Calculating Service Gross Margin for Sales Commission Purposes

An Operational Maturity Level© Best Practice

Top-performing Solution Providers pay sales commission based on actual (“As-Delivered” or “realized”) Service Gross Margin, not imputed or guaranteed Gross Margin. This ensures that a critical part of their team – the Sales people – are fully engaged in optimizing true (income statement) Gross Margin before and during the engagement or contract.

Using actual or As-Delivered Gross Margin for the purpose of paying sales commission can be difficult to set up. The Solution Provider must be prepared to invest the time and resources necessary to assure that labor costs are accurately set up. Specifically:

- The billable people must be disciplined in posting their time accurately, and
- The systems within the firm must be performing in concert to report the financial results of each service transaction that is eligible for commission.

For these reasons, it is unfortunately often easier to simply estimate or set an arbitrary Gross Margin for each type of Service offering sold and use that standard or “imputed” Gross Margin to pay the Sales representative. This is often done by applying a “given” Gross Margin percentage to the Revenue of the deal, or by applying a pre-calculated loaded labor cost for each billable hour.

Such methods have three flaws:

1. They can only estimate the actual Gross Margin that will go into the company’s income statement, making financial planning and performance measurement and management difficult.
2. Since realized Service Gross Margin is often lower than the imputed or guaranteed Gross Margin would have been, sales commissions are often over-paid as compared to Best-in-Class. We don’t want Sales people to earn less, we just want them to earn their fair share of a higher, realized Gross Margin.
3. Most critically, such methods isolate the Sales representatives from actual Gross Margin at the exact points that they can influence it most: before and during the engagement or contract. As a result, Service Gross Margin is frequently lower than it would have been. Interestingly, high Service Gross Margin correlates to high customer satisfaction. Hence the Sales representative will have a financial inducement to participate in delivering quality as well.

High-performing Solution Providers (Best-in-Class) know that by paying Sales representatives on As-Delivered" Service Gross Margin, their Sales representatives will work closely with the customer and the Service team to ensure the most cost-efficient and high-quality delivery, before and during the engagement.

The basis for identifying and calculating As-Delivered Gross Margin on Service-related transactions is the ability to set and maintain accurate, fully loaded hourly Cost of Goods Sold (COGS) for each billable technical resource within the firm.

Labor costs are the largest component of Service COGS and are typically allocated to Service transactions through the firm's Professional Services Automation (PSA) tool as the technician posts his or her time. If the hourly cost of the technician is accurate, the COGS associated with the transaction or agreement will be accurate and therefore, Gross Margin will be accurate. As a result, the commission paid to the Sales representative will be correct, the Sales representative will help manage to optimum margin and quality, and in most cases, will produce an optimized sales expense that positively affects overall Net Profit.

**Get Started Now**

If you’re not already a SLIQ© subscriber, you can get instant access to the steps necessary to report As-Delivered Gross Margin on individual service deals, and pay sales commissions on actual Gross Margin accurately. [Get started with SLIQ today](#).

If you’re already a SLIQ subscriber, this step-by-step guide can be found in SLIQ>Diagnostics/Rx>Functional Area: Compensation>OML Trait: Service Gross Margin Calculation for Commissions.
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Contact Us

Paul Dippell, CEO
Service Leadership, Inc.
Tel +1 972-798-1288 x111
Fax +1 469-362-1179
Paul@Service-Leadership.com