Certified Public Accountants

Guide to Commission-Based Pay for Sales Teams

As a business owner, you likely understand that commission-based pay can be a powerful tool for motivating your sales team. However, the key to maximizing its effectiveness lies in structuring your commission models to align with your business goals and drive growth.

In this document, we'll provide a look at commission-based pay for sales teams. We'll discuss different commission structures, how to choose the right one, and best practices for implementing them.

Bases and commissions

Commission-based pay means your sales reps earn a portion of their income based on their sales. Depending on your setup, commissions can be their entire pay or additional compensation on top of a base salary, giving them a clear incentive to close more deals.

While 100% commission may provide a greater upside for a sales rep, many prefer a base plus commission because it provides greater stability. Furthermore, a base plus commission model may attract more candidates for open sales positions than a 100% commission model.

If your compensation model is 100% commission, you might consider providing a draw against commissions. With a draw, the employer essentially makes a loan to a sales rep, which future commissions repay. For example, the employer may provide a draw of $4,000 a month. If a rep's commissions are greater than $4,000 in a given month, the excess is first applied to any draw balance owed, and the remainder is distributed to the rep. A draw is helpful when sales are cyclical or inconsistent month after month.

Considerations for effective commission structures

Revenue vs. gross margin commission

A key decision when structuring commissions is whether to base them on top-line revenue or gross margin. In a revenue-based model, sales reps earn commissions as a percentage of the total sales amount. This approach is often suitable when gross margins are relatively consistent across products and services. It allows you to maintain profitability without disclosing sensitive cost information to your sales team, preserving confidentiality around your profit margins.

With a gross margin model, you base commission on the profit generated from each sale. For instance, if a product sells for $1,000 with a margin of $300, the rep's commission is a percentage of that $300 margin. This structure rewards reps for maximizing gross margin, discourages excessive discounting, and motivates them to promote higher-margin products. It's particularly effective in businesses where profit margins vary significantly across offerings, or reps have the power to set pricing or control discounts.

When choosing between these models, consider how transparent you want to be with your employees regarding profit margins and whether variability in margins requires a focus on profitability. A revenue-based commission model is typically easier to manage. But, if maintaining gross margin is challenging, the gross margin model might be better.

Recurring revenue

In businesses that sell subscription-based products and services, the key is determining how and when to pay commissions. Instead of receiving one payment for a sale, the company receives recurring revenue over the life of the subscription. Many businesses with subscription models pay commissions over a period of time as payments are received. This helps align cash outflows with inflows.

It's common to limit the period of time in which a company pays a commission on a new subscription. For example, commissions may be paid on payments made within the first 12 months of the sale. If commissions were paid indefinitely, then sales reps may begin to rely on accumulated residual income and lose the incentive to acquire new clients. Unless the salesperson manages the account and provides ongoing support, their commission should conclude after a reasonable timeframe.

Renewals

You also need to consider whether you'll pay commissions on contract renewals. Often, a sales rep secures the initial contract and then hands the customer to an account manager who handles the ongoing relationship and future renewals. If so, the rep's commission should be based mostly, if not entirely, on the initial sale.

However, if the salesperson must secure a renewal, they should receive commissions for these efforts. This approach compensates them for the additional work and incentivizes them to ensure customer retention.

Enhancing incentives within your commission structure

You can incorporate additional mechanisms to fuel specific sales efforts. These aren't standalone commission structures but enhancements to your existing plan that align with strategic goals.

For instance, you might offer a tiered commission rate that increases the commission percentage as reps reach higher sales volumes or exceed their targets. For example, a company might set commission rates at 5% on monthly sales up to $20,000, 7% on sales between $20,000 and $50,000, and 10% on sales over $50,000.

Studies have shown that tiered commission rates can significantly enhance motivation. However, reps may be inclined to delay closing deals or push sales into the next month if they're having a slow period, manipulating the timing to bump their commissions into a higher tier in the following cycle. To address this concern, monitor metrics throughout the sales cycle to identify unusual patterns, such as a sudden spike in sales right after a new period begins. Also, consider team-based incentives in addition to individual commissions. When reps are rewarded for collective performance, they're less likely to focus solely on individual sales timing.

Incentives for pre-sale activities

Effective sales aren't just about closing deals; they begin long before with proactive efforts that fill the sales pipeline. Activities like outbound cold calls, scheduling meetings, product demonstrations, and nurturing leads are critical steps that lead to eventual sales. However, sales reps often experience a "roller coaster" effect - intensely focusing on closing deals at the expense of generating new leads, which results in a dry pipeline once current deals conclude.

To mitigate this, consider incentivizing pre-sale activities to keep the pipeline consistently full. By rewarding reps for these foundational efforts, you encourage a balanced focus on both immediate sales and future opportunities. This is especially important for products and services with long sales cycles, where it may take months before a deal is closed. These early incentives also help maintain your sales team's motivation and engagement.

Boost motivation with competition and short-term incentives

To boost motivation for specific goals like promoting a new product or achieving quick sales targets, consider offering short-term incentives. For instance, you might award a monthly bonus to the top-performing sales rep. This can create excitement and foster friendly competition within your team. Non-financial incentives like recognition and career development opportunities can also enhance motivation and performance.

How much to pay

Determining total target compensation varies based on several factors.

Industry norms

Benchmark your commission rates and structures against industry standards. Industries vary widely in typical commission rates, so align your plan with what is customary in your sector.

Market or territory conditions

Take into account the specific challenges and opportunities within different markets or territories. Reps in less lucrative or more competitive regions may require higher commission rates to compensate for the additional effort needed. Ensure fairness by adjusting quotas and targets based on regional variations.

Legal considerations

When creating a compensation structure, be mindful of legal requirements such as minimum wage laws and overtime pay.

Even if your reps are paid on commission, they must receive at least minimum wage for all hours worked. Ensure that the total earnings (base salary plus commission) meet or exceed these requirements. Also, non-exempt employees are entitled to overtime pay, so you must determine if your commissioned sales reps are exempt or non-exempt and comply accordingly.

Avoid commission caps

Capping commissions can demotivate top performers by limiting their earning potential. High achievers may feel discouraged if they reach the cap and have no further financial incentive to continue pushing for sales. Keeping commissions uncapped rewards continued excellence and can drive greater revenue.

Transparency

If you offer commission, you should have a written agreement that outlines how commissions are calculated and when they are paid. Reps are more motivated when commission plans are straightforward and easy to understand, so ensure your plan is simple with clear calculations and transparent criteria for earning commissions.

Your agreement should also include clawback provisions to recover commissions if certain conditions occur, such as a customer canceling a contract or returning a product. This protects your company from overpaying commissions on unrealized revenue and encourages sustainable selling practices. To avoid issues with clawbacks, consider basing commissions on when customer payments are received since cash flow may not always align with deal closures. However, ensure that sales reps aren't penalized for factors beyond their control, like customers leaving due to poor customer support.

Implement real-time reporting

Provide reps with dashboards that display their metrics alongside those of their peers. This visibility encourages sales reps to continuously monitor their progress and fosters healthy competition.

Next Step

While this document provides a general overview of various commission-based pay structures, selecting the right plan for your business involves many nuances. Every organization is unique, and what works for one may not be ideal for another. If you're seeking personalized guidance to determine the most effective compensation structure for your sales team, please contact our office.

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