BY MELANIE HODGDON

Making Commissions Work

I've had a number of questions from clients recently about how to handle sales commissions. A big question is whether these should be considered a job-related cost (and therefore recorded as part of cost of goods sold, or COGS) or overhead (recorded as an expense). In this article, I'll examine what you need to think about. Please note that percentages included in this article are not intended to be recommendations for commissioning. Also, all figures are theoretical and do not include any allowance for slippage.

WHAT ARE COMMISSIONS BASED ON?

It's important to provide salespeople with incentives in order to keep them selling. But you need to lay down some ground rules, and one of the most important is that salespeople need to aim for a target margin, not a number. It's one thing to sell $500,000 worth of jobs, but unless those jobs hit the target margin, they can be detrimental to the company's financial health. To explain why, let's look at two scenarios, A and B, detailed in the charts below.

Scenario A: Commissions based on sales. In Scenario A, the salesperson hasn't been provided with a target margin and is free to sell a job at whatever price seems to work for the customer. His or her focus is on making the sale since that's what the commission is based on. This is good for the customer and good for the salesperson, but it's bad for the company.

In Scenario A (see chart, below), the sale price was achieved using a range of markups between 29% and 35%. This fluctuation may have been due to the salesperson's assessment of what the customer would easily

Scenario A

	Job 1	Job 2	Job 3	Job 4	Job 5	Total
Estimated Costs	$35,000	$68,000	$50,000	$30,000	$28,000	$211,000
Markup Used	32%	29%	34%	32%	35%	
Selling Price	$46,200	$87,720	$67,000	$39,600	$37,800	$278,320
Theoretical Gross Profit	$11,200	$19,720	$17,000	$9,600	$9,800	$67,320
Theoretical Gross Margin	24%	22%	25%	24%	26%	24.19%
Commission on Sales Price @ 1.50%	$693	$1,316	$1,005	$594	$567	$4,175
Net (Gross Profit Less Commission)	$10,507	$18,404	$15,995	$9,006	$9,233	$63,145
Effective Gross Margin Incl. Commission						22.69%

Scenario B

	Job 1	Job 2	Job 3	Job 4	Job 5	Total
Estimated Costs	$35,000	$68,000	$50,000	$30,000	$28,000	$211,000
Markup Used	37%	37%	37%	37%	37%	
Selling Price	$47,950	$93,160	$68,500	$41,100	$38,360	$289,070
Theoretical Gross Profit	$12,950	$25,160	$18,500	$11,100	$10,360	$78,070
Theoretical Gross Margin	27%	27%	27%	27%	27%	27.01%
Commission on Gross Profit @ 5.35%	$693	$1,346	$990	$594	$554	$4,177
Net (Gross Profit Less Commission)	$12,257	$23,814	$17,510	$10,506	$9,806	$73,893
Effective Gross Margin Incl. Commission						25.56%

Scenario A

Income	$278,320
COGS	$211,000
Commissions (as COGS)	$4,175
Gross Profit	$63,145
Gross Margin	22.69%
Net Margin	22.69%

Scenario B

Income	$289,070
COGS	$211,000
Gross Profit	$78,070
Gross Margin	27.01%
Commissions (as Overhead Expense)	$4,177
Net Profit	$73,893
Net Margin	25.56%

swallow. This approach results in the following:

- The salesperson ends up with $4,175 in commissions.
- The company ends up with $67,320 from which the commission amount is deducted.

Scenario B: Commissions based on achieved gross profit, or margin. In this scenario, the commission is based on the achieved profit (or more likely, the achieved gross margin) of the completed project, so the salesperson is motivated to sell jobs at a price that will produce as much profit as possible. Commissions are based on a stepped percentage plan: If the project fails to meet the target margin, the commission will be reduced; if the project's target margin is exceeded, the commission will be increased. It's to the salesperson's advantage to sell high, as that should produce the greatest profit, and therefore the greatest commission. This is good for the salesperson and good for the company, and if the price is realistic, it's good for customers, who should receive an exceptional experience owing to an adequate production budget.

In Scenario B (see chart on page 27), the sale price was achieved using a strict 37% markup because the company's target gross margin is 27%. If a price doesn't provide the target margin, the salesperson's commission will be reduced or eliminated entirely. Therefore, she's motivated to sell with an eye to engineering profit rather than on simply making the sale. As a result:

- The salesperson ends up with $4,177 in commissions (note this is $2 more than in Scenario A).
- The company ends up with $78,070 from which the commission amount is deducted.

HOW TO CLASSIFY COMMISSIONS

Because many contractors believe that commissions are part of job costs, their impulse is to classify commissions as cost of goods sold (COGS). In fact, this creates a number of problems.

Cost of goods sold = muddled margins. As soon as commissions are included in COGS—with direct costs such as materials, labor, and subcontractors—the achieved margin from the actual production portion of the job is diluted. In Scenario A (see chart, above left), the original (precommission) margin was 24.19%. However, because commissions were included in COGS, the gross margin reported on the Profit and Loss dropped to 22.69%. If you wish to create a profit-sharing or bonus program based on gross margins, the inclusion of commission costs muddies the waters. Profit-sharing and bonus plans should encourage production workers to strive their utmost to use efficient production practices to maximize gross profit. Mingling sales-related costs with production costs confounds this.

Overhead = customers paying for commissions. If you include commissions as part of your overhead, then your customers pay for them, because your markup is designed to cover your overhead. (If it isn't, you're in big-time trouble!)

By classifying commissions as an expense (see chart for Scenario B, above right) rather than as COGS, you will get a clear achieved margin that includes only production-related (as opposed to sales-and-production related) costs. This number will be useful for calculating bonuses or profit-sharing. Excluding sales commissions will also restrict COGS to costs that are, at least to a certain extent, controllable by your production workforce.

Adding the cost of commissions to your overhead allows you to include the cost of commissions when creating a budget, and ensures that your customers pay for them.

MAKE IT WORK FOR ALL PARTIES

Whenever you make decisions about how to handle a new cost, both in reality and in terms of your financials, be sure to look ahead and engineer a policy that will work for the benefit of all parties (company, employee, customer). Structure your financials to avoid having to "back out" costs or explain things to your workforce, your tax preparer, or a prospective buyer.

Melanie Hodgdon is owner of Business Systems Management.