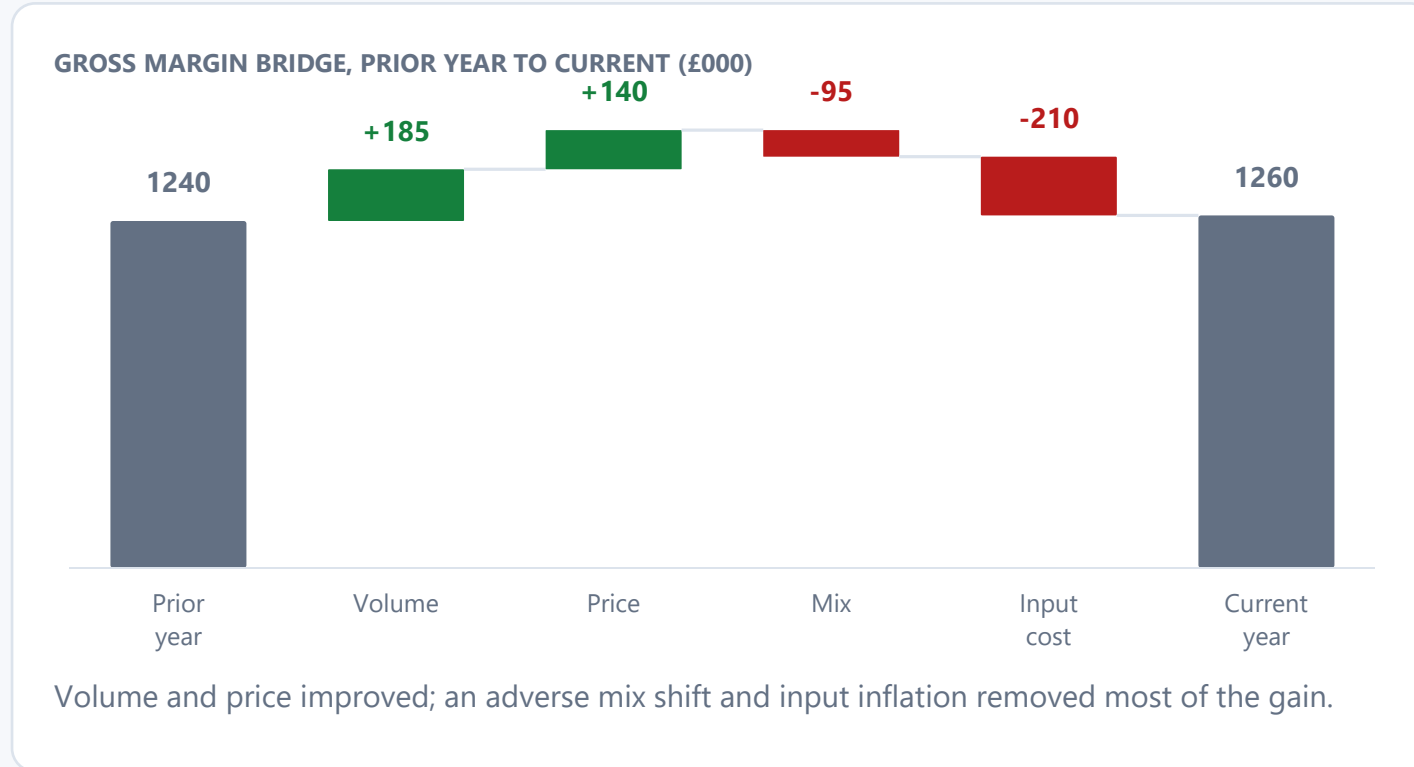
More measurement, more maintenance, and a model someone must own.

READING THE CASE THROUGH THIS LENS

The fuel case is an activity problem in disguise: shared loads and complex terminals mean the cost of a delivery depends on the route and the mix, not on its size.

Decomposing a margin movement

Four effects, each quantified, summing to the total change



VOLUME

Same margin, more of it

Units sold × prior-period unit margin. Isolates growth from everything else.

PRICE AND COST

Rate effects

What changed per unit, holding volume and mix constant. These are the levers management actually pulls.

MIX

The one that surprises

Selling a different blend of products or customers moves total margin without any price or cost changing.

Four margins, four uses

Using the wrong one is how pricing decisions go wrong

Margin	Calculated as	The question it answers
Gross margin	Revenue – cost of goods sold.	Does the core product make money before running the company?
Contribution margin	Revenue – all variable costs.	What does one more unit add? This drives pricing, mix and break-even.
Operating margin	Revenue – all operating costs, including fixed.	Does the whole operation work at this scale?
Customer margin	Revenue – cost to serve that customer, allocated.	Which relationships are worth keeping on these terms?

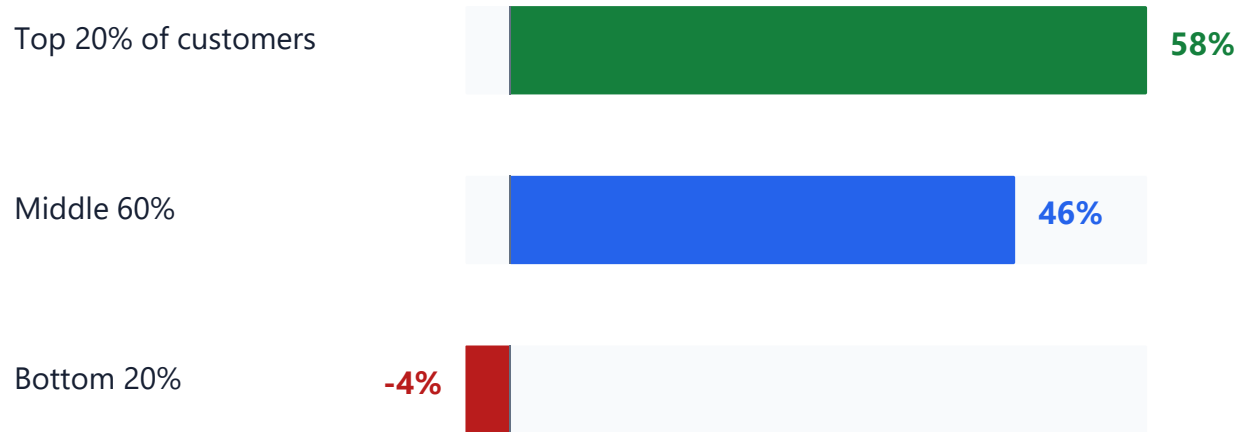
THE CONFUSION THAT COSTS MONEY

Contribution margin is the one most often confused with gross margin. The difference is whether fixed production costs sit inside it — and that difference decides whether a marginal order is worth taking.

The average customer does not exist

A blended margin conceals a distribution that usually looks like this

ILLUSTRATIVE CONTRIBUTION BY CUSTOMER DECILE



The reported blended margin was 42%. No customer actually sits there.

Kaplan, R. & Narayanan, V. (2001). Measuring and managing customer profitability. Journal of Cost Management, 15(5).

THE PATTERN

Whale curve

A minority of customers generate most of the contribution; a tail consumes it. Common enough to expect.

WHY IT HIDES

Cost to serve

Small orders, special handling and support rarely appear in cost of goods — so the tail looks profitable.

WHAT TO DO

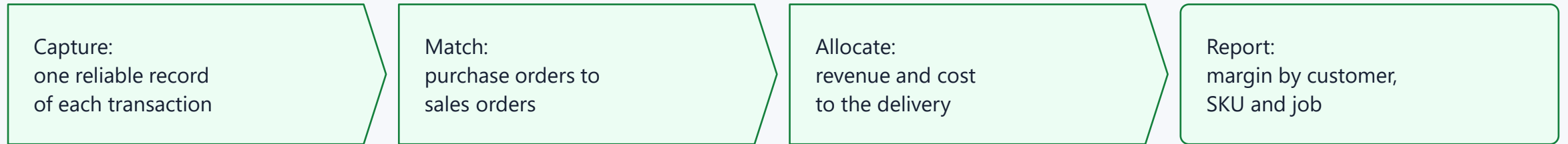
Re-price or re-scope

Unprofitable customers are usually mispriced, not unwanted. Change the terms before ending the relationship.

What has to happen before a margin is attributable

The fuel case failed three times at the second step

FROM TRANSACTION TO DELIVERY MARGIN



THE STEP THAT IS SKIPPED

A data warehouse solves capture. It does not solve matching or allocation — which is why three earlier attempts left the allocation problem in place.

How precise does the allocation need to be?

Precision has a cost, and beyond a point it buys nothing

TOO COARSE One blended rate across everything. Cheap, and it cannot support a pricing or mix decision.	DECISION-GRADE Enough pools and drivers to separate the choices you actually face — customers, routes, product families.	OVER-ENGINEERED Dozens of pools maintained by nobody. Accurate on paper, stale within two quarters.
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CHOOSING THE LEVEL

Ask	If the answer is yes
Would a different allocation change a price, a mix or a customer decision?	The extra precision is worth buying.
Can the driver data be captured without manual entry?	The model will survive past its first quarter.
Does one person own the model?	It will be maintained. Otherwise it will not.

Three allocation habits that produce confident wrong answers

Each survives review because the arithmetic is correct

Allocating on revenue

Looks like Overhead spread in proportion to sales.

Why it fails It guarantees that big customers look expensive and small ones look cheap.

Fix Allocate on what actually drives the cost.

Ignoring cost to serve

Looks like Margin measured at gross level only.

Why it fails Support, handling and returns fall outside it — which is where the tail loses money.

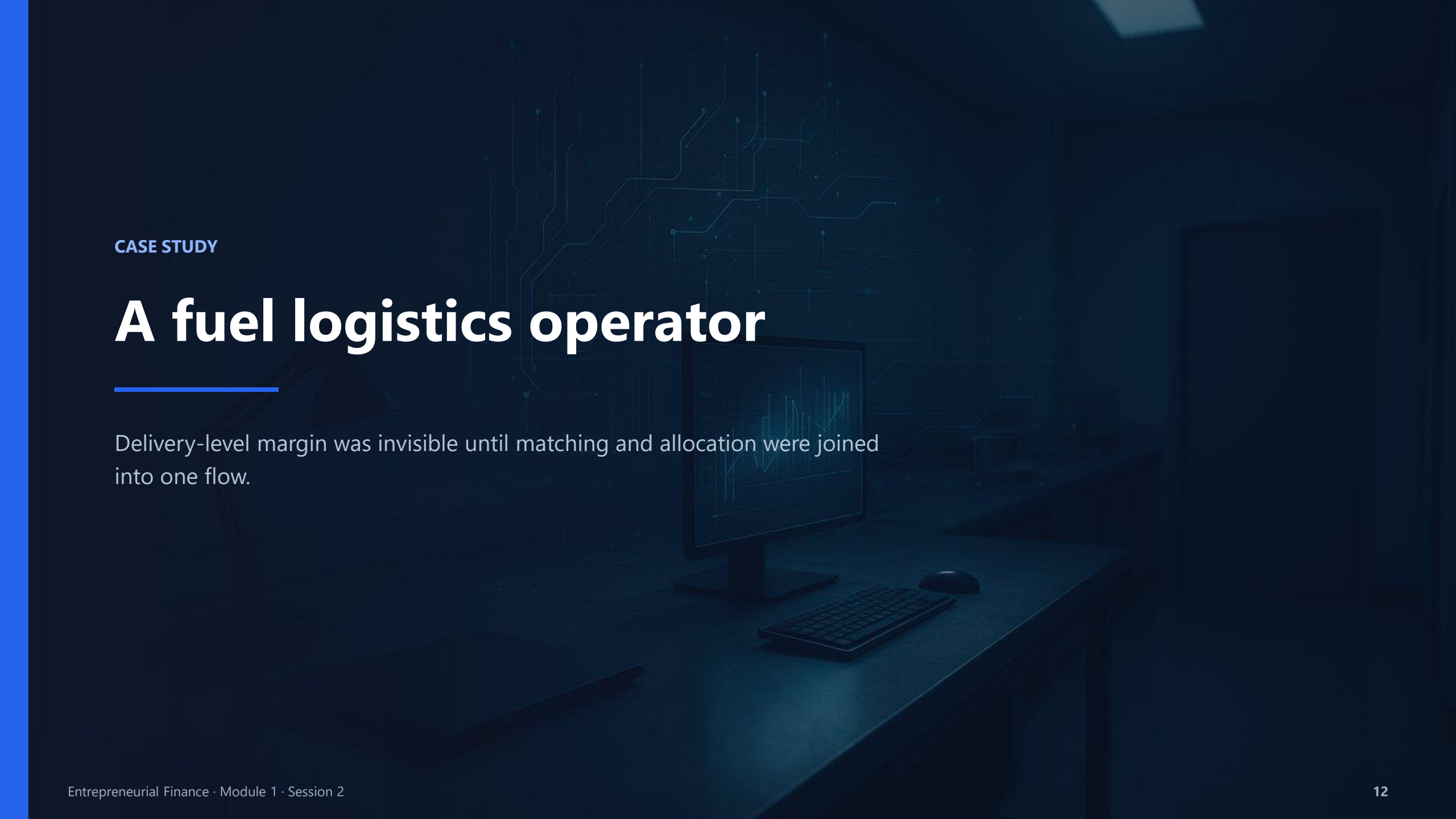
Fix Build customer margin, not just product margin.

The unexplained movement

Looks like “Margin fell two points.”

Why it fails Without a bridge, the cause is guessed and the response is generic.

Fix Decompose into price, volume, mix and cost every period.



CASE STUDY

A fuel logistics operator

Delivery-level margin was invisible until matching and allocation were joined into one flow.

From 70% to 99% visibility

Matching and allocation joined into a single flow

THE OBSTACLE

Why totals concealed the deal

THE CONDITIONS

Complex terminals, uneven invoice quality, and shared loads across customers.

THE CONSEQUENCE

Gross margin could not be determined at delivery level; profit visibility was around 70% accurate.

THE PERSISTENCE

Three prior attempts with consultants and technology had not resolved the allocation problem.

THE ARCHITECTURE

Matching, then allocation

FOUNDATION

A data warehouse replaced fragmented source conditions.

MATCHING

Purchase orders matched to sales orders in near real time.

ALLOCATION

Revenue and costs assigned by delivery — profit visibility reached 99% accuracy.

READING THE CASE

Accurate margin depends on the path from transaction to delivery, not only on the final total. A warehouse alone does not resolve the question of which cost belongs to which job.

Drawn from the session case pack.

Bringing the theory to LedgerLift

Building a margin view that can support a decision

Step	What you decide	LedgerLift example
Define the object	What you need margin for.	Per customer account, since pricing is negotiated per account.
Separate direct costs	Traceable without judgement.	Per-account infrastructure, integration hours, data egress.
Pool the shared costs	Grouped by activity, not by department.	Onboarding, support tickets, custom reporting.
Choose drivers	The thing that makes each pool grow.	Onboarding by hours; support by weighted ticket count.
Build the bridge	Price, volume, mix, cost.	Margin down 3pts: price +1, volume +2, mix -4, cost -2.
Act on the tail	Re-price before you withdraw.	Bottom decile: move to standard onboarding or a higher tier.

WHAT COMES NEXT

Session 1.3 makes sure these numbers are produced reliably each month, before anyone decides on them.

What to carry out of this session

1

An allocation base is a causal claim.

Choose the driver that makes the cost grow, not the one that is easiest to obtain.

2

Blended margin hides the distribution.

Expect a profitable core and a tail that consumes contribution.

3

Know which margin you are using.

Contribution drives pricing and mix; operating margin judges the whole operation.

4

Decompose every margin movement.

Price, volume, mix and cost — a two-point fall has a specific cause.

5

Precision has a cost.

Build only the granularity that would change a decision, and give it an owner.

Sources for this session

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