Why target average margin programs may be limiting your upside… and what you can do about it

Times are tough and your bottom line has been taking a beating. You know the sales force influences a great many pricing decisions, but is compensated primarily on revenue. Maybe that's pushing down your margins. You need to hit 20% gross margin just to cover the cost of doing business, so you put a stake in the ground: "Everyone must average at least 25% gross margin from now on to be eligible for quarterly commissions". A simple, yet bold move. Unfortunately, it's also one that could cost you a lot of money.

The problem defined

The problem is that target average margin (TAM) programs can give your sales force permission to take deals with undesirable margin levels.

For example, let's assume you tell your sales rep that he will be evaluated on his ability to achieve $5M in annual sales as long as he achieves an average gross margin of at least 25%. The first sale the rep makes is a large basket of goods at 31% gross margin. That's an excellent sale that has just created a great deal of value for your organization. Unfortunately, your TAM policy of 25% has just given him permission to turn around and sell that same basket of goods to the next customer at about 19% (or another basket of goods with equally unattractive margins) which would average the rep's gross margin to 25%. You are probably not too happy with that; especially if you need 20% just to break even. In fact, you probably prefer that he not make that second sale at all because the gains of the first sale are all but erased.

Maybe this example is rather simplistic and obvious, but often the TAM program isn't set up intentionally and it isn't easy to spot. Many companies with TAM programs don't even know they have them. One industrial manufacturer had set up an "expenses" fund for each sales person. The rep could put any excess margins achieved in deals into this account to be used for any purpose. Unfortunately, the net effect was that when a sales rep would sell a deal above target, he would be able to "bank" the excess over target in this fund and use it later to subsidize a deal that was otherwise unacceptable. The worst part was that sales reports counted the subsidy as part of the customer payment, so managers did not even know this was going on. Management just thought the reason that margin percentages were so consistent was that they were great at forecasting, their sales force was a well-oiled machine and their marketplace was very efficient. In reality, they were giving the sales rep an excuse to take unacceptable deals and lower overall profitability. The sales rep didn't care because he was really paid on revenue.

It's typical that when the margins achieved under a TAM program hover around the target level, many in management may mistake this for a success. They'll never know how much more margin could have been achieved had it not been so easy for the sales rep to sell for less.

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One solution

One way to address the issue is to utilize mechanisms that analyze and compensate each sale separately. One such very successful compensation program used by a value-added reseller of computer equipment utilized two key mechanisms to keep margins up:

- Deals were evaluated individually for contribution margin and the rep was paid a commission depending upon the contribution margin dollars achieved.
- Salaries were adjusted to reflect the rep's volume contribution, in this case, quarterly. If the volume was below a certain threshold, the rep could be handed his walking papers.

These two components forced the rep to focus on both the top and bottom lines, thus aligning the rep's goals with those of the company.

Guidelines for success

There are many ways to implement compensation programs that avoid the TAM pitfall, but they all share the same three characteristics:

- *Measure margin at the lowest practical level (e.g., a transaction)* – TAM programs tend to measure margin over a time period such as a month or a quarter. If, for example, you instead measure each transaction separately you will be much better positioned to make good decisions. This does not imply that accepting low margin deals is never acceptable. Sometimes there are strategic reasons for doing so. The primary issue is whether these deals are being accepted knowingly and for strategic reasons.
- *Evaluate the sales rep for the margin achieved* – Any sales rep who influences pricing significantly, even indirectly, must have a meaningful portion of their compensation tied to the value of the deals they create. Even sales reps who don't set prices can have a significant impact on customer-specific prices by influencing the price setters, who are likely not as close to the customer.
- *Make margin implications visible to the sales rep* – A sales rep cannot make good margin decisions without having access to the right information. This doesn't necessarily mean that the rep needs to calculate or even see margins. However, the rep should have insight into how changes in prices will impact compensation.

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Yes, TAM programs can be easily implemented. But like a lot of worthwhile things, implementing a sales force compensation program that encourages the sales force to push for higher margins can be more difficult. The bottom-line results will be worth the effort.

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