Handling Commissions In Job Pricing

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How can contractors make sure that paying sales commissions on jobs doesn't lead to losses on jobs? (A surprising number of contractors lose money on almost every job on which they pay a sale commission!)

Consider three contractors, Evers, Tinker, and Chance. Each employs a commission-only comfort consultant for residential replacement sales. Each contractor is in doubt over how to set prices that cover commissions and ensure adequate profits. Each of the contractors is pricing a job with direct costs of $2,500.

Each contractor has the same overhead (26%) and the same net profit goal (10%) for a gross margin of 36%. Using the single-factor divisor method, each contractor would price the job as follows:

$$\frac{\$2{,}500}{1-0.36}=\frac{\$2{,}500}{0.64}=\$3{,}906$$

But neither Evers, Tinker, nor Chance can make a 10% profit at this price. Let's find how they *should* price this job.

Evers's Case

Evers pays 7% commission on the total sale. His comfort consultant must charge set prices from a retail sales book. If the job is sold for $3,906, the comfort consultant receives a 7% commission of $273 ($3,906 x 0.07), leaving Evers with a *real* sale of $3,633 and a gross profit of $1,133 ($3,633 less $2,500 for costs) less $3,906 x 0.26 for overhead, or another $1,016, leaving him with only $117 in profit (3%), a far cry from 10%.

Evers should figure the job price on something higher than his normal gross margin of 36%. To determine the correct percentage, he should apply the following gross margin equivalent:

GM for Straight Commissions:
G — RG + R

in which G is the normal gross margin (36%) and R is the commission rate (7%).

Here is how this works for Evers:

0.36 – (0.07 x 0.36) + 0.07 = 0.404

Instead of using a gross margin of 36%, Evers should use 40.4%. How does this affect job pricing?

$$\frac{\$2{,}500}{1-0.404}=\frac{\$2{,}500}{0..596}=\$4{,}195$$

Now, when Evers pays his comfort consultant a commission of 7% of the sale, he pays him $294. This leaves $3,901 for Evers. (The $5 difference from the first price is due to rounding off).

Tinker's Case

Tinker's situation is different. He pays his comfort consultant a 25% commission on the gross margin of the sale. But Tinker's comfort consultant also charges prices from a retail price book.

When Tinker uses conventional pricing for the job, his gross margin is $1,406, of which his comfort consultant receives 25%, or $352. Tinker's gross margin is reduced to $1,054, which is only 27% of the sale, not 36%.

To earn an adequate profit, Tinker must use this equation for his pricing:

Sell Price With Commission Paid on the Gross Margin

$$S=\frac{C-RC+RCG}{(1-G)+RG-R}$$

Tinker's equation is more complex than Evers's, and here is how it works out:

$$S=\frac{\$2{,}500-(0.25\text{x}\,\$2{,}500)+(0.25\text{x}\,\$2{,}500\text{x}\,0.36)}{(1-0.36)+(0.25\text{x}\,0.36)-0.25}$$

$$S=\frac{\$2{,}500-(\$625)+(\$225)}{(0.64)+(0.09)-0.25}$$

$$S=\frac{\$2{,}100}{0.48}=\$4{,}375$$

Tinker now has enough gross margin. The 25% sales commission amounts to $469. Tinker's sale is now effectively $3,906 ($4,375— $469).

Once Tinker knows how his new sales price relates to his old one, he can save time in the future by applying a "fudge factor" to his normal pricing. In this case, $4,375 is 12% higher than the figure he would have used under his old pricing method. Therefore, Tinker could set the prices in his book by adding 12% to the figures obtained using his normal gross margin calculation.

Chance's Case

Chance pays his commission-only comfort consultant a variable commission based on the job gross margin, but the comfort consultant has full control over job pricing.

If he sells the job for $3,906 (36% gross margin), he receives a commission rate of 50% of the job gross margin percent (36%). Half of 36% is 18%. Therefore, he earns 18% of the gross margin of $1,406, or $253.

This leaves Chance with $3,653 for himself—which gives him a gross margin of only 32%, not 36%.

To earn an adequate profit, Chance must use this formula:

Sell Price with Variable Commissions Tied to Job GM

$$S = \frac{C \times (1 - RG + RG^2)}{(1 - G) \times (1 - RG)}$$

Here's how the sample job must be priced:

$$S = \frac{\$2{,}500 \times (1 - (0.50 \times 0.36) + (0.50 \times 0.36^2))}{(1 - 0.36) \times (1 - (0.50 \times 0.36))}$$

Or, simplifying

$$S = \frac{\$2{,}500 \times (1 - 0.18 + (0.50 \times 0.1296))}{(0.64) \times (1 - (0.18)}$$

This becomes

$$S = \frac{\$2{,}500 \times (0.82 + 0.0648)}{(0.64) \times (0.82)}$$

$$S = \frac{\$2{,}500 \times (0.8848)}{(0.5248)}$$

$$S = \frac{\$2{,}212}{(0.5248)}$$

$$S = \$4{,}215$$

Chance must pay his comfort consultant half of 36% (or 18%) of the job gross margin. Since the gross margin is now $1,715, the comfort consultant gets $309, leaving Chance with $3,906.

Notice that since Chance gives his comfort consultant full control of the job price, Chance cannot apply the "fudge factor" that Tinker uses because the ratio of the new price to the old price will change from job to job.

Chance could, however, devise a table of factors that could be used to adjust the normal selling price for commissions. Here is an example:

Job GM	Fudge Factor	Commission*
30%	0.903	4.8%
35%	0.9824	6.5%
40%	1.0774	8.6%
45%	1.1925	10.9%
50%	1.3340	13.5%

* as a percentage of sales

Chance's system motivates his comfort consultant to maximize the gross margin on each job because his commission depends on the price. A good comfort consultant should love this system, and so should a good boss.

For more information on Lodestar Consulting Systems or my seminars, check my web page (www.lodestarconsultinginc.com) or check with your distributor, or write me at lodestar51@cox.net.