Want To Increase Your Profit Margins? Use This Sales Commission Model.

6 min read

profit margin

Key Takeaways

- Net Revenue Vs. Gross Margin Commission Model: The gross margin commission model pays a percentage of the gross profit margin percentage made on any particular sale.
- Gross Margin Commission Model Benefits: Focuses on profit margins, shields against losses, and eases offering discounts.
- Revealing Flaws in Your Commission Structure: Contribution Margin can be helpful in assessing the commission payment model your business uses.

We don’t need to tell you that your business depends on sales, and you must find ways to continuously motivate your sales force.

You know that already. And the obvious and most popular method for motivating your people and aligning employees around sales goals is sales commission because it directly ties the personal financial success of your people to that of the company.

But- before you start paying your people commission on their sales, you need to determine how much you're going to pay and how sales commission will be structured in your business. Just simply picking a number or a percentage out of the air could get your bottom line into serious trouble.

Net Revenue Commission vs. Gross Margin Commission

Commission payment structures vary across businesses and industries. Sometimes commissions are paid out in flat rates, as fixed percentages of sales, or on a sliding scale that changes based on sale volume.

Two of the most commonly used commission payment models are net revenue and gross margin.

What Is the Net Revenue Commission Model?

Basically, the net revenue commission model pays employees a commission that's a fixed percentage of a total sale.

For example, if a sales representative at a marketing agency signed on a new client for a $1,000 package, and you pay a 10% net revenue commission, the employee would make $100 on the transaction.

The net revenue commission model is used quite frequently because it's easy for business owners to understand and remember. Plus, it's simple to calculate and administer.

That being said, the model is certainly not without flaws.

What Is the Gross Margin Commission Model?

The gross margin commission model pays a percentage of the gross profit margin percentage made on any particular sale. So, while the commission percentage might remain the same, the actual amount paid fluctuates based on the profitability of the particular transaction.

Let's get technical for just a second...

To calculate a gross margin commission, you must first determine your gross profit margin on a job.

- **Gross Profit Margin** = (Revenue - Cost of Goods Sold) / Revenue

For example, if you bring in $10,000 on a job and spend $7,000 in direct costs, then your gross profit equals $3,000 and your gross profit margin is 30%.

Now, if you pay a 5% gross margin commission, on the same job you'd pay 5% of the 30% profit margin or $150.

If on another job that brings in $10,000, your costs are elevated to $8,000, you'd pay 5% of the 20% profit margin or $100.

Which Commission Structure Is Better for Your Business?

Determining your sales commissions structure is one of the bigger decisions you will make for your business.

The net revenue commission is easy to use, but that's really the only benefit it has over the gross margin commission model – especially if your services aren't set at fixed price points.

Although the **gross margin commission model** requires a bit more explaining to ensure your people understand how their commission works and your administrative staff know how to calculate and distribute commission payments, it's well worth the effort in your business for several reasons.

Here’s why...

Focuses on Profit Margins

Using the gross margin commission model gets your sales team thinking about the most important KPI in your business, profit margins. As a result, their focus shifts from total revenue to the bottom line. So, your people will concentrate on selling the kinds of jobs to the types of clients that truly earn them (and the business) the most money – those that generate the strongest profit margins.

Shields Against Losses

When you decide to use the gross margin commission model in your business, you'll first need to establish the amount of money required to cover overhead costs. Then you'll generate a minimum target profit as the floor for a sale.

By paying commissions as a percentage of the profit margin, you're then shielded from incurring losses due to poor price negotiations or the added variable cost of the commission itself.

Eases Offering Discounts

Thanks to the profit floor that's necessary for paying out gross margin commissions, you'll also find it easier to offer discounts because they'll work in the same way and be deducted from the total revenue before your employee's commission rate.

As a result, your business will be better protected from suffering losses on a sale due to discount negotiation.

How Contribution Margins Reveal Flaws in Your Commission Structure

Contribution margin is highly useful in evaluating the financial health of your business. It can also be helpful in assessing the commission payment model your business uses.

What Is Contribution Margin?

Recall the basics- contribution margin is the revenue left over after subtracting out variable costs such as sales commission.

- **Contribution Margin** = Revenue - Variable Costs
- **Contribution Margin Ratio** = Contribution Margin / Total Sales

To make it easier to make decisions, we recommend looking at the numbers a little differently- so that you'll be able to see both your gross profits and your contribution margin at the same time.

- Total Revenue - COGS = **Gross Profit**
- Gross Profit - Sales, General, and Administrative Variable Costs = **Contribution Margin**

These general calculations look at gross profit and contribution margin for your business as a whole, but you can break them down into figures for individual jobs or clients using unit economics.

To look at contribution margin by unit, have your accounting/finance function prepare the following equation:

- **Per Unit Contribution Margin** = Sales of Specific Job/Service/Client/Product - Variable Costs of Specific Job/Service/Client/Product
- **Per Unit Contribution Margin Ratio** = Per Unit Contribution Margin / Total Per Unit Sales

When you examine contribution margins by unit, you'll be able to determine which of your revenue channels are most and least profitable and whether any are actually costing you money due to variable costs.

Assessing Margin Commissions With Contribution Margins

Although enhanced margin commissions are the more desirable sales commission model, they are not completely foolproof. However, regularly assessing your contribution margins will help you identify if there are any jobs, services, clients, or products with which your commission structure is not working ideally.

Consider the following example:

A construction company pays the same sales commission on a job to replace regular windows as it does on a job to replace specialized, curved windows – even though the specialized window replacement project is going to cost more due to requiring more work, more time, and a greater degree of knowledge and craftsmanship.

1. Regular Windows

- Price = $20,000
- Gross Profit = 50% ($10,000)
- Sales Commission = 20% ($2,000)
- Contribution Margin = $8,000
- CM Ratio = 40%

2. Specialized Windows

- Price = $100,00
- Gross Profit = 30% ($30,000)
- Sales Commission = 20% ($6,000)
- Contribution Margin = $24,000
- CM Ratio = 24%

As you can see in the example, with the greater costs associated with larger jobs, it's extremely difficult to be profitable without assessing both your profit margins and contribution margins by job type before updating (or establishing) your pricing structure.

How Do Management Reports Help You Price Right and Establish The Right Commission Structure?

> "Our reports are everything I need to make critical decisions about my company to grow."

👉 Read more on how detailed reporting has helped fuel this company's national expansion (and are on track to increase their bottom by 20% at the end of this year)

From optimizing pricing to sales commissions- it starts with accurate, reliable data.

When you're aware of the differences in costs associated with different jobs or clients, you can optimize your pricing to achieve targeted margin goals – and you can build a highly motivated sales commission model right into your project quotes to ensure your people are satisfied in their jobs and also aligned with the company's overarching goals.

Learn more about how we help our clients get the insights they need to make profit-driving decisions for their business.