White Paper

Destroying Returns with Margin Dollar Compensation Schemes: How wholesalers destroy returns with financial accounting and what to do about it.

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January 2012

The predominant practice of wholesale distributors is to reward outside sales on margin dollars. Unfortunately, this mechanism often runs contrary to driving maximizing returns. Many distributors unknowingly reward sellers at the expense of the long term returns and value generation of the firm. A better understanding of how profits are generated and linking compensation to account returns can help adjust the imbalance.

Outside selling is one of the more revered and sought after positions in the wholesale firm. The position offers a greater chance in controlling one's personal income and more freedom that most positions; including executive management. Our work in evaluating the contribution of outside sales efforts to returns finds that sixty percent of the margin dollars generated by assigned accounts either destroy returns (negative profits) or generate low returns. Additionally, forty percent of assigned accounts generate returns which cover the low or negative investments.

The primary dislocation in financial logic between sales compensation on margin dollars and measuring returns (defined as return on transactions) is the difference between financial accounting, predominantly the income statement approach, and managerial (cost-to-serve) accounting used to develop a financial return on customers and associated entities. The difference in these approaches, and their effect on returns is significant. Our focus on returns and defined as Transaction ROI is the total of labor costs and support costs allocated to the customer on a transaction basis and divided into the returns after deduction of the transaction costs. We consider the ratio to be a value measure as it looks at returns on service labor that produces "value added" services and is akin to return on capital measures which have a strong correlation to value ." [1] While labor or human capital is not on the balance sheet, returns on human capital investment have a long history of research and relation to the overall return of the firm.

Our experience is that balancing financial accounting based compensation tempered with a return logic can lead to greater returns and better value. Transaction ROI is not without detractors. It measures the return on human capital which is outside the return on invested capital measure that uses assets of primarily plant, property and equipment. While there are arguments to place labor capital on the balance sheet, the hesitancy from accounting is that the "capital" is not owned; it can walk out the door at any moment. However, return on labor is important for supply chain firms in that the primary expense outside of cost of goods is labor. Typically 60% to 70% of operating expenses are in labor. Additionally, our argument is that since activity costing determines activity profitability of customers, segments, and sales territories, it is appropriate to measure the return on labor of these entities for insight into how financially productive the labor is.

Counting Margin Dollars vs. Measuring Returns

The typical B2B wholesale firm is a thin margin business. Return on sales, for many vertical markets, average 2.5%.[2] At this level of performance, the shareholders, when adjusting for liquidity, market value of the stock, and diversification of the public markets, would often be financially better off taking equity out of the firm and investing in the public markets.[2-A] Our research finds that some 50% to 60% of firms sell for asset value which means that management failed to add value to the firm.

The fundamental issue in wholesale industries is that financial accounting gives an inaccurate picture of how profits are made. Consider a mock wholesaler, Hobart Distributors, where a recent income statement parallels Exhibit 1. In the Exhibit, sales are 107MM, gross margins are $22.6MM, operating expenses are $21.4MM and pretax profits are 1.2MM or 1.12% of sales. The firm has a hurdle rate of 18% on investments.

		Exhibit 1
Hobart Supply		
Consolidated Income Statement		
FY 2011		
Sales	107,198,615.00	
Cost of Goods	84,546,556.00	
Gross Margins	22,652,059.00	
Operating Expenses:		
Payroll Expenses	15,650,997.79	
Occupancy Expenses	1,393,582.00	
Other Expenses	4,395,143.22	
Total Operating Expenses	21,439,723.00	
Operating Profit	1,212,336.00	

Most wholesalers pay a substantial portion of sales compensation in the form of commissions or bonuses and as based on the generated gross margin dollars. For instance consider that Hobart Supply seller, A. Pewtor, has the following territory dynamics:

- 75 Accounts

- 1.8 Million in sales
- 26% Gross Margin
- $450,000 in margin dollars
- 4% Average sales growth

Most wholesalers would consider the territory fairly healthy given total sales, margins, and growth rate of the territory. The gross margin percent of A. Pewtor's territory is approximately 5% higher than that of the parent company.

Hobart's policy is to pay approximately 20% of margin dollars to sellers in the form of salary and commission. Since A. Pewtor's territory generates $450,000 in margin dollars, the total compensation would be $90,000. Hobart management pays out 60% of allocated territory margin dollars, monthly, as salary and the rest as quarterly commissions. An average quarter for A. Pewtor would be $13,500 in salary and $9,000 in commissions for a quarterly total of $22, 500.

From an income statement perspective, the compensation scheme is simple and drives margin dollars. Sales compensation is capped at 20% of margin dollars and management doesn't pay out a commission unless margin dollars exceed the quarterly salary allotment. In this type of compensation, however, there are significant disadvantages for shareholders including:

- The salesperson gets paid regardless if the firm increases earnings.
- Margin dollars have no inherent link to investment expense in customers or their supporting transactions. Modern day cost-to-serve models find that 40% of customers have a Transaction ROI greater than the hurdle rate, 20% have a Transaction ROI with a low return and typically below the cost of capital, and 40% yield a negative return.
- Margin dollars are not balanced with expense measures and hence are a poor representation of how the firm creates returns.

For example, A. Pewtor has as an account, Tye Dye Manufacturing, that generates $252,000 in sales at a 25% gross margin. The account would generate $63,000 margin dollars that yields $12,600 in annual compensation. However, if the account's service costs were $68,000 in the year, the account would lose (-$5,000) and the Transaction ROI would be ($-5,000/$68,000) or (-7%). Gross margin dollars are measured in time periods of months, quarters etc. and are easy to review as the period based income statement is updated. Returns, however, need to be measured specific to the "investment" and whether the "investment" definition is a customer, transaction, segment, or sales territory, the time period based income statement offers no means to understand it's ROI. **We distinguish between counting profits using an income statement logic, and measuring returns by allocating labor consumption and associated costs to the marketing and sales "investment." Unless wholesalers begin to measure returns of "investment" in territories and accounts versus counting margin dollars through an income statement approach, the industry will literally pay sellers to marginalize or destroy returns.**

Rebalancing and Reworking Sales Compensation to Drive Returns and Value

Over the past six years using a transaction based cost-to-serve model for merchant wholesalers, we have found no instance of gross margin driven compensation that has any meaningful correlation with generating returns; defined as Transaction ROI. In essence, the seller whose compensation is tied to generated margin dollars has no financial incentive to improve the long term value of the organization. Why? Simply put, increasing margin dollars, without consideration of cost-to-serve expenses associated with said margin dollars **has a very low correlation with Transaction ROI. Furthermore, variations on gross margin compensation including straight commission, salary and bonus, or salary and commission have an insignificant correlation towards improvement in returns.**

Too often, wholesalers dismiss our findings pointing to instances where, when changing compensation programs, margins go up and so do bottom line profits. Where we have been able to dissect the financial results of changes to compensation programs, our findings include:

- Most changes to compensation and ensuing growth in sales or bottom line profits are not isolated from other macro-economic events such as GDP growth or key customer changes which lift earnings.
- The before and after time periods are not sufficiently isolated and don't contain enough data points to smooth out random noise.
- Management changes other variables as compensation is changed including decreasing expenses as costly sales are brought into the corporation.
- Low or negative cost to serve sales are pulled into the firm in a current time period and are served from an existing labor capacity buffer. Their destruction of value occurs in later time periods when the capacity buffer is depleted and management has to incur overtime or add headcount. Management almost never measures the effect of the new business on later time periods when the existing capacity buffer is depleted.

Hence, management too often believes that margin dollar dominated compensation schemes automatically increase bottom line profits and improve value but the proprietary research is often poorly designed or the logic is flawed. **Our research overwhelmingly finds that sales compensation plans that predominantly rely on margin dollars have almost as good a chance of destroying value as they have of increasing it.**

To drive returns and, more importantly, link returns and value to sales compensation, most distributors will have to undergo a substantial change not only in the compensation system but in their philosophy and understanding of why managing value is important. Without the enhancement of value as an erstwhile goal, distributors will remain mired in a kind of linear (income statement) thinking, substitute accounting profits for financial value, and unnecessarily but severely limit shareholder returns.

The Reason for Measuring Transaction ROI

Most discussions regarding value involve the concept of "value added services." The concept is that a distributor adds value to the physical inventory through services including breaking bulk, storage, shipping, customer credit, warranties, returns, and product knowledge. For all intents and purposes, however, value is a construct with little tangible meaning and representing limited action items for management. There is no reasonable way to measure the value of the services when consumed by customers, sales territories, market segments, etc.

Our interest and conversion to a value approach began in 2006 as we grew increasingly disappointed with the ability of wholesalers using financial accounting metrics and ratios to increase the value of their firms. For all intents and purposes, over half of the distributors we reviewed, who sold their firms in the past six years, received slightly more than asset value. The educational and consultative venues for wholesalers were dominated with financial accounting reports (PAR or POR) as gleaned from inputs from sector specific wholesalers. Also, the field of Activity Costing or variants using Average Order Size was the predominant vehicle of managerial costing. However, across the entire distribution sector, we could find no definitive link of these tools with sustained profit improvement and increased market value. During this time, Robert Kaplan of the Harvard Business School and inventor of Activity Costing during the 1980's recanted the discipline of activity costing citing complexity and general impracticality of "activities." Kaplan announced Time Based ABC as a new discipline with the primary advantage of measuring labor capacity. We began to look for a model that accurately reflected a cost basis for B2B distributors and buy/sell supply chain ventures. The transaction basis of channel profitability states that the primary economic value of distribution is focused on the transaction where aggregating differing products of a transaction creates sufficient margins to cover fulfillment costs of the transaction. This theory is taken directly from the microeconomic school of channel theory[3] which states that "if all distributed tasks were performed, the supplier or producer's marginal cost would exceed marginal revenues. Hence, channels evolve to perform these distributive functions more efficiently."

By 2010, the transaction costing model had been developed to where we applied for a patent on Labor Differential Transaction Costing. We define transactions as base transactions such as stock, non-stock-special, drop shipment, counter sale, and non-stock branch transfer, etc. In addition, we attach cost definitions of outside sales assignment or unassigned, inside sales assistance or e-commerce, shipping or customer pick up (counter or retail), to base transactions. Ergo, we typically have four or five base transactions with variations on outside sales, inside sales, and shipping which typically totals 12 to 22 transaction types.[4] The territory for A. Pewtor is broken apart on a transaction basis in Exhibit 2. In the Exhibit, we see that the territory uses seven of the fourteen transaction types as the account base is assigned.

			Transaction Type Allocations	Exhibit 2		
			A. Pewtor Territory			
			FY 2011			
Transaction Number	Transaction Type					
		Invoice Total	Line Total	Line Cost	Invoice Cost	Total Transaction Costs
1	Stock-Unassigned-Order Writer	0	0	$ 8.30	$ 43.46	$ -
2	Stock-Assigned-Order Writer	1844	3319	$ 8.30	$ 75.10	$ 166,033.76
3	Stock-Unassigned-ECommerce	0	0	$ 6.00	$ 43.46	$ -
4	Stock-Assigned-ECommerce	455	819	$ 6.00	$ 75.10	$ 39,084.50
5	Retail-Unassigned-Order Writer	0	0	$ 7.25	$ 12.98	$ -
6	Retail-Assigned-Order Writer	1233	2219	$ 7.25	$ 48.50	$ 75,891.15
7	Retail-Assigned-ECommerce	322	580	$ 5.95	$ 48.50	$ 19,065.62
8	Retail-Unassigned-ECommerce	0	0	$ 5.95	$ 12.98	$ -
9	Non-Stock-Unassigned-Order Writer	0	0	$ 15.03	$ 45.43	$ -
10	Non-Stock-Assigned-Order Writer	956	1721	$ 15.03	$ 76.46	$ 98,959.38
11	Direct-Unassigned-Order Writer	0	0	$ 3.81	$ 11.62	$ -
12	Direct-Assigned-Order Writer	288	518	$ 3.81	$ 43.37	$ 14,465.66
13	Direct-Unassigned-ECommerce	0	0	$ 2.77	$ 11.62	$ -
14	Direct-Assigned-ECommerce	56	101	$ 2.77	$ 33.37	$ 2,147.94
	Totals				Total	$ 415,648.01

The cost totals for the territory are $415,648 with the resulting operating profit $34,352 ($450,000 Margin Dollars-$415,648).

The use of transactions and transaction profit was, we believed, a significant improvement over existing allocation methods and the model greatly improved the understanding of labor, labor cost, and labor capacity usage. However, the focus on transaction profitability ($34,352) for A. Pewtor's territory, granted limited predictive insight into return goals of management. The problem was that we were still in the financial accounting headset that looks for a net profit number after all expenses are taken into account. Even though a territory profit number, less transaction costs, is superior to the focus on gross margins, we had difficulty in using the metric to drive returns. For instance, the ratio of transaction profits to sales ($34,352/$1.8MM or 1.9% for A. Pewtor) was of limited usage and indeed the transaction profit percent of territory sales at 1.9% is greater than the operating profit of Hobart Supply at 1.1% of sales. But we found transaction profit percent of sales misleading. Why? The metric does not directly measure "investment" cost of the customer (primarily in labor) and hence there is no comparative to the return desired by the firm and **no way to qualify the attractiveness of the unique investment**. With the corporate hurdle rate at 18%, we needed to compare the returns generated compared to the transaction costs of the customers and the sales territory. Since the territory earned $34,352 and "investments" or costs were $415,648, the Transaction ROI for the territory is 8.2%. While a positive contributor, the territory as an investment is some 55% less than the hurdle rate of the corporation. The upshot of the below average ROI for the territory is that substantial changes need to take place in the Mr. Pewtor's territory for Hobart to recognize it as a profitable investment and there is **absolutely no way to know this by focusing on margin dollars or transaction profits as a percent of sales.** We follow with a history of our work in working with negative and below hurdle rate investments in the wholesale firm.

Driving Capital Returns in Sales Territories

It is important for us to remind the reader that gross margin dollars are not the issue in A. Pewtors' territory. The problem is that the gross margin dollars are too few compared to the expenses and the ROI of the territory is well below par. Too, it is important to note that simply piling on more margin dollars won't solve the problem with the ROI of the territory. **Our overwhelming experience with transaction costs is that they are step in nature but extremely aggressive and closely follow sales and margin dollar activity.** Therefore, changes to gross margin dollar sales compensation does not solve the expense issue and improve ROI; it is merely an exercise in increasing margin dollars without any insight into their contribution to the value of the firm. In essence, by changing margin dollar compensation, Hobart supply may increase margin dollars but would incur a 20% probability that those margin dollars would be below the hurdle rate of 18% and 40% of the margin dollars would not cover their service costs. Hence, the firm would end up with higher sales and margins but the overall earnings of the firm would likely remain at a dismal 1.1% of sales.

Wholesalers, to improve Transaction ROI, need to understand what caused some customers to have low returns while others generated stellar returns. The difference in "customer value" is due to the mix of transactions which closely models labor costs and linking transaction costs to compensation, specific to the account, was needed to drive returns. **In essence, distributors need to engage both the margin dollars and the supporting expense dollars to drive growth while improving territory Transaction ROI and this calls for a substantial change in sales compensation as well as changes in what sellers, their managers, and supporting personnel do.**

We list, in no particular order, the events that have had the greatest impact on improving the capital investment for territories and the wholesaler at large.

1. **Trim back on the outside sales effort and supplant them with lower cost of solicitation models.** We have found that a consistent 40% of accounts and territories destroy returns. In essence the Transaction ROI for these investments are negative. Placing sellers on negative value accounts and territories typically makes the situation worse. Sellers are expensive as evidenced by the stock-assigned-order writer invoice cost of $75.10 versus the Stock-Unassigned-Order Writer cost of $43.46 (Exhibit 2). In essence, Hobart Supply's stock order costs that are assigned to an outside seller are $31.64 greater than an unassigned territory. We advise clients to move negative investment accounts to telesales solicitation, internet solicitation, or catalog (electronic or paper form) solicitation. Often we can find where traditional margin compensated/geographic sales territories can be reduced by a third and much of the solicitation replaced with alternate forms that are much less expensive. For instance, our work in telesales finds that they are some five to six times more productive or eighty percent less expensive than the outside sales effort while offering equivalent growth. We are not anti-outside sales but we have found no financial and reasonable logic to support putting the most expensive functional resource on negative investments.

2. **Engage transaction type pricing.** We have employed transaction type pricing in the field for a decade and the results are often operating profit increases of thirty percent or more. Transaction type pricing means that stock transactions are priced differently versus non-stock transactions, counter transactions, and drop shipment transactions. **We don't mean that these transactions merely have different margin percents but they have different pricing mechanisms that are supported by sound analysis and pricing system design.**

3. **Remove or scale back unwanted or too costly services from low or negative ROI territories or accounts.** Wholesalers are notorious for over-servicing accounts and we attribute this to the sales and margin bent of the industry. However, we've helped clients claw back service value in any number of ways. Events such as placing a break-even order size for FFA orders, requiring a deposit for non-stock specials, moving transaction intensive accounts to e-commerce, charging a re-stocking fee, and charging for late payments are common means of aligning services with costs-to-serve. Too, transaction costing such as LDTC has the advantage of giving distributors insight into transaction shifting opportunities. For instance, A. Pewtor should investigate Tye Dye Manufacturing to understand if they can move from costly orders such as non-stock transactions or small orders such as counter (retail) transactions to less costly and more profitable transaction types. Shifting large non-stock transactions to a directs (drop shipments) can save a significant amount as evidenced in Exhibit 2 where the invoice cost difference in a non-stock vs. direct shipment is approx. $33.

4. **Create a balanced compensation system using ROI metrics and transaction profit measures along with margins and sales.** In the existing compensation scheme A. Pewtor gets 20% of margin dollars of which 60% is paid out as salary and the rest is given as a bonus. We advocate for a balanced approach between sales, margins, capital return, and transaction (operating profits). For instance, in A. Pewtor's territory, we could pay as follows:

    - 1.5% of Top Line Sales or $36,000
    - 4% of Margin Dollars or $18,000
    - $2500 for each 1% increase in Transaction ROI over prior year (currently 8.2%) up to hurdle rate where each 1% increase over 18% gets $5000
    - 20% of territory transaction profits or $6870

    The payout from the current year, including no increase in ROI, would be $60,870 which is slightly more than the current base salary of $54,000. However, the incentive is balanced including payouts on sales, margins, ROI and transaction profits. Too, the payouts are weighted toward transaction profits and ROI. The calculations are done by account and accounts are totaled during the payout period. For the territory at large, if A. Pewtor gets ROI to 18% from the current 8%, he would earn an incremental $25,000.

If he gets the ROI to 22% he earns an additional $20,000. Of course, the compensation scheme, at present is some $30,000 less than A. Pewtor earns on a gross margin dollar basis. **However, the goal of balancing compensation is to motivate Mr. Pewtor to become a more positive influence on operating profit and contributing to returns by seeking sales that generate higher returns on their allocated labor costs.**

In summation, there are many ways to balance compensation using transaction profits and Transaction ROI measures but the overall goal is to respect the existing goals of driving sales and margins but to balance them with goals to drive returns and operating contribution of the territory. Too, it's important to realize that some means of improving Transaction ROI don't reduce the overall expenses of the organization but they do reduce the labor consumed by an individual account or territory. Our hope is that as labor capacity is freed up, the firm can reduce the capacity overage or use it for incremental business without adding overtime or headcount.

Once you've changed the seller's compensation plan, it makes sense to train them on means to increase the ROI and transaction profits of their account base. This training includes the aforementioned areas of service claw back and pricing along with ways of increasing the transaction size and mix of transactions. Transaction size tactics include working with the customer to take large orders by forecasting better or having an on-site inventory. Too, consolidating suppliers is a worthwhile goal for sellers to pursue as this typically increases order size. Changing the mix of transactions involves review how the customer buys and what they buy. For costly transactions such as counter sales this would include having higher inventory levels where counter visits are lessened, substituting non-stock sku's with stock items (for instance brand switching, kitting, etc.) and shipping non-stock specials directly to the customer site. Too, it is possible to link pricing to order size and while the subject is not covered in this White Paper, it is covered in our book on the subject.[5]

The Quest for Value

While value is typically linked to return on invested capital, wholesalers need a new measure to understand how one of their most significant costs, labor, is being used to drive returns. We have found the usage of the Transaction ROI, generated from new age activity costing models, to be a useful and powerful means of allocating labor and driving returns. Changes to compensation plans away from margin dollars and balancing them with new measures are needed. To get the new measures and make them reliable, wholesalers will need to develop and use accurate cost-to-serve models that accurately measure capacity and differentiate among capacity costs that support unique investments. To this end, we believe the transaction approach is highly accurate in measuring how different transactions consume labor and how this effects returns. The value approach has been shown to be superior in driving shareholder value and is used by some of North America's leading companies and investors.[6] We believe the need to use ROI of labor is necessary for wholesalers as their business model will come under continuing challenges including price deflation of globalized manufacturing and low cost models that combine ecommerce solicitation, reduced brick and mortar locations, and low cost foreign goods for prices that are often 30% less than traditional full-service distributors. The change to sales compensation and the subsequent rethinking, reworking, and retraining required are substantial but the effect on returns makes the efforts worthwhile.

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[1] Koller, T., Dobbs, R., Huyett, B. *Value: The Four Cornerstones of Corporate Finance,* pg. 4, McKinsey &Co., Wiley Publishers, 2011.
[2] A recent PAR report for the Electrical Wholesale Industry had return on sales as 2.4%
[2-A] A ROS of 2.5% equates to an ROE of 9% to 13% in most B2B wholesale vertical markets. The long run return of public markets is 11% with the associated advantages of diversification, market value of stock, and liquidity.
[3] Hardy, K., McGrath, A. "Schools of Thought in the Study of Channels," *Marketing Channel Management,* pg. 27, Scott, Foresman, and Co., 1988
[4] Benfield S., Follow the Value Streams or Risk Selling the Distributorship for Asset Value, November 2011, IS Supply Online Newsletter, http://www.industrialsupplymagazine.com/file_open.php?id=14, pg. 8.
[5] Benfield, S., *Building Value: Driving Wholesaler Returns Through Strategic and Tactical Investment,* book due out by Spring of 2012.
[6] Koller, T., Dobbs, R., Huyett, B. *Value: The Four Cornerstones of Corporate Finance,* ppg. 15-16, McKinsey & Co., Wiley Publishers, 2011.