COMPENSATION PLANNING:

The Key to Profitability

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Preface

This book can help brokers create effective individual company compensation plans by giving them a better understanding of how changes to existing compensation schedules affect the company finances as a whole. All examples shown are solely for the purposes of illustration and are in no way intended to set or suggest a specific plan to be adopted. It should be noted that open discussions of commission policy and amounts, particularly among competing brokers, can be interpreted as a form of price fixing. For this reason, all such discussions should be in the form of example only, avoiding specific references or comparisons. Should it be required, competitive information is available in the market through a variety of sources that do not require open discussions of commission policy and amounts. Such discussions or sharing of information among brokers is strongly discouraged by the authors and should not be tolerated by any broker or group of brokers.

The authors also strongly suggest your attorney and accountant review your final compensation plans for financial impact and compliance with all local and federal laws and rulings.

Introduction

We are all very aware that there is no room for mediocrity in today's business environment. More than ever, businesses must abandon outdated though traditional approaches and explore more flexible and creative options. As the real estate industry matures, new systems and tools of evaluation are essential in order to adapt and ensure survival in the present economic environment. The incorporation of flexible and creative compensation plans can be an important step towards increasing profitability and stability for today's business.

Many companies have floundered because they did not respond to the winds of change or because they created compensation plans which were not fiscally responsible to the company. To change compensation schedules in a company without understanding the full impact of the changes can prove disastrous, and may be more harmful than not changing anything.

This book introduces a number of compensation options so that a company owner may choose and design plans that will best meet his or her company's needs. Since the combined effect of any grouping of plans should always be tested first, we recommend using a computer program that can accommodate an unlimited variety of approaches—from combining different features of multiple plans in order to create an entirely new individual plan, to seeing the effect of using several different types of compensation plans within a company. Test models should be run against a company's actual production numbers for any compensation plan considered.

When designing compensation schedules, it is important to always bear in mind a number of considerations and to keep an objective viewpoint. You will want to know if your plans will achieve the necessary goals. You will want to be sure your company has budgeted to ensure profit. You will also want to know if your plans are well suited to motivate and meet the needs of the individual agent.

The purpose of this book is twofold. First, it will provide owners and managers with an understanding of the concepts crucial to running a real estate business. Second, by enabling them to offer compensation plans that are both attractive and financially viable, this book can help owners and managers restructure their companies with maximum flexibility for the agent and maximum profitability for the company.

It should also be noted that throughout this book we have included a number of graphs and tables which have been generated using computer software. Computer technology has proven invaluable in tracking numbers and visualizing ahead of time the impact that various decisions can have on a company.

Finally, we would like to express our appreciation and gratitude to Clare and Andrew Robertson for their efforts in making this book readable.

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CHAPTER

1

History of Compensation in Real Estate

Over the last three decades, tremendous changes have taken place within the real estate industry—most notably in the way real estate brokers have begun to compensate their agents. Compensation plans in the real estate industry vary widely but, more often than not, good business considerations have less influence over how compensation schedules are set than do marketplace trends, concerns with bookkeeping, or creativity of management. In other words, plans are often set in response to external factors and the myths surrounding them rather than as a result of careful business planning.

There are many understandable reasons behind faulty planning. For example, a broker might think that by offering the highest plan in the area, his or her company will attract high-producing agents. Similarly, a broker might want to treat high-producing agents too generously in an attempt to ensure they aren't either lured away by the competition or tempted to open up their own offices. This rather haphazard approach, often based on flawed thinking and which has traditionally driven compensation plans, can result in bad financial times for a company. The most rational companies consider a variety of factors when setting plans, and are attentive to the strategies they wish to use in the marketplace.

Significant change began in the early 1970s when the real estate industry began to mature and agents realized that brokers were making quite a bit of money. (As the old adage goes, "excessive profits create ruinous competition.") Agents quickly realized that they would be better off going into business for themselves. This inevitably created new pressures and raised the level of competition in the marketplace. As a result, the real estate business was forced to evolve quickly, although there is still room for improvement.

Before things started changing, brokers paid for everything (fixed and variable expenses) and compensated their agents with the traditional 50/50 split. Brokers devised an overall company budget and ran the year through without tracking individual agent's expenses—treating everyone in the same manner and not concentrating on what each agent was contributing towards fixed expenses. Such general treatment in the hands of the brokers led some of the higher-producing agents to feel dissatisfied—and rightly so, as the lower producers were being paid more than they were worth and the higher producers, less.

Therefore, many brokers began using the quartile system, placing their agents into one of four categories. The four categories are low-producing agents, agents producing in the mid-range, high-producing agents, and top-producing agents. Brokers placed agents into one of these four categories according to gut feeling more than anything else, with each category receiving a different split. This was feasible in the brokers' eyes, as they would be averaging their overall payout between the four groups. Under the quartile system, the company assesses the need to retain 35 percent of the gross commission income (GCI) to cover expenses and make a profit. Therefore the company must create compensation plans commensurate with the need to keep this 35 percent company dollar. The agents are lumped together en masse so that high producers are, in effect, subsidizing the low producers.

Quartile System

Average Split for Group		Portion of Co.% of GCI		Overall % that Agent Retains	Type of Agent
55%	×	30%	=	16.5%	low producers
67%	×	55%	=	36.85%	mid-range producers
75%	×	10%	=	7.5%	high producers
83%	×	5%	=	4.15%	top producers
				65.00%	

Using this system, 100 percent of the agents retain 65 percent of the overall GCI split.

This all might seem reasonable, but there were inherent problems. The first problem was that, in order to attract and retain agents, the splits given by the brokers tended to pay too much to the agent at GCI levels below the breakeven point. For example, assume the breakeven of a company is $20,000 GCI. Instead of paying agents on a 50/50 split until the breakeven was reached—and then paying the high splits only over the breakeven—brokers started offering higher splits at lower levels (levels below the breakeven).

The second problem was that brokers were still dividing the total fixed expenses by the number of agents in the firm. Theoretically, this would be acceptable if every agent was able to reach his or her breakeven point, but unfortunately this was not usually the case. (This point will be further discussed when we examine agent breakeven in a later section.)

The result of this was that companies were forced to rely on profit/volume dollars brought in by high producers to pay for fixed expenses that were not recovered. Thanks to the top producers, brokers were still paying people at the bottom more than they were worth, subsidizing the low earners with money from the top earners. Understandably, this caused resentment among the high producers.

This led to the era of the 100 percent plan. Admittedly, 100 percent plans were not entirely new to the real estate industry and did not come into prominence entirely "out of the blue." Rather, the common 100 percent plans seen today represent the evolution of an earlier style of real estate business. As far back as the 1950s, it was not unusual to find a significant number of real estate companies offering 100 percent splits to their agents (although the quartile system continued to exist and does so to this day in certain markets). Under this 100 percent concept, compensation was similar to that offered today, with the agent receiving all of the commission charged minus the costs owed to the company. It should be noted that back then many agents operated independently of anyone else, thus facilitating this early implementation of the 100 percent plan.

The main differences that are associated with today's 100 percent plans were introduced in the mid-1960s and moved rapidly across North America. This system allowed brokers to offer the agents 100 percent of GCI in return for fixed payments designed to cover the costs of doing business, such as office space, answering of the telephone, and quantity buying of supplies (such as advertising). These payments, once collected from all the salespersons, could allow companies to recover all expenses and make a profit.

It thus became necessary for competitors not offering the 100 percent concept to pay out high splits in order to retain their high producers. But again, in their attempt to restructure, these companies failed to correctly adjust the splits for the low producers. They also didn't charge properly for company services, and as a result the company dollar shrunk. For these companies, even the smallest of changes in expenses had a dramatic effect on their bottom line, making them extremely vulnerable to market shifts.

Such companies would have been fine had they been operating in a steadier and less competitive market—like the environment of the 1950s and early 1960s. In the new environment, however, such companies could no longer rely on good business (high volume sales) to mask their mathematical errors. Therefore, today there are few companies in North America which do not incorporate some variation of the 100 percent plan as an option available to their agents.

Because of the effects of the 100 percent concept in specific markets along with increased competition, the compression of sales in the marketplace and more sophisticated technology for designing compensation plans, the quartile system fell apart. Therefore a new system needed to be implemented where each agent is viewed as a separate profit center (to be discussed in a later chapter). Under this system, the broker/manager looks at each type of employee differently.

For example, let's look at an agent we'll call Sam. When Sam first joined his company, he needed a lot of support from his boss in order to get the feel for how things worked. His boss didn't expect him to bring in much money since Sam was in his learning stage. Two or three years later, Sam's enthusiasm and hard work paid off and, with some good deals behind him, Sam had become an earner. Both he and the company were profiting from his hard work and energy and he brought in a lot of business. After several years of being an earner, Sam's priorities changed. He had paid off his mortgage, put his kids through college, and now felt like taking life a little slower. Sam is still a valued employee who brings money into the company—he likes making big sales and his skills are still sharp—but he's no longer a top producer.

Under the new system, Sam would be working under a compensation plan most suited to the stage he is at in his career. The goal of the compensation plan at any one time would be to maximize the payout to Sam while, at the same time, ensuring that he is able to recover his share of fixed expenses.

It should be noted that the real estate industry is still in its embryonic stage and that there are pockets where brokers are still operating with the age-old idea of lumping agents into the quartile system and treating them accordingly. However, with the impact of computer technologies and the increasingly competitive market, the industry as a whole will inevitably move in new and exciting directions.

CHAPTER

2

Compensation for Agents

There are a multitude of different compensation plans currently being used by brokers and agents in the real estate industry. For the most part these are formed by combining aspects of the following types of plans. As you might imagine, the component parts of any one plan can be as varied as the imagination of the creator and no one formula will guarantee success! Any combination of the basic types of plans (presented later in this book), amounts, and options may exist, thus making the total number of possible compensation schedules infinite. A schedule should be tailor-made to fit any situation. The more you experiment, the more finely tuned and effective your plan designs should become. While there are no set rules or guarantees, when defining plan options the chances of devising successful, fiscally responsible plans are maximized if a variety of "what if" scenarios are tested against actual numbers. This is made relatively easy with the introduction of new software programs since, among other things, they can show the impact of various plans on a company's finances. As a result they serve as helpful budgeting and planning tools that are essential for planning a profitable business. Now, more than ever, this is important since the real estate business, being an industry based on relationships, can deal more from the heart than from concrete business acumen!

The problem of determining appropriate compensation concerns meeting the competition for sales associates services. If compensation is too low, there will be no associates to produce revenue and hence no profits. As the rate of compensation is increased, more agents are attracted to your company, to earn commissions through your company. Ultimately you might attract all of the available real estate agents. However, if compensation rates are too high, even if all the available sales associates are producing revenue, there is insufficient revenue to cover the higher expenses. The goal is to find somewhere in between a level of compensation which attracts enough revenue production for the company to cover expenses and produce a profit. Obviously, you would like to find the right level of compensation that optimizes the profitability of your company, providing the maximum profit. Needless to say, there are a lot of factors involved—the market and the competition are continually changing and thus the optimal compensation rate is likely to continue changing as well.

As you increase compensation rate, you attract revenue producers and you increase company revenues. If you continue to increase compensation rate for a given revenue, you decrease profit. The combination of these two effects is that, as the compensation rate rises, profit increases to a point of optimal profitability, then falls as the compensation rate continues to rise.

Computer-based models have attempted to provide the broker with tools to deal with this dilemma. Part of the problem is to determine the relationship between compensation rate and the extent to which agents will associate themselves with a company. For the most part, this is left to the broker's sense of the specifics of the company's milieu. But the computer-based models do provide the broker with a means of comparing the company's commission splits to those of competing companies. Keep in mind that compensation can take the form of many different commission splits and other benefits such as salary and working conditions. The other part of the problem is to determine the profitability of a certain compensation scheme. These models can determine the profitability associated with having a specified roster of agents producing specified revenues on specified commission splits, with specified expenses being incurred by agents and company.

The following section will describe a number of different features that are used to build compensation plans. It will then provide a brief description of some of the most common types of compensation plans, which are based on one or a combination of these features. A basic comprehension of the differences between these plans, as well as of their respective strengths and weaknesses, is essential for understanding the key factors in company profitability. It will also help in understanding the analysis of the breakeven point, found later in this chapter.

FEATURES OF COMPENSATION PLANS

➢ SPLITS

Splits are perhaps the most important component of compensation schedules, and refer to the division of the gross commission income into two parts—one for the agent and one for the company. The split is usually expressed as a percentage, such as in "a 50 percent/50 percent split." Generally, the percentage split awarded to the agent does not remain constant as more commission is earned, but rather increases to reward higher production with a higher split. In most cases, agents are billed separately for any other expenses included in their compensation plans, and the company side of its other expenses is rarely, if ever, shown to the agents.

Frequently, there are a variety of fees that may be the responsibility of the agent, the company, or both. Examples of such fees may include franchise fees, taxes, and insurance. When a fee is deducted prior to the split being divided, it is considered to be taken from the gross commission income (GCI). On the other hand, when fees are deducted after splitting with the agent, it is said to be deducted from the adjusted gross commission (AGC).

The levels at which new percentage splits are given are referred to as split levels, plateaus, thresholds, or steps. Often, the arrival by an agent at the new level is associated with some form of recognition, such as qualification for an award. New split levels are often tied to the amount of the GCI brought in—

for example, for a GCI up to and including $20,000, a 50 percent/50 percent split is given. For $20,001 to $40,000, a 60 percent (agent)/40 percent (company) split is awarded, and so on. When dollars are used to determine splits, the split can be calculated on a variety of factors such as straight GCI dollars, the net commission dollars earned by the agent, or the net commission dollars retained by the company per agent or after an off-the-top fee has been deducted.

Occasionally splits are tied to points earned for the number of sides (sales or listings sold) closed or the type of business conducted. For example, each transaction has two sides—one being the listing and one being the actual sale, and a point can be earned for each. Similarly, the type of business in which you are engaged might receive a certain number of points (in-house sales earning more than listings sold, which in turn would earn more than referrals closed). As with using dollars as a basis, higher percentage splits are awarded to the agent once a certain number of points have been accumulated. Point systems are effective when there is a need to focus the agent on a specific type of business and point values can be adjusted periodically to steer agents in the direction most valued by the company. Be aware, though, that they do not accurately reflect the true GCI received and can lead to erroneous assumptions when designing compensation plans.

➤ CHARGE-BACKS

Some expenses may be deducted from the agent's share as defined in the various compensation schedule designs. These charges are called "charge-backs." Commonly, charge-backs are made to an agent for facilities and services provided by the company. These entries may be costs paid directly by the agents under a particular plan, even if in other plans they are paid by the company.

Charge-backs are used by the company to recover expenses while meeting a target profit. Many charge-back entries correspond directly to expense entries in the company's expense list, especially in situations where the costs are incurred by the company but are paid for by agents under a particular plan. Charge-back amounts may be fixed (charges per annum or per month) or they may be variable, depending on the amount of gross income, income after an off-the-top fee has been deducted, units sold, and the agent's share. A charge-back is often a company expense incurred by business operations, for example the rental of office space and the electricity and telephone costs.

For this reason, it is important to be able to calculate the cost of office space, and since the costs are often recovered through charge-backs, it might be appropriate here to sidetrack briefly and explain how this might be done. Costs may be attributed as following.

DE Per desk: parking, furniture, phone service, washrooms, and so on.

PE Per person: file space, voice mail, answering service, and so on.

AE Per office space area: cost per area unit (square feet or square meter), heat, light, cleaning, rent, utilities, taxes, and so on.

➢ PREMIUMS

Premiums are not expenses, but rather they are the charges and credits associated with particular office spaces. These charges and credits accrue toward the overall cost of the facility. Premiums may be attached to locations within the building, such as view, quality of access, decoration, quality of furnishings, services, and so forth. Some offices may also have advantages with respect to parking, client access, neighborhood, long-distance phone charges, and so forth. In addition, negative premiums may be associated with deficiencies such as poor furnishings, basement location, lack of windows, and the like.

Common space (access, service, and so on) and unoccupied space can be charged against the agent office space area (AE). It can also be charged on an equal amount per office (OE—per office expense), but this would tend to have those who can afford less (the lower) subsidizing the higher producers.

There are many office expenses which relate to volume of activity—calls handled, client meeting room use, electricity, voice mail, faxes, and so forth. These should be identified and billed separately.

The method of calculation of the cost of an office is as follows.

$$OE + n \times PE + d \times DE + a \times AE + \text{premium}$$

where:

- n the number of persons who use the office (includes assistants, secretaries, and other office support staff)
- d the number of standard desks plus associated furnishings
- a units of area

To determine the premium associated with intangibles, agents may bid for office space.

Returning to the topic of charge-backs, examples may include such things as a desk fee of $1000 per month, a transaction fee of $250 per transaction, and an annual membership fee of $500. Charge-backs can also be expenses for which the company no longer pays but instead are now the responsibility of the agent.

It is worth noting that charge-backs can also be negative to a company, as would be the case if the company offered a benefit (such as a company car or a salary) to the agent as a part of the compensation plan. In this case, it is the company who is paying out to the agent, not vice versa.

DIFFERENT TYPES OF COMPENSATION PLANS

➢ INCREMENTAL PLANS

Perhaps the most well known, and traditionally the most commonly used type of compensation plans, are the incremental plans. These generally consist of several "levels" or "thresholds" based on the amount of annual GCI. Under an incremental plan, the higher an agent's GCI, the higher that agent's percentage share of earnings. The upper and lower limits of the various levels in the plans are differentiated by specific dollar amount of GCI, agent's share, or company dollar. For each level there is a predetermined split of gross revenue between agent and company. The specified percentage of the agent's share applies only to income earned while at that level. Each year the agent starts at a lower split and works back to a higher split. Once an agent reaches the lower limit amount of the next level of GCI, he or she moves up to the next level. The agent then begins to receive the higher percentage pertaining to this level of earnings (GCI falling within the limits of this level). Since in real estate there is no limit to how much GCI an individual agent may earn, the highest level of an incremental plan does not have an upper limit. The percentage rate paid at the highest level of incremental plans will apply for all earnings exceeding the lower limit of this highest level.

A sample incremental plan could be as follows. For an agent with GCI earnings up to and including $20,000, the agent and the company evenly split that revenue in a 50 percent/50 percent split. This can be called Level 1. Once the agent achieves between $20,001 and $30,000 GCI, his or her share of each subsequent unit of GCI is then calculated at 60 percent of gross, with the company receiving the corresponding 40 percent. This can be Level 2. Similarly when the agent earns between $30,001 and $40,000 GCI, his or her share is then calculated 70 percent and the company's at 30 percent (Level 3). For all earnings in excess of $40,000 ($40,001–infinity), the agent receives 75 percent of the GCI amount, and the company's portion is the remaining 25 percent (Level 4—the highest level). It should also be noted that in this example we have used four levels with arbitrary percentage splits. An incremental plan, however, may have any number of levels, including different percentage splits.

Earlier we defined a compensation plan as having both a commission split schedule and a list of charge-backs to be paid for by the agent. A characteristic of traditional incremental plans is that, relative to other plans, the level of charge-backs the agent must pay tends to be low.

Progressive incremental plans are incremental plans in which, at the start of each year, the agent starts at a split level based upon the agent's previous year's production. These types of plans are more attractive to higher producers since at the beginning of each year they do not have to return to Level 1 of their plan.

If the agent's level of production decreases from the previous year, the agent may not generate enough income to cover the expenses associated with being carried at last year's split. To decrease this risk to the company, instead of unconditionally maintaining the agent at last year's split, the agent could be started at one level lower than the level achieved in the previous year. An alternate approach would be to allow the agent to start the new year at the last year's higher split, but require the agent to make up any shortfall in company dollars in the event that the agent does not attain his or her breakeven by year end.

There are a number of advantages and disadvantages associated with incremental plans, summarized as follows.

Advantages

- The agent bears a relatively low degree of risk as incremental plans tend to have lower charge-backs than other plans.
- The agent has definite goal levels (useful for motivation).
- The agent may have the option of staying at a higher split as sales increase.
- The agents feel rewarded for doing well.
- The company retains more money as step levels increase, since the agent's share increases only on each next step and is not applied retroactively.
- This type of plan is easy to understand.

Disadvantages

- The agent must step through levels to earn more and tends not to reach the maximum payout unless there is only one step level.
- Higher-producing agents subsidize lower-producing agents if the first step breakeven is too low or if the lower agents start at too high a split.
- When an agent is required to return to a lower level, he or she can become dissatisfied and lose motivation.
- The company typically pays more costs for the agent up front.
- The company bears a relatively higher risk when the agent, based on the last year's performance, is allowed to stay on a higher split for the following year. This is especially true when the market system no longer allows the agent to reach the breakeven associated with this higher split.

➤ RETROACTIVE PLAN

The levels within retroactive plans are based upon the total GCI earned to date, recalculated each time a deal is closed. This includes all income earned while at lower levels. The split for the achieved level is applied to all income for the year, also including income earned at lower levels. When an agent achieves the next level, he or she receives a retroactive payment for the increase in split applied to all the income for the year.

In optimally designed plans, the advance to each step is determined by the breakeven point for the percentage of the next step. The agent then will not advance to the next level until he or she is producing enough GCI to cover all expenses and budgeted profit applicable to that higher split.

For example, consider the following case study. Suppose an agent with GCI earnings up to and including $20,000 is working on a retroactive plan at which Level 1 is calculated at a 50 percent/50 percent split up to $19,999 GCI, and Level 2 is calculated at a 60 percent/40 percent split for GCI at $20,000 and above. As the agent reaches the $20,000 mark, he or she advances to the 60 percent/40 percent split for all new earnings and also receives a retroactive payment of 10 percent of all commissions previously earned and paid at the lower split. Obviously, a major advantage for agents operating under retroactive, rather than incremental plans, is that they are paid the retroactive percentage at each step back to the first dollar. This motivates agents to strive towards higher levels in order to receive the retroactive payment when they reach the next level. Other advantages (and disadvantages) are listed below.

Advantages

- The agent has clear, predetermined goal levels.
- When the agent reaches the goal level, he or she is paid the new split percentage as if he or she had been on that split since the start of Dollar 1.
- The agent receives lump sum cash rewards for achievement.
- This type of plan provides good motivation.

Disadvantages

- The agent may become disgruntled if he or she just misses the level for the next higher split. Feeling cheated, he or she may leave the company.
- The company may not have reserved the cash for increased payout and thus may encounter cash flow problems.
- The company may have to make concessions to agents who fall just short of the step level, thereby reducing profit or possibly losing money.

➢ 100 PERCENT PLANS

100 percent plans are usually set under a contract for a one-year period and, in its most basic and purest form, an agent would receive the full commission earned from a transaction. However, the agent then is responsible for paying the broker/owner a set amount of monthly fees for the use of shared services such as desk space rental, telephone answering, and so forth. These fees might also include such things as membership fees, office space rental, institutional advertising, availability of resources, secretarial services, and similar items. As mentioned earlier, when agents make payments of specified amounts for specified expenses through their plan to the company, these payments are called charge-backs. It is through these payments that the company covers its expenses and earns a profit.

In addition, under a 100 percent plan the agent is responsible for a variety of other costs related to doing business, such as signs, long-distance telephone charges, and so forth. Some of these items can be purchased from the company, often for a good rate depending on the quantity used. Others may be purchased externally. To summarize, 100 percent plans, while giving 100 percent of the GCI to the agent, are only 100 percent in the sense that initially 100 percent is received. This, of course, is reduced once the various charges have been levied.

For example, imagine an agent is working under a 100 percent plan. The terms of this plan, with respect to fees and charge-backs to be paid by the agent, might look like the following: The agent earns 100 percent of the GCI. Out of this, he or she must pay a 5 percent off-the-top brokerage fee, as well as a variety of charge-backs. The charge-back fees include the following fees.

$ 800	monthly desk fees
$ 100	per unit transaction fee
5%	of gross for office services
$1,350	annually for board dues, and errors and omissions insurance

This 100 percent plan includes a number of advantages and disadvantages for the agent.

Advantages

- There is a high split for the agent.
- There is independence and the opportunity for the agent to plan and control his or her own marketing strategies.
- There is incentive to be more efficient, since the agent controls his or her own expenses.
- The agent can achieve status, recognition, and a way of justifying nonparticipation with the office.

Disadvantages

- The agent must make a payment of fixed monthly expenses, regardless of cash flow income.
- The agent bears all variable expenses directly via charge-backs. These variable charges should recover any variable expenses which the company pays.
- The agent bears a degree of risk—at low incomes the agent earns less than he or she would under other plans. It is even possible for the agent to lose money. This would happen if the total GCI brought in by the agent falls short of the amount required to cover his or her charge-backs.
- The agent becomes responsible for more nonselling services (such as arranging personal advertising, preparing own promotional mail, and so on) which takes time and energy away from selling.
- A contract to commit is usually attached.

As the real estate business has matured and evolved, so have individual plans—there are now quite a variety of plan options included in 100 percent plans. These options range from the one described above to those which offer a "pay as you earn" method of covering rent and other fixed costs. In the "pay as you earn" method, the agent and company split commissions until the company has regained its costs plus the target profit specified in its plateau. After this point, the agent retains the full commissions less specific constant service fees. This type of 100 percent plan might be referred to as "100 percent once base costs have been regained by the company." It is aimed at those agents who want a 100 percent plan but are not able to commit to the regular monthly financial obligations. Such options can prove useful as a recruiting tool, demand active participation on the part of the agent, and effectively minimize a lot of the risk associated with other 100 percent plans. On the negative side, this kind of 100 percent plan can dramatically affect company cash flow as agents go over plateaus, and may result in the company running on volume to support overhead—a deadly business scenario!

From a broker's perspective, offering a 100 percent plan allows him or her to act as a kind of wholesale broker, in which a variety of goods and services are purchased and then resold to the agent for a profit. The broker no longer focuses on revenues generated from listings and sales commissions, but rather makes a profit acting as an intermediary who distributes essential services to the sales associates. Offering the 100 percent plan can also act as an attractive recruiting tool and demands less involvement and management time. Additional reasons for offering a 100 percent plan are as follows.

- As a means of competing with other brokers
- To attract a high producer who may, in turn, bring in others
- As a tool for retaining high-producing agents in the company
- To ensure a certain degree of company stability since guaranteed monthly payments can be used to recover expenses (this is true of most but not all 100 percent plans)

Overall, 100 percent plans appeal to independent and confident high producers who enjoy being in control and who are willing to take the risks necessary for the attainment of the 100 percent split. It should not be recommended to low-producing agents or to those who are inexperienced since both the company and the agent risks losing money.

Before enthusiastically offering agents 100 percent plans, however, a broker/owner must be aware of the risks and pitfalls associated with the plans, as well as a variety of considerations. For example, what actions should be taken if an agent is having difficulty meeting his or her financial obligations or has missed his or her base? Are provisions in place in the broker-agent agreement for an annual adjustment of the base and/or fees that will be charged to the agent? What policies are in place for dealing with shared costs and how are intangible benefits taken into account? Are systems in place to accommodate agents who choose to opt out of a 100 percent plan? Are all brokerage fees that are to be charged clearly explained and defined in advance? If these questions are not answered, the resulting confusion and possible confrontation can cause problems in the future.

➢ THE HIGH SPLIT PLAN WITH CHARGE-BACKS

The high split plan is a compromise between the traditional incremental plan and the 100 percent plan. Under a high split plan, the agent generally will receive higher splits than if he or she were under an incremental plan, however, the agent will also be responsible for relatively more expenses. In turn, expenses paid by the agent will not be as high as those under a 100 percent plan. The company recovers some of its variable expenses (and possibly even makes a profit) by charging the expenses back to the individual agents who incur these variable costs. The company must first decide which expenses are to be paid by the agent and which expenses will be paid from the company's share. The costs which are to be paid by the agent will be deducted at source from the agent's share (charge-backs). Whereas 100 percent plans build in charge-backs designed to recover all the company's expenses, the charge-backs in high split plans can only reduce the amount of fixed and variable expense which must be recovered (via the split schedule and variable charge-backs). This package is, therefore, attractive to agents who are looking for relatively high splits with less risk than would be found in a 100 percent plan. Thus, the high split plan with charge-backs is a compromise between the traditional incremental plan and the 100 percent plan—it is a plan which will offer an attractive split with a little more security than the 100 percent plan.

When considering a high split plan with charge-backs, it is important to be aware of the relative advantages and disadvantages for both the company and agents respectively. They can be summarized as follows.

Advantages

Company

- The company is able to attract agents and thus gain market share.

Agents

- The agents receive a relatively high split.
- They also pay lesser monthly fees.

Disadvantages

Company

- The company gets reduced cash flow during lower-selling seasons.
- The company may not be able to maintain enough company dollar from the agents on these splits to cover those agents' share of expenses. Thus the company might have to inject funds into the business during a poor period of sales or change (downward) in the market. This could result in the closure or sale of the business. (Many a company has fallen prey to the recruiting of agents with high splits without regard to the effect of the breakeven point per agent and its overall long-term effect on the company's profitability.)

Agents

- The high split plan doesn't provide stability.
- Because the company can't necessarily invest in attractive goods and services, the agent suffers from lack of support services.
- There may be problems retaining loyalty of the clientele since they might be tempted to change companies when business is down.

➢ THE ROLLING AVERAGE PLAN

This plan differs from previously discussed plans in that an agent does not start over again each year. The premise, then, is that an agent's split is continually recalculated based on the amount of income that the agent brings in over a specified period. When an agent is on the rolling average plan, the income over the past period determines the split to be used for a deal or for the next period.

If, for example, during the last period an agent brought in a large amount of GCI, then that agent would have a high split for the next earning period. Conversely, if the agent had a low GCI income during the last pay period, then the following period would see that agent receiving a lower split.

The past period tends to be quarterly or monthly, but can be more or less. The next period, which indicates how often the rolling average is recalculated, is generally shorter than the past period, but there's no set rule. It can be as short as a day, or as long as three months. For the purpose of recalculating the rolling average, monthly and quarterly periods are frequently used.

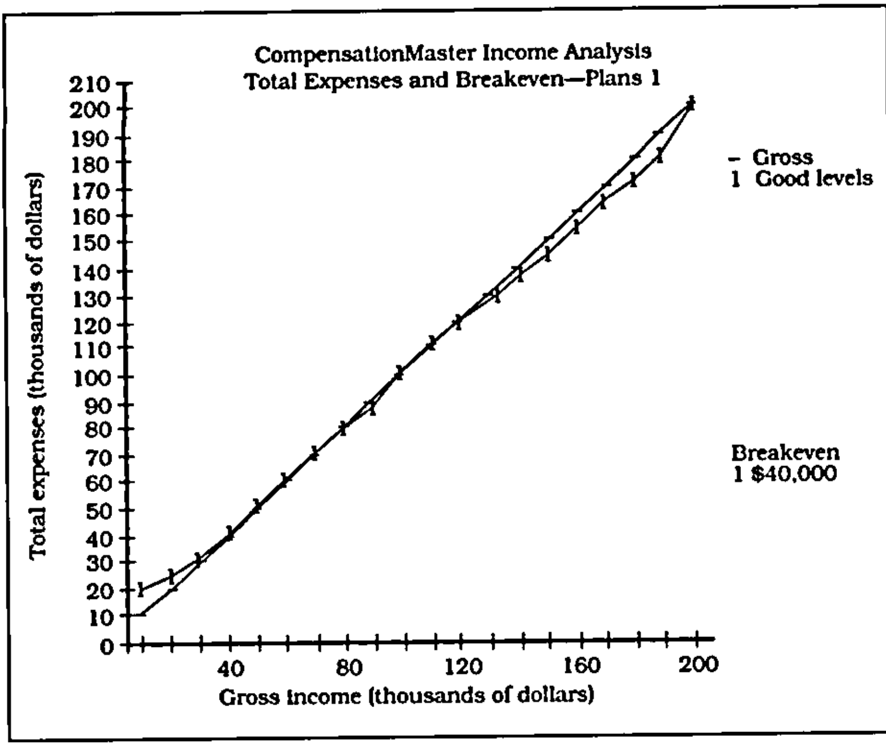
For example, at the end of each quarter the GCI for the last four quarters can be used to determine the split for the next quarter. If the agent's GCI for the last four quarters allows the agent to reach the 80 percent level, then the agent will receive 80 percent on all closings during the next quarter. Similarly, the rolling average can be recalculated any day there is a transaction. The split for each deal would be determined by the GCI over the past year. This would mean that the past period for this plan is one year and the next period is one day (or the length of time it takes for the next transaction to occur). This is called a daily rolling average.

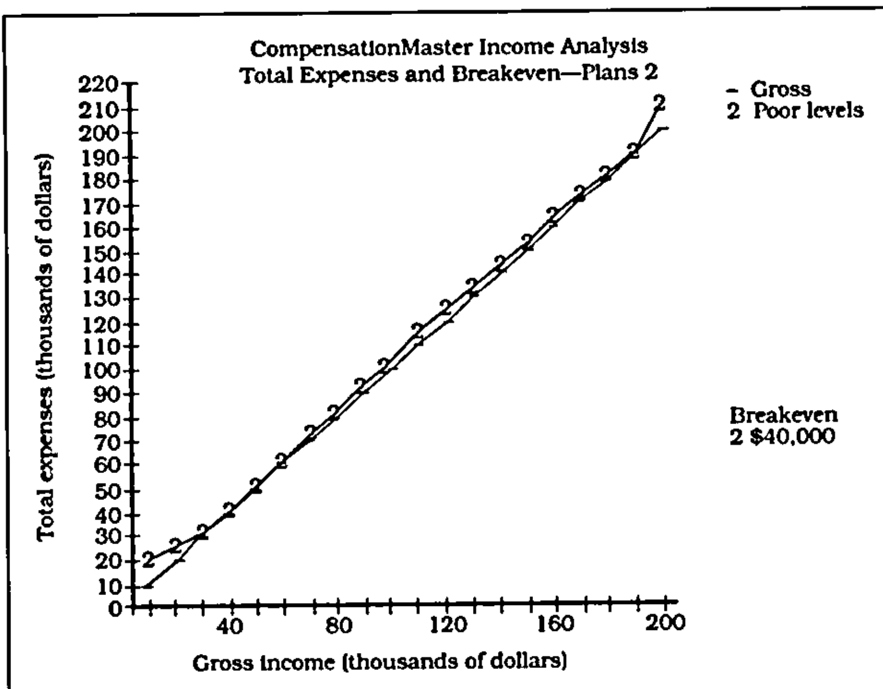
The split schedules for rolling average plans are generally comparable to those of retroactive plans, given similar expenses to recover—the numbers involved tend to turn out the same. The difference between the two lies in how the split is applied. The retroactive plan applies the split to income earned during a given year. The agent then starts the plan over again the following year. Under the rolling average plan, the agent's split is continually recalculated so that the agent has the potential to maintain a fairly high split throughout the year, assuming that sales are relatively steady.

The first graph shows a "good" rolling average schedule. In this graph, the line labeled "good levels" dips below the income line. This shows that the agent's GCI is high enough to cover both the additional expenses he or she will incur (due to generating the higher GCI) as well as the company's targeted profit. In "good" rolling average plans, the step level breakeven points are based upon the next split level to be given, thus ensuring that the company has the money at the next split level of the rolling average. Here, the company is precollecting the additional split payable for the next step level. This promotes profitability and stability.

The second graph illustrates a "bad" rolling average schedule. Look at the line labeled "poor levels" at the lower income levels. In this area of income the risk for the company starts off being high, because initial expenditures have not even begun to be recovered. Notice that the "poor levels" line skips above the income line—this means you're paying out more than your gross income. Obviously, this is a bad situation for business.

Note that poorly designed plans of this type are typically created by calculating the breakeven at the different step levels (for example, 50 percent, 55 percent, 60 percent, 65 percent, and so on) and allowing the agent to advance to the next step level as soon as the previous step level has been achieved. The agent now gets paid at the breakeven point based on the calculations of the second breakeven (which hasn't yet been reached), leaving the company in a loss position until the agent reaches the next breakeven level. This is especially devastating if the company hasn't calculated a target profit equal to the split differences into the breakeven.


CompensationMaster Income Analysis
Total Expenses and Breakeven—Plans 1
Total expenses (thousands of dollars)
210
200
190
180
170
160
150
140
130
120
110
100
90
80
70
60
50
40
30
20
10
0
40
80
120
160
200
Gross income (thousands of dollars)
- Gross
1 Good levels
Breakeven
1 $40,000


CompensationMaster Income Analysis
Total Expenses and Breakeven—Plans 2
Total expenses (thousands of dollars)
220
210
200
190
180
170
160
150
140
130
120
110
100
90
80
70
60
50
40
30
20
10
0
40
80
120
160
200
Gross income (thousands of dollars)
- Gross
2 Poor levels
Breakeven
2 $40,000

As with other plans, rolling average plans contain a number of advantages and disadvantages.

Advantages

- The agent maintains a higher split based upon the rolling period and does not go back to the lowest level unless sales drop accordingly.
- The agent has ample motivation to maintain high sales levels in order to stay on a higher split.
- Experienced agents can be placed on a starting split based upon their previous production history.
- When breakeven split levels are set correctly, rolling average plans allow improved company cash flow as agents progress through levels and before the next rolling period.

Disadvantages

- Many agents may not understand this plan since it is often perceived to be the same as a retroactive plan. Extra clarification is often needed.
- Agents will not be happy if the percent split of each level in the rolling average is set too far apart since the drop to the next lower level can be dramatic.
- If the period between the rolling average is set too long, it can have disastrous results to a company—especially if the market softens with respect to cash flow.
- Rolling average plans can be difficult to administer and basically require a management computer package.

➢ COMBINED SCHEDULES

Combined schedules can be used when an agent is given a different percentage of GCI for different types of sales activities. This means that different split schedules are applied to various types of sales activities. Combined split schedules may comprise any type of compensation plan. It is important to note that no matter which type of sales activity occurs and which split schedule is applied to it, the GCI from all sales activities counts towards the total GCI, which in turn determines when the agent moves up to the next level in the schedule.

Combined schedules are useful for providing incentive and for recruiting and retention purposes. Combined schedules can provide incentive by encouraging an agent to make more in-house sales than cobroker sales and referrals. (This is achieved by awarding a higher split of GCI to in-house rather than to cobroker sales or referrals.) As for recruiting and retaining, if a broker knows that only 20 percent of sales are in-house, then he or she will be able to offer an attractive split for these sales while offering an acceptable percentage split for other types of sales. This could prove very attractive to potential agents and to agents who are considering a move to a different company.

The following is a sample split calculation.

Agent Split		Average % of GCI			Type of Sale
60%	×	40%	=	24%	in-house
50%	×	50%	=	25%	co-op sales
40%	×	10%	=	4%	referrals
				53%	

True Split = 53%

Advantages

- This type of plan can be set to motivate agents to sell to the advantage of the company.
- Overall, the combined split is actually lower than the agent may perceive it to be since most agents tend to focus on the highest split offered. This is an advantage to the company because the company retains more money.

Disadvantages

- Sometimes agents feel penalized rather than rewarded for one type of sale over another.
- If, due to a higher split being rewarded for a particular sales type, agents focus strongly on that kind of sale, then the company could pay out more than it anticipated.

➢ BASE-PLUS PLANS

Base-plus plans may involve either incremental or retroactive type plans. Level 1 of a base-plus plan is the basic split which the agent will receive on all earnings and which also underlies the calculations made for splits applicable to all higher levels. The percentage amount of all higher splits represents how many additional agents will be paid on top of the basic split once they reach the amounts of GCI required for these higher levels. Thus, at higher levels, in addition to the agent's basic split specified at Level 1, the agent will receive the specified additional percentage of his or her basic split amount.

Consider an example of an incremental base-plus plan with three levels.

Level 1	Basic split 50%	to $20,000
Level 2	Basic split 20%	to $40,000
Level 3	Basic split 40%	above $40,000

Level 1: The agent receives 50 percent of the GCI (the basic split) until the agent's share is $20,000.

Level 2: The agent receives the basic split (50 percent) plus 20 percent of the basic split. This applies to income that falls after Level 1 and until the agent has received $40,000 at the basic split of 50 percent of GCI.

Level 3: The agent receives the basic split (50 percent) plus 40 percent of the basic split on income above Level 2.

In effect, the agent is on Level 2 up to a GCI of $80,000 and receives 60 percent of GCI. At Level 3 the agent receives 70 percent of GCI. Therefore, an agent who produces $100,000 income would receive 50 percent on the first $40,000 GCI ($20,000), 60 percent on the next $40,000 GCI ($24,000), and 70 percent on the last $20,000 GCI ($14,000)—for a total of $58,000.

Though this way of expressing a split schedule may be confusing, the amounts of income required to move to a higher level appear lower than they would if expressed in terms of GCI or agent's share, and the split may appear higher (50 percent plus 20 percent instead of 60 percent). If the plan were retroactive, then the higher splits would apply to all income within the year, so an agent who produces $100,000 GCI would receive $70,000 as his or her share.

The advantages and disadvantages of base-plus plans can be summarized as follows.

Advantages

- Agents have definable goal levels.
- Motivation is in place to reach the next level.
- Agents typically have less to pay for and therefore bear less risk.
- The company retains more money while agents go to each next step.

Disadvantages

- The company pays for more and is at higher risk.
- Top agents can be paying for lower-producing agents if the lowest split is too high. Agents can become disgruntled as a result.

INGREDIENTS FOR SETTING UP A SUCCESSFUL COMPANY

Therefore, what are the main ingredients for setting up a successful company? In *Real Estate Brokerage: Income, Expenses, Profits*, a recent study of residential real estate firms conducted by the economic research division of the National Association of Realtors, the common characteristics of successful North American firms are outlined. They can be summarized as follows.

Compared to their lower-producing counterparts, high-producing firms tend to be smaller than average. They are able to offer relatively large commission splits to their agents, spend a smaller percentage of GCI on advertising, have productive agents, and operate with a low fixed-to-variable cost ratio. They also tend to share as much as possible the burden of fixed expenses with their agents.

When designing profitable compensation plans, you should keep in mind the "Three Rs" in Real Estate.

1. Recruiting—Design your compensation plans to both assist new agents coming into the business and to attract experienced agents to your company.

2. Retention—Ensure that the design of your compensation plans is market competitive in order to keep existing agents in your company.
3. Reality—Make sure you have an accurate reflection of the cost of running your business in relation to the compensation plans so that you don't go broke!

The owner of a successful real estate firm also understands the three most common reasons why agents leave a company. As the result of a study conducted by Dr. Michael Abelson at Texas A & M University, the following reasons were pinpointed.

1. **Uncontrolled Circumstances**—This refers to agents retiring from the business, transferring to another location, and so forth.
2. **Illusion about Compensation**—The appearance of competitive compensation plans gives agents the illusion of making more money elsewhere. However, often they move to another company only to be disappointed.
3. **Management . . . or Lack Thereof**—Management is the single most common factor in keeping agents or losing them to the competition. It is also the only one of the three reasons listed here that a company should be able to control.

Finally, keep in mind that there are three myths to be overcome when designing sound real estate compensation plans for a successful business. These myths are now no longer true, and the fallacies behind them will become clear as you continue reading this book.

1. **Myth 1: Commissions Cannot Be Managed**—With the emergence of sophisticated computer technology, it is now possible to finitely manage commissions.
2. **Myth 2: Top Producers Always End Up Supporting the Low Producers**—This may still be true in companies with poorly designed compensation plans (for example, the quartile system), but with a full understanding of the numbers and the viewpoint of each agent as a separate profit center, companies can avoid this situation.
3. **Myth 3: You Can't Integrate Multiple Compensation Plans Inside a Company**—If each agent is viewed as a distinct

economic center, you can design any combination of plans to suit the personality and abilities of each agent.

Perhaps a look at diversity and flexibility outside of the real estate world will help illustrate how variety in your compensation plans can be beneficial to your company. Take, for example, the case of Sam's restaurant. Many, many years ago, Sam opened a small little restaurant called The Octopus' Tentacle. As you might have guessed, the "Tentacle" offered patrons a delicious menu of octopus in its various forms, including Octopus Salad, Octopus Soup, Macaroni a la Octopi, and Octopus Milkshakes.

For a number of years business was good. The waiters and waitresses all wore cute little green jackets which had not two but eight sleeves—a delight among children and adults alike. Sam's business was going along at a nice clip—such a nice clip, in fact, that unfortunately the old maxim, Excessive Profits Create Ruinous Competition, comes to mind. Can you guess what happened next?

Up until then, there hadn't been too many other neighborhood restaurants which specialized in just one species of seafood—and practically no other neighborhood restaurants which served more than one type of seafood. But then, just three doors down from the "tentacle," the sharklike competition in the form of the Crabby Crab appeared. However, the Crabby Crab didn't stop at offering crab. It also had haddock, cod, shrimp, oysters, . . . and octopus. The staff at the Crabby Crab also dressed up in a variety of costumes, which were extremely popular.

Late one night, not long after the Crabby Crab appeared on the scene, Sam found himself looking over his accounting books. His beloved "Tentacle" seemed to be strangling. "Something's a little fishy here, I think," thought Sam to himself. Suddenly it dawned on him. "It's those Crabby people!" he shouted, knocking over a jar of octopus pâté in the process. Sam began to plot and plan for the survival of his restaurant. The Crabby Crab didn't just serve crab, therefore The Octopus' Tentacle didn't have to serve only octopus.

After two weeks of closed doors and renovations the Octopus' Tentacle became a different place—filled with a variety of seafood dishes. People began to pour into the restaurant, selecting their favorite types of brain food so that they might become as clever as old Sam.

What's the moral of this story? Simply put, for the purposes of recruitment and retention, it is essential that you are able to offer your agents a diverse "menu" of compensation schedules to meet the competition.

When designing compensation schedules, the consequences of selecting cutoff levels, percentages and charge-backs, and choosing one option over another can be critical to the success of a company. *Before* presentation to prospective or existing agents, the interaction between these factors and values must be carefully explored and adjusted in order to reach optimum effectiveness. Plans should be tailor-made so that they simultaneously achieve your profit objectives while offering inexperienced agents and low producers an adequate amount of security, not to mention sufficient motivation to increase production. It is unlikely that the same plan will satisfy the needs of high producers and low producers alike. Remember, there are advantages and disadvantages to each type of plan, depending on one's perspective.

Comparing your plans to the plans of your competitors should be an integral part of this process, as it is with any other business. Compensation plans must be sufficiently competitive and attractive to agents in order to recruit and retain quality agents. When assessing a competitor's plans it is important to get as many details based on fact as you possibly can. This would include level amounts, percentages, policy on anniversary dates, charge-backs, hidden expenses, and so on. With incorrect or incomplete information your competitor's figures will appear distorted and you may find yourself trying to compete with a plan which in reality does not exist! It should also be noted that it is not necessarily required—or even prudent—to match your competitors' plans identically. This is because your expenses probably will be different and also because there is an intangible value attached to the association of your company.

It should be mentioned here that there are instances where agents are paid on a salary basis. This form of compensation tends to be typical and prevalent in the sale of new homes where a developer has control over the inventory and makes the agents accountable for their activities and productivity. Therefore, this type of compensation requires a structured environment and more management time, requiring the company to have a greater degree of control over agents than in normal real estate transactions. The risk is obviously higher for the company since the agents represent a fixed expense, but on the other hand, higher profits can be achieved due to the fact that payouts to agents are fixed in advance and represent a lower overall percentage cost of gross income.

The following pages will provide you with an understanding of why the characteristics mentioned earlier with respect to compensation plans help ensure profitability and, moreover, why it is important to keep these principles in mind when designing compensation plans. Keep in mind, however, that a compensation plan is only a statement of how sales associates will be paid, and what charges or expenses they will be responsible for.

While this book focuses on the importance of compensation plans, you should realize that compensation plans form only part of a larger package of goods, services, and supplies offered by brokers to agents. The theory that high-producing agents can be recruited and retained simply by offering the highest dollar return through a compensation plan is fallacious or, at best, short-term. There must be something else offered that other brokers might not be able to offer—something that is needed by the agent.

There are basically two ways to compete in a marketplace. A company can offer the standard package common to the marketplace, adjusting specific areas upward or downward (and adjusting the bottom line as necessary), or choose to be completely different. Consider a typical marketplace that uses traditional brokerage splits with the agents. The main differences between the companies in this particular marketplace are in the details relating to split points, perks offered, and the amounts recouped through charge-backs. A broker might choose to compete by offering plans that essentially conform but may offer slightly better splits, or the broker might incorporate such innovations as agent teams and a variety of cross incentives in order to attract agents. If the first approach is taken, the broker must consider the following in order to offer agents tangible competitiveness.

- The amount of GCI dollars between of split levels
- What perks and bonuses are to be offered
- Franchise fees
- What operation costs will be levied as charge-backs
- Initial investment

These are also considerations for a broker using the less traditional approach of innovations and variety, but these usually receive less emphasis because of the inclusion of more nontangible, nonmonetary factors. The broker must view himself or herself as a wholesale purchaser of goods and services that he or she then sells at retail value to agents. The agent then uses these same goods and services in the hopes of generating real estate transactions through the consumer. A real estate company is, in a sense, a form of distributorship whereby the agents use the goods and services supplied by the broker to generate more business than the agent could generate by operating alone.

As just mentioned, there are a number of elements besides the actual compensation plans that make up the "value package" that brokers must offer to agents and which will, it is hoped, contribute not only to the success of individual agents but by extension to the company as a whole. This "value package," will probably include a variety of nontangible considerations. These considerations that can be incorporated into an attractive package along with compensation plans include the following goods and services.

- Access to training, information, and career development programs
- A good office environment complete with support staff, facilities, image, management systems, equipment, and resources

- Systems in place that control recruiting, retention, rehiring, and maintenance of quality agents and support staff
- Positive company image and a strong reputation in the community
- Strong management that limits potential for errors and maximizes opportunities for business
- Systems that reward and recognize successful and contributing employees, as well as provide motivation and guidance

MOTIVATING AGENTS THROUGH COMPENSATION AND REDUCED COMPENSATION FOR PASSIVE BUSINESS

Recent surveys have shown that firms that concentrate on selling their own listings (in-house sales) tend to be more profitable than those that generate most of their business through cooperative sales and referrals. By definition, firms with high in-house sales keep a greater percentage of the GCI generated by each transaction than do firms that get most of their revenue from cooperative sales and referrals. This is because commissions coming from the latter have to be split three ways, not two. Typically 50 percent of the GCI goes to the firm which provides the listing or sale. After the referral has been paid, the rest is split between agent and broker, according to the compensation schedule they have between them. It should be noted that depending on the area in which a company is operating, state or provincial laws may require an agent to disclose to another company if they are receiving any in-house bonuses. This is done to ensure that there are no unfair advantages for either party during the selling process.

The above paragraph should not be interpreted as a suggestion to organize your business solely around in-house sales. Depending on the market and the location of a company, it may make better business sense to focus on cobroker listings and sales or referrals. Although most agents make all kinds of sales, a broker may want them to spend more time and energy in one particular area. Through careful planning of compensation plans, a company can help direct agents towards the type of activity which is most beneficial to the company. The company generally makes this in the agent's best interest as well.

It may be smart to reward "active" business with higher and more generous splits than received by "passive" business. "Active" business is business generated solely by the agent's efforts. "Passive" business refers to a sale in which the agent is provided with a lead or tip. Such a lead could come from another company, or from a coworker or broker within the agent's own company. Obviously, if the lead has been provided externally, the referring company is compensated appropriately. However, more consideration needs to be given to cases in which the lead is provided to the agent by someone in his or her own company.

In such cases, brokers often neglect to compensate themselves for the time and/or money they have spent in getting the lead. By compensating agents for "passive" business with a split similar or identical to the split given for "active" business, the incentive for agents to hustle up their own leads is lessened. In addition, by not taking their own "referral fee" of, say, 25 percent off-the-top and then splitting the remaining GCI accordingly, the broker misses a valuable (and deserved) opportunity to recover money which could be used to pay fixed expenses and therefore buy down the breakeven point for the company. It is justifiable then for brokers to offer reduced compensation for any "passive" business. At the very least, the agent should be aware of the monetary value that they are receiving from the passive business given to them by the company. For example, if an agent receives 10 percent of his or her income from passive business leads from the company, then that 10 percent may put the agent in a higher overall split with the company. The difference in the overall split the agent receives with and without "passive" business has direct measurable value, and should be shown and calculated as a benefit to the agent.

RISK AND REWARD

The concept behind risk and reward is quite straightforward. Agents who pay their own expenses and a monthly fee deserve to receive a higher overall payout than those who expect the company to pay their share of fixed and semivariable expenses. This is because the company needs more money to bankroll agents on compensation plans where the company bears all or most of the risk. Anything put up by a company for resources or service is done so with the expectation of financial return. The concept of risk and reward can also be applied to the individual agent. For example, the amount of risk the agent is willing to take under any particular compensation plan should be reflected in the overall payout.

THE BREAKEVEN

One of the most important concepts in this book is the idea of breakeven. Understanding everything else—for example, the best possible plan to offer an agent, the business risks involved in various decisions, and how to keep your business afloat—hinges on a firm understanding of the breakeven.

It might be useful here to give some appreciation of how the GCI (or what may more precisely be called "closed deal money collected commission dollar") is typically broken down. There are a number of categories, each of which eat up a few cents of each dollar brought in. It is important to know what percentage of each dollar is distributed to each area of expense in order to have a complete picture of the costs of running your business.

The first category contains the moneys paid out in commissions and fees paid. If you visualize each dollar coming into a company as a pie chart, this would typically be by far the largest piece of the pie! These moneys are paid either directly to the agent or something of tangible monetary value is given to the agent. Examples of commissions and fees paid include commissions paid to agents, business and professional taxes paid on behalf of the agent, referral fees paid to an association, and off-the-top fees (such as franchise fees, awards, gifts, prizes, and bonuses) given to the agent.

The second category contains the moneys used in advertising. Advertising is an important part of business and typically eats up a significant part of each company dollar. Direct advertising relates to a specific agent or property, and includes such things as classified ads, magazines used to sell homes, and flyers. Institutional advertising is used to create and promote the image of a company as a whole. It includes television and radio advertising, brochures, telemarketing, and entries in the yellow pages.

The third category contains the expenses related to office occupancy. (Note that some items could fall under other categories. What category you choose to place a particular item in is not that important as long as everything is accounted for somewhere!) Occupancy costs include rent, utilities, janitorial and cleaning costs, property taxes, insurance (such as fire, theft, and property liability), repairs, and maintenance.

The fourth category contains the costs associated with office equipment. (This is tied into occupancy.) This category includes computers (including all hardware and software costs), vehicles and their related costs, and the purchase of telephones, fax machines, answering machines, and photocopiers.

The fifth category contains the moneys needed to run an effective communication system. Many of these costs are semi-variable in the sense that they usually fluctuate relative to the amount of business and could be charge-backs when it comes to developing compensation plans. Communication costs include telephone-line charges, system rents or amortization, long distance and fax charges not billed to the agents, paging equipment and all related charges and supplies, and postage meter and costs.

The sixth category contains the moneys spent on materials and supplies. These costs include printing, forms and business cards, paper, staplers, pens, paper cutters, and electronic media supplies.

The seventh category contains the costs associated with sales promotions costs. Sales promotion costs are those connected to projects and include agent recognition items and sponsorships (such as Career Nights, conventions and seminars, public relations not connected to institutional ads, and novelties to promote projects).

The eighth category contains the expenses connected to education and travel. These include in-office training and resource materials, education for support staff (if part of a benefit package or requested by the company), travel for support staff and other employees, salaries, and benefits or compensation to the education trainers if they are not regular staff members.

The ninth category contains the moneys spent on salaries for all employees of the company. These include the value of the broker's nonselling services (excluding profit before taxes) and compensation to all individuals not included under commissions, fees paid, or professional services. Examples of specific costs include salaries for all support staff (administrative assistants to janitorial), override payments not included under commissions or fees paid, and contract payments (for example, temporary help).

The tenth category contains the values of staff benefits. These benefits include vacations, pensions, bonuses and gifts to support staff, and any other perks.

The eleventh category contains moneys spent on professional services. These moneys include professional organization fees and dues not related to advertising, bank charges, fines and dues for MLS, and fees paid for accounting, legal, consulting, and public relations services by nonstaff members.

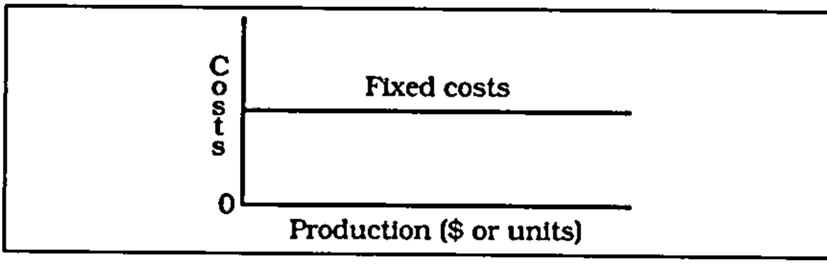
The twelfth category contains moneys incurred with debt service. These costs can be long-term, short-term, or in the form of lines of credit. Payments should be counted in amortized form. Examples of this category include payments made in order to resolve debt that is incurred for the purposes of the company.

The thirteenth category contains moneys set aside as reserves. Reserves are important to have, and are used for unanticipated expenditures, emergencies, new equipment, and so forth.

The fourteenth and last category fills in the remaining "hole" in the pie. Once we have subtracted Commissions/Fees Paid and the total of net operating expenses, what is left over is viewed as a simplified "Profit before Tax." This is not only the return on investment and risk, but the amount of profit before taxes are deducted. It is indicative of the worth of the business.

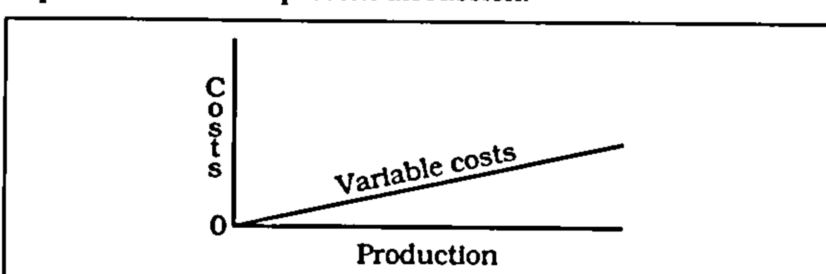
As you may have noticed, each of the expenses outlined above can be classified as either "fixed" or "variable" costs. These can be defined as follows.

Fixed Costs—Fixed costs are expenses that do not increase as business increases. They remain constant no matter how much or how little business a company does. These expenses are expressed in fixed dollar amounts. Examples of fixed expenses include mortgage/rent of office space, utilities, value of owner's nonselling services, and support staff salaries.

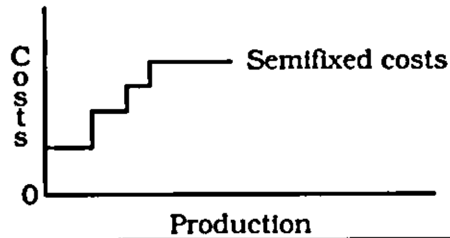


Variable Costs—Variable costs are expenses that increase or decrease in proportion to the amount of business a company does. They vary with each unit of production and, in fact, are caused by production. Variable expenses are usually expressed as a fraction or percentage of GCI. The relationship between the fraction or percentage and the GCI may be natural, statistical, budgetary, or contractual in nature. Examples of variable expenses include commissions (each sale causes an additional unit of commission expense), franchise fees (when they are paid based upon productivity), telephone charges, and transaction fees.

There is also a third type of expense—semifixed costs. These are also known as semivariable costs. They do not play an important role in the present discussion.



Semifixed Costs—Semifixed costs are expenses that are fixed only over a limited range of production. Examples of semifixed costs include the addition of office space, new equipment purchases, and the hiring of more support staff to accommodate an increase in business due to increased growth.



We will define the breakeven as the amount of income where profits are zero, or the lowest amount of income required to just cover total operating expenses. Here, the total expenses are considered the sum of the fixed expenses and the variable expenses outlined in the categories described earlier. At any point upwards of the breakeven the company will earn a profit, as all expenses have been recovered. (This is company breakeven as opposed to agent breakeven—a difference which will be explained later in this book.)

Note that if the variable expenses (including the agents' percentage share of GCI) exceed 100 percent of the total GCI, the company will find it impossible to hit the breakeven. This will result in a loss. However, because they increase proportionately with business, the variable expenses do not pose a problem for company breakeven (provided the percent split paid out to the agent does not exceed the percent the company needs to meet its ongoing variable percent obligations). Rather, it's the fixed expenses that pose the real problem for company breakeven. This will be clarified under the section entitled Business Risk. At a low GCI, fixed expenses may exceed the remaining company revenue. It is in such cases that an understanding of the breakeven and the contribution margin become especially important.

The contribution margin is what helps the company to achieve breakeven. It is the amount of money, expressed as a percentage of the GCI, that the company has available after paying variable expenses (including agents' commissions). It is the amount of money which is used to recover fixed expenses and then, once breakeven is reached, to earn a profit. This is illustrated by the following.

Contribution Margin (C.M.) = total GCI − variable expenses

If C.M. > fixed expenses, the company earns a profit

If C.M. = fixed expenses, exact breakeven is achieved

If C.M. < fixed expenses, the company has a loss

Let's say that a company's fixed expenses are $10,000. If the variable expenses, including the agent's percentage of the GCI, equal 80 percent of the total GCI, then the contribution margin equals 20 percent ($20 of every $100). Using these figures, the company's breakeven point can be calculated using the following formula.

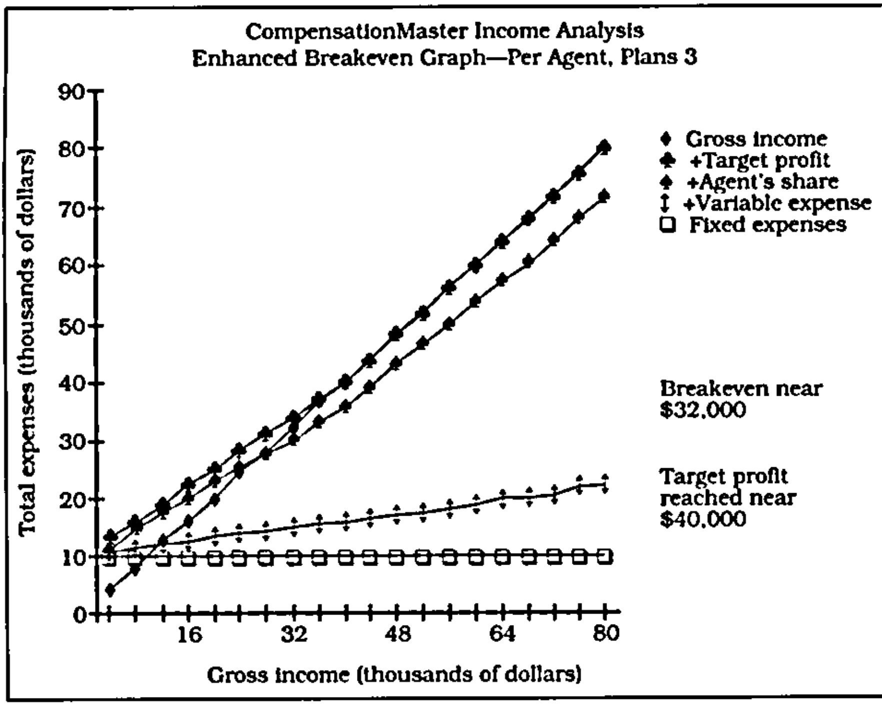
Fixed Expenses	×	Inverted percentage of C.M.	=	Breakeven (in GCI)
$10,000	×	(100/20)	=	$50,000

The bigger the percentage of GCI in the contribution margin, the faster the company's fixed expenses are recovered, and the faster the company reaches breakeven.

TARGET PROFIT POINT—PLANNING FOR PROFIT

Of course, companies aren't satisfied with just breaking even. The goal of most companies is to make a profit. This next section will teach you how to plan for profit by factoring a profit margin into the breakeven, just as you would an expense.

If you look closely at the graph on page 41, you'll notice one very important line. This is the target profit line, and it represents all expenses (fixed and variable) plus target profit. By budgeting profit as an expense in breakeven calculations, it is now necessary to calculate a second breakeven point. We call this new breakeven the Target Profit Point.



Why should profit be considered as a budgeted expense? For one thing, profitable plans are not things which happen by accident. Therefore, we support the view that profit should be budgeted for, and that compensation plans should be created to provide a budgeted profit.

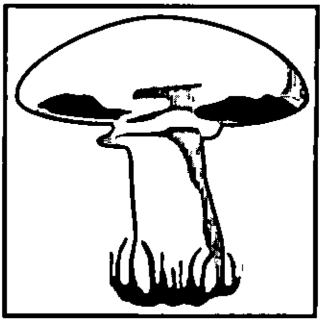
How do we tell if and when the Target Profit Point is reached? Take another look at the graph above and find the point at which the income reaches or surpasses all of the company's expenses, including the budgeted profit. (This is the point where the income line crosses the target profit line.) When this point is reached, the company achieves target profit on its plans.

Here is a summary of why profit is important:

- Keeps the company strong
- Allows for continuous support
- Allows for upgrading of facilities and equipment
- Maintains stability in the marketplace
- Maintains a stronger relationship with clients
- Gives stability to the agent's business
- Makes the company worth running

WEAK COMPENSATION PLANS MAKE YOU VULNERABLE!

Compare your plans for the following symptoms associated with the often "FATAL MUSHROOM" type compensation plan.



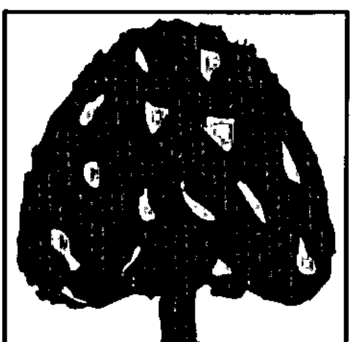
Are you:

1. Establishing plans without having first determined a true breakeven point?
2. Changing agents' plans from a high to a low dollar contribution margin plan?
3. Using a plan that pays out a high split before the true breakeven points has been reached?
4. Providing rolling average or retroactive plans without having first established the true breakeven points for the various step levels?
5. Using high split plans that do not include sufficient charge-backs to reach breakeven or plans that have the company incur expenses that should be charged to the agent?
6. Changing from fixed expenses recovered plans to a high percentage split plan
7. Offering only a single commission plan within your company?

"Today's agent wants the freedom to choose a compensation plan that best suits his or her own individual needs."

WIN/WIN COMPENSATION PLANS . . .
THE COMPETITIVE EDGE!

Compare your plans' features to those associated with the strength of "SOLID OAK" type compensation plans.



Try being a "SOLID OAK" by:

1. Establishing the true breakeven point.
2. Changing agents' plans from a low to a higher dollar contribution margin plan.
3. A plan that pays out a high split before the true breakeven point has been reached.
4. Determining the true breakeven point at the different step levels for rolling average or retroactive type plans.
5. Having appropriate charge-backs in plans with higher initial splits.
6. Allowing agents to move from a fixed expense recovered plan to a high percentage split plan only if the breakeven point can be reached.
7. Offering multiple commission plans within your company.

EACH AGENT IS A "PROFIT CENTER"

Perhaps our main concern and goal in this book is to provide brokers with an understanding of how to get their company to hit the breakeven point. After all, a stable and profitable business really can't be achieved without the breakeven being reached first. However, the breakeven analysis for the entire company is incomplete without also considering the breakeven analysis for individual sales agents. One has to look at individual agents as "mini-companies," each one striving to make a profit. This means that each agent is really an individual "profit center" and, as such, we must take into account individual breakeven when trying to determine the larger issue of company breakeven.

Consider as an example the following true story. It's not often you get a call from Annette. She says she and her husband have decided to sell their real estate company and wonders if you are interested in buying it. You have always wanted a better presence in his market area, which is not too far from you. Annette indicates to you that her total gross commission income is in the $615,000 range. She would like $100,000 for the business and is willing to be paid back over 5 years. Her accountant gives you a statement (for discussion purposes only between you and Annette) which shows a profit before a management fee of $224,113. Sounds pretty good so far—or does it?

You tell Annette's accountant that all you need are the business expenses, agent revenues, the description of the compensation plans, and what the agents of the company are responsible for paying. This information is all faxed to you and is represented as follows.

Revenue Group List

	Agent	Reps.	Units/Rep.	$/Unit	Plan	Revenue
1.	Annette	1	50	$4,700	1	$235,000
2.	Charlie	1	32	$3,545	2	$113,440
3.	Rhonda	1	22	$3,500	2	$77,000
4.	Jeff	1	5	$2,150	2	$10,750
5.	Harold	1	9	$4,495	2	$40,455
6.	Margorie	1	14	$2,600	2	$35,100
7.	Karen	1	14	$2,600	2	$35,100

8. Albert	1	12	$3,440	2	$41,280
9. Tony	1	1	$4,830	4	$4,830
10. Marci	1	4	$4,150	5	$16,600
11. Ted	1	1	$3,459	2	$3,459

Expense and Profit Allocation

	Rate	Per Annum
1. Profit?	(we'll leave this out for now)	
2. Interest income	−5,000 per annum	$5,000
3. Vehicle/Travel	$17,000 per annum	$17,000
4. Institutional	$6,130 per annum	$6,130
5. Entertainment	$150 per month	$1,800
6. Signs	$3,500 per annum	$3,500
7. Office lease	$9,400 per annum	$9,400
8. Bank charge	$2,313 per annum	$2,313
9. Content insurance	$700 per annum	$700
10. Phone (fixed)	$700 per month	$8,400
11. Phone (long distance)	$9,195 per annum	$9,195
12. Depreciation	$6,000 per annum	$6,000
13. Equipment rental	$3,600 per annum	$3,600
14. Fees and dues	$1,800 per annum	$1,800
15. Business taxes	$1,200 per annum	$1,200
16. Professional fee	$3,936 per annum	$3,936
17. Office expense	$16,000 per annum	$16,000
18. Utilities	$3,780 per annum	$3,780
19. Secretarial	$28,000 per annum	$28,000
20. Miscellaneous	$3,294 per annum	$3,294

Compensation Plan #1 Summary

Plan name: 75 plan

Plan is Incremental type

Rep's %	to Gross $
75	$45,000
90	

Compensation Plan #2 Summary

Plan name: 75 to 70,000

Plan is Incremental type

Rep's %	to Gross $
75	$70,000
90	

Compensation Plan #3 Summary

Plan name: 85/15 plan

Plan is Incremental type

Rep's %	to Gross $
85	$1
85	

Compensation Plan #4 Summary

Plan name: 65/35 plan

Plan is Incremental type

Rep's %	to Gross $
65	$50,000
75	$70,000
90	

Compensation Plan #5 Summary

Plan name: 60 plan

Plan is Incremental type

Rep's %	to Gross $
60	$40,000
70	$70,000
90	

After entering all the information into your computer, you get the following final business summary display.

Unable to calculate Fully Productive Equivalent.

Dividing by 1 rep gives the fixed expense per rep of $115,723.

Total fixed expenses $115,723

Fixed expense recovered $104,836

Result: Deficit of $10,887

Derived from revenue group list:

Average units per rep 14.82

Average revenue per unit $3,761

Number of reps in revenue groups 11

Total revenues $613,014

Total variable expenses (2.5 percent of revenue) $15,325

Total fixed expense (18.88 percent of revenue) $115,723

Total Reps' share is (80.4 percent of revenue) $492,853

Total expenses plus reps' share (101.78 percent of revenue) $623,901

Expenses exceed expected revenues by −1.78 percent ....−$10,887

Once these figures have been analyzed, you quickly realize that Annette is her own best producer, with an annual gross commission income of $235,000. The loss after all agents were paid was in fact $10,887. This puts a much different light on the $224,113 profit before management fees! You realize that Annette's offer isn't quite what it seemed at first and now, if Annette is really interested, you can negotiate knowing the facts and purchase from a position of strength.

Bearing this example in mind, it's helpful to view the individual agents as you would small companies—in this sense, the agents collectively form a sort of conglomerate. However, it is the brokerage, or the "parent company" of this conglomerate, which must ultimately make the breakeven. In addition, when designing plans (particularly the incremental type), the "to amount" at each level should be the breakeven point for the specified split. The agent will therefore advance to a higher level only when that breakeven point has been achieved since fixed expenses will then have been recovered.

It only makes sense that, when designing compensation schedules, a company should create a plan that makes the individual agents' "companies" profitable. In this way, the conglomerate as a whole will be profitable.

Unfortunately, each agent is not always a source of profit. As in the example of Annette's company, some of the company's sales associates can fall short in the recovery of their full share of the company's fixed expenses.

BUYING DOWN THE BREAKEVEN

If you have doubts about the ability of your agents to recover their share of expenses, it only makes sense that as a broker you will do everything in your power to ensure that the amount of money you lose is as little as possible. In order for this to occur, it is necessary to try to get every agent to breakeven. The best way to do this is to buy down the agent's breakeven point. There are a number of ways to go about this. Keep in mind, however, that your goal is to reduce your costs and make sure that it doesn't cost you anything to keep your agents.

Let's look at ways you can buy down the agent breakeven. To begin, a real risk lies with low producers. An obvious course of action, therefore, involves reducing the resources the low producers consume. For example, you could reduce the consumable resources by having the agent work at home, or having two or three agents share a desk in the office. Another way of buying down the breakeven involves reducing the agent's split of GCI. Off-the-top, or transaction, fees would reduce this split. A risk also lies with agents on high splits that don't allow for the fixed and variable expenses to be recovered. Here, the breakeven point cannot be reached even though there is sufficient GCI to meet a revised breakeven (recalculated breakeven based on the contribution margin). A transaction fee would adjust the breakeven point and would recover the money required to break even. Another risk occurs when fixed expenses are not recovered, such as when the rent per office is set too low on a payment-type compensation plan. This payment could be adjusted accordingly or the maximum split could be reduced.

Possibly the best way to reduce risk associated with low-producing agents is to focus on training to help low and new agents get to the breakeven point. This solution will also help the company make its largest financial gain.

OPTIMAL FULLY PRODUCTIVE EQUIVALENT AND DETERMINING THE FIXED EXPENSE PER AGENT

Before getting agents to recover their share of fixed expenses, it's necessary to determine exactly what an agent's share of fixed expenses is. One approach is to divide the company's total fixed expenses by the number of associates. Traditionally this was the way it was done, and such a system would be workable and fair providing that all sales associates consume the same amount of company resources and that all agents produce enough to recover their share of the fixed expenses. Unfortunately, this rarely happens. Therefore, dividing by the number of agents is not entirely satisfactory. An important aspect to remember is that the fewer the number of sales associates by which one divides the company's total fixed expenses, the higher the fixed expense per agent, and hence the higher an individual agent's breakeven point will become in his or her compensation plan.

There is another approach to determine an agent's share of fixed expenses. This prudent, effective, and fair method takes into account the partial contributions of lower-producing agents. First, the number of "full" producers in the company needs to be calculated. Here, a low-producing agent is not considered a full producer. By adding one share from agents who have achieved their breakeven, and a partial share from those who have not (thereby combining the partial recovery from low producers with the full share recovery of high producers), the number of full producers can be effectively calculated. This calculated number of agents is what we will call the Fully Productive Equivalent (FPE).

When we speak of the Fully Productive Equivalent, we refer to the accumulated number of times the production (or part of the production) of the agents contributes to the breakeven point. For example, when there are a lot of agents at different levels of production, some may and some may not reach the breakeven point. If a broker were to add one share for each agent who reaches the breakeven point, then add the balance of the contributions made by the balance of the agents, then the broker could establish how many times the breakeven point was reached.

Now increasing the Fixed Expense per Agent, and thus increasing the breakeven point for a compensation plan, will decrease the extent to which agents reach the BEP for the compensation plan. Fewer agents reach breakeven and for those who don't, they achieve a lower fraction of the BEP. Thus if FE/A is increased, Fully Productive Equivalent is decreased. Conversely, if FE/A is decreased, FPE is increased.

Now if you are using the BEP to design commission plans, which have a lower split up to breakeven and then give a higher split, increasing the FE/A increases the number of dollars for which the agent receives the lower split. Hence the company receives a higher share (a larger contribution margin) over more income. Thus, designing a compensation plan to cover a higher fixed expense per agent will improve company profitability. Similarly, decreasing the FE/A used to design plans lowers company profitability.

If one has a target profitability, there is hopefully some FE/A which will allow you to set compensation plans which recover expenses and provide just that target profitability. Corresponding to that "just right" FE/A there is a FPE; this we call the Optimal Fully Productive Equivalent (OFPE).

Simply put, the FPE is the best number of agents by which the company's total fixed expense can be divided. Instead of dividing the fixed and semivariable expenses by the total number of agents, now the division is by the OFPE. This enables a broker to recover the total fixed expenses by factoring in the collective contributions of the agents.

This method can be highlighted by the fictional, tiny Alaskan company of Glacial Homes. With 10 agents, they have fixed expenses and semivariable expenses totaling $30,000. The company is quite successful, and each of these 10 agents consistently reaches or exceeds his or her breakeven. Therefore, the amount of expenses each agent is expected to recover is $3,000. The company ensures a 50/50 split to breakeven, $6,000 GCI then a 90% split. Then four new agents join Glacial Homes. Of these four, no one reaches the breakeven point. One reaches 75% of the breakeven and three reach only 50% of the breakeven.

This is where an understanding of the OFPE becomes crucial. Instead of dividing by the number of agents to determine the fixed and semivariable expense per agent, we divide by the number of "fully productive units." The total number of times the breakeven point is reached is calculated below:

10	×	breakeven	=	10.0
1	×	75%	=	.75
3	×	50%	=	1.50
Total is:				12.25

With an FPE of 12.25, the amount each agent is expected to recover towards fixed and semivariable expenses ($30,000 divided by 12.25) has dropped from $3,000 to $2,448.98. Dividing simply by the number of agents (in this example, 14), the expense per agent ($30,000 divided by 14) would be $2,142.86—a difference of $306.13. While this might seem an insignificant amount, this kind of error multiplied by a large number of agents over a long period of time would have a major effect on a company's finances.

If one were then to revise the commission plan to give the agents a higher split above the lower breakeven point, the higher producing agents would receive more as a result of adding the new agents. And the lowered breakeven point would mean that the lower producing agents are reaching a larger percentage of the breakeven point than was used to calculate the FPE of 12.25.

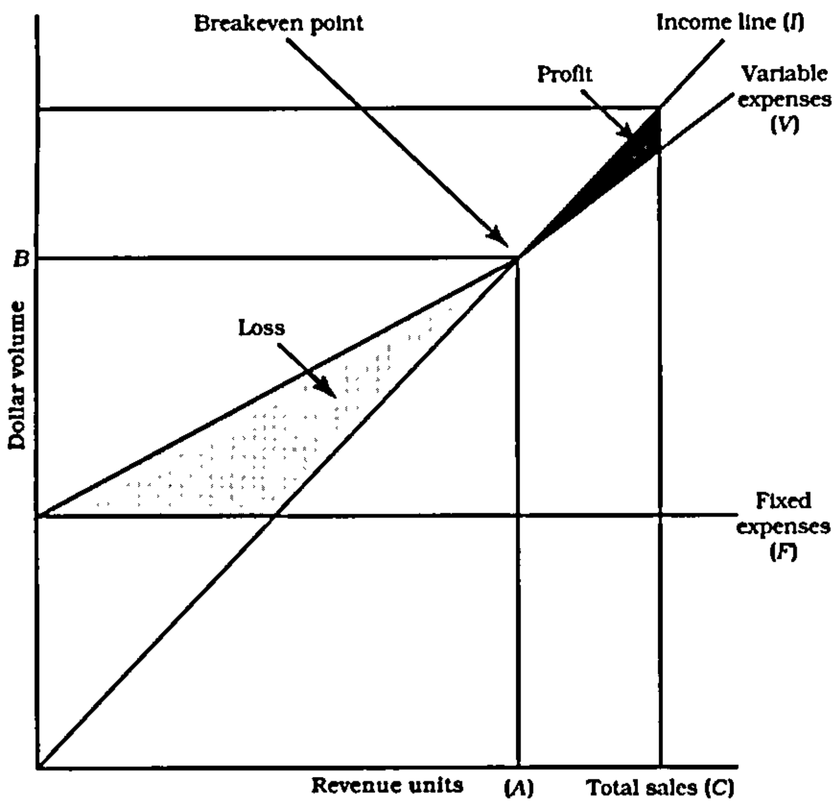
So the calculation can be repeated again and again, giving a new FPE and using it to calculate a new FE/A and hence a new breakeven point and a new compensation schedule. Eventually one would arrive at Optimal Fully Productive Equivalent, the OFPE.

Are the top producers subsidizing the lower agents here? In this case, the answer is no. Recall that in the beginning, 100 percent (10 out of 10) of the agents were effective. After the four additional agents were hired and the OFPE was used, the percentage of effective agents dropped to 87.50 percent (12.25 out of 14). However, due to the accumulated dollar contribution from each agent the breakeven point dropped. The dollar contribution of the lower producers benefited the top producers.
Understanding the financial value/burden of high and low producers is critical. Low producers, even those who do not reach their individual breakeven points, do make a contribution to the company. Adding or retaining low producers who make a partial contribution can reduce the fixed expense per agent, provided that they do not increase the company's fixed expense per agent, that is, that they do not increase the company's fixed expenses more than they recover. Conversely, high producers may not produce a full share of fixed expense recovery if compensation plans are not designed correctly. In cases where the agent receives a high split, the company may have a very small margin with which to work. If an agent is a positive contributor to the well being of the office and if a low producer is consistent in his or her dollar contribution, this creates a win/win situation. If an agent does not do these things, a lose/lose situation is created.

Now look at the following graphs, which may make conceptualizing the Optimal Fully Productive Equivalent a little easier.

The first graph shows the fixed expenses (*F*), the variable expenses (*V*), and the income line (*I*). When the variable expense line crosses the income line, the breakeven point is reached. If a line is drawn straight down from this point, the number of revenue units (*A*) required to reach the breakeven point is found. Drawing a horizontal line from the breakeven point to the left, indicates the dollar volume of the breakeven point (*B*). The total number of units contributed by the 14 reps of Glacial Homes goes beyond the number of units for breakeven to point *C*.

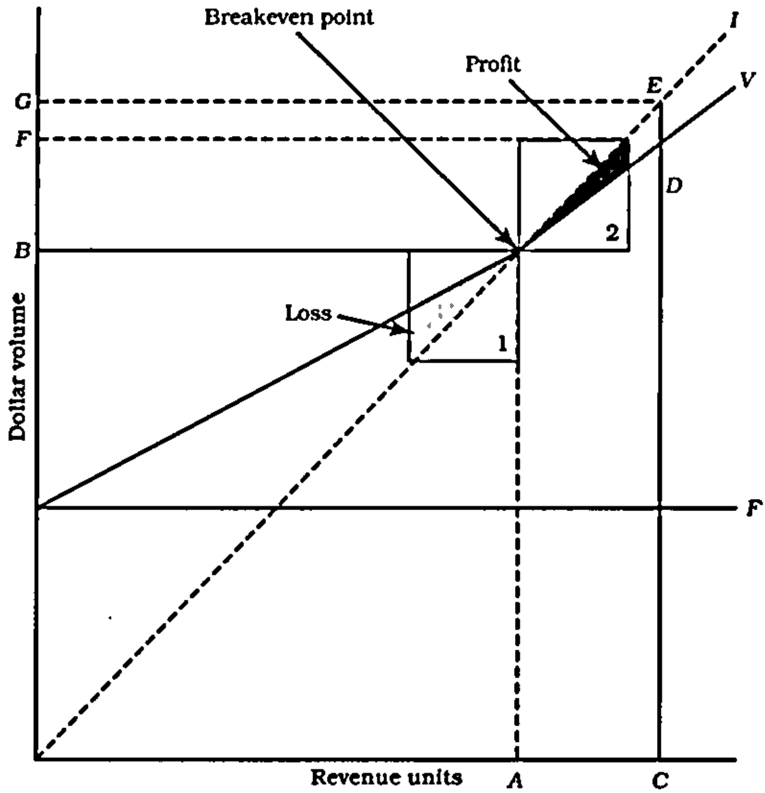
Graph 1



But if you look at similar breakeven graphs for the individual agents, you find that four did not reach the breakeven point.

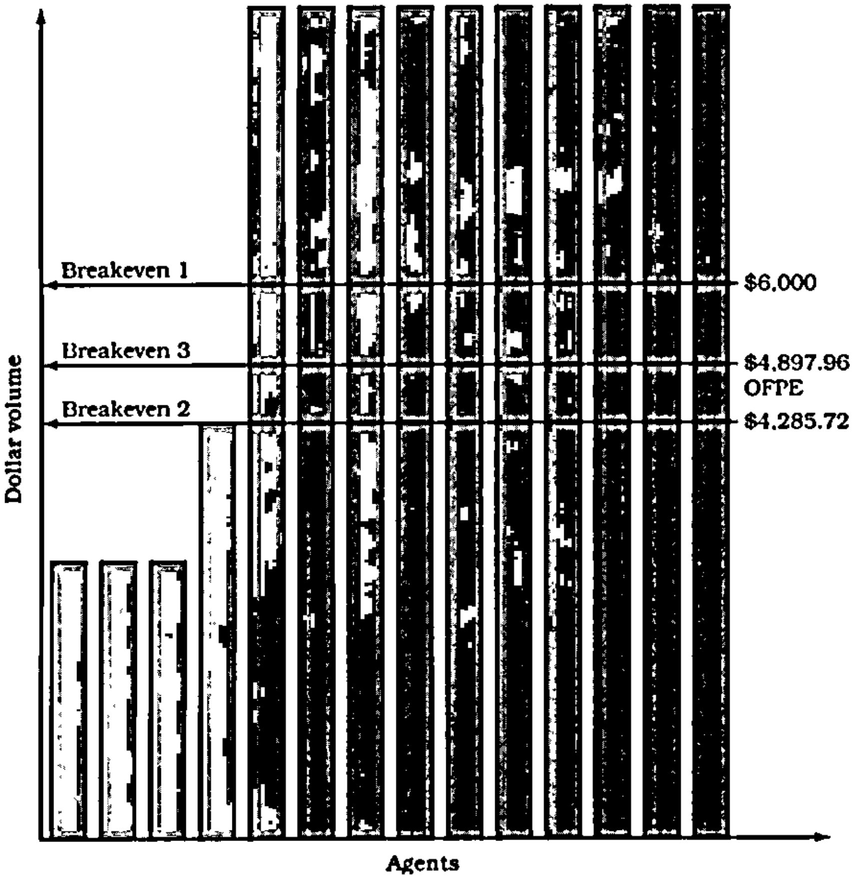
A profit is being made. However, part of the profit is at the expense of volume because not all the agents reached the breakeven point. Now look at Graph 2 with the same breakeven point (*A*) and number of units sold (*C*). For agents who do not reach breakeven, the loss on fixed expenses not recovered is shown in box 1 and for agents who exceed breakeven, the recovery of the fixed expenses as a result of volume sales is shown in box 2.

Graph 2



Finally, look at Graph 3, which represents the revenues generated by each agent in bar chart form. With 10 of 10 agents reaching the breakeven point (Breakeven 1) the OFPE is obviously 10, since each agent is meeting 100 percent of his or her breakeven point. When the revenue generated by the four new reps (some of whom do not reach the breakeven point) is added, two changes occur. First, the OFPE changes to show 12.25 (not 14) since overall, the agent productivity drops to 87.5 percent. Second, Breakeven 3 is now the true breakeven point since it takes into consideration the financial contributions from all of the agents, whether they meet their individual breakeven or not.

Graph 3



As mentioned earlier, traditional practice has always been to divide the fixed and semivariable expenses equally between each sales agent. The problem with this is that the breakeven point that you would calculate and apply your compensation plans to, would drop to Breakeven point 2. If you were then paying out higher commissions to the top agents and not recovering your fixed expenses from the sales agents below the breakeven, you would have a problem. You would have to recover your fixed expenses not received by the low-producing agents at a much larger level of dollar volume, possibly more than is being generated by the high producers. The breakeven point created by dividing the fixed and semivariable expenses equally by all the agents would be artificially low. With the lower breakeven point, your payout would be higher. You would be putting your company in a higher risk position, which would require more dollar revenue to truly reach breakeven.

Clearly, the Optimal Fully Productive Equivalent calculation will allow for a more realistic and reflective breakeven point, and that allows for more financial stability in a company. It also allows management the opportunity to recognize the efficiency of their operation. If an office has a low OFPE, working with agents to help them achieve the breakeven point would result in the largest financial gain to the company, while at the same time reducing the business risk. Other ways of dealing with the fixed and semivariable expenses would be to have the lower agents make a financial contribution to the company, bringing them up to the breakeven point, or have them pay for certain expenses that you, the broker, currently pay on their behalf.

In any event, each sales agent should be considered as a profit center, profit should be built into the breakeven point, and each agent should have a competitive compensation package that allows both the sales agent and the company to maintain a win/win relationship.

BUSINESS RISK

In order to fully understand the concept of breakeven analysis, we must also discuss business risk analysis. Business risk refers to unexpected, and therefore generally undesirable, changes in a company's gross profit (the profit before interest and taxes have been deducted). Unpredicted changes in the profit can be caused by external factors, such as an economic downturn in the market or an increase in competition. However, risk can also come from internal factors, such as the presence of fixed costs and the ratio of fixed to variable costs. Since business risk (or nonmarket risk as it is also called) can be associated with the internal organization of the firm, this section will attempt to provide management with the tools to assess and quantify the amount of business risk present and how best to manage it.

As mentioned above, business risk refers to variability in gross profit. While fluctuations in profit may be positive, variability is often risky because, as long as the amount of profit is uncertain, there is a possibility that the company will not be able to cover its fixed expenses. The repeated inability of a business to meet its fixed responses could ultimately lead to its bankruptcy. There is a degree of business risk wherever there are fixed costs. Also, the amount of business risk fluctuates in direct proportion to a change in fixed costs—the greater the fixed costs, the greater the amount of business risk.

The importance of the relationship between a firm's fixed and variable expenses in assessing business risk is made clear in the following simplified example. (This example is based on one given in *Real Estate Financial Management*, 2nd Ed. by David Doeleman and Ronald C. Rogers, published by the Realtors National Marketing Institute, 1986, found on pages 71–73.) Consider the fortunes of two similar companies, Company X and Company Y. A comparison of their income statements is as follows.

Year 1: Analytical Income Statements

	Company X		Company Y	
Gross income	$1000	100%	$1000	100%
Variable costs	600	60%	200	20%
Fixed costs	200	20%	600	60%
Profit (before taxes)	$ 200	20%	$ 200	20%

Both Company X and Y have gross incomes of $1000 and total expenses of $800, but they have very different proportions of fixed and variable costs. The analytical income statement shows that Company X has $600 (60 percent) variable costs and $200 (20 percent) in fixed costs while Company Y has $200 (20 percent) variable and $600 (60 percent) fixed. Remember, business risk refers to variability in profit and there is more business risk when fixed costs are higher. Let's see if this is true for Companies X and Y.

Assume that in the following year business is good and, as a result, gross income increases by 10 percent ($100) for each company. Of course, variable costs also rose—also by 10 percent. The resulting income statements for that year would look like this.

Year 2: Analytical Income Statements

	Company X	Company Y
Gross income + 10%	$1100	$1100
Variable costs + 10%	660	220
Fixed costs	200	600
Gross profit	$ 240	$ 280
Change in profit margin:	+20%	+40%

In this example we can see that a higher level of fixed costs resulted in a larger percentage change in profit for a given change in gross income. The 10 percent increase in GCI caused a 20 percent increase in profit for Company X but a 40 percent increase for Company Y. Luckily for Company Y, their proportion of fixed costs paid off and they benefited more than Company X from the change in profit.

Would Company Y still fare better than Company X if there was a drop in the gross income? Now assume that due to increased competition, Year 2 instead witnesses a 10 percent ($100) decline in business from the original scenario. Variable costs also dropped by 10 percent.

Year 2: Analytical Income Statements

	Company X	Company Y
Gross income − 10%	$ 900	$ 900
Variable costs − 10%	540	180
Fixed costs	200	600
Gross profit	$ 160	$ 120
Change in profit margin:	−20%	−40%

Once again the company with the higher level of fixed costs (Company Y) saw a greater fluctuation in gross profit. Unfortunately, this time it was a change in the wrong direction. While both companies suffered the same decrease in gross income earned compared to year before, the profit of Company Y declined by 40 percent, while that of Company X declined by only 20 percent. These results occurred because fixed costs do not change as production changes. Therefore, the large portion of variable costs protected Company X.

In conclusion, a small change in production caused a large change in profit for Company Y, whereas the same change in production at Company X resulted in a relatively small fluctuation in profit. Company Y does very well when business in good, but it fares poorly in relation to Company X when the market is weak. In a weak or volatile market, many managers would prefer the management strategy employed by Company X.

As the example above illustrates, fixed costs can act as a double-edged sword. Increased fixed costs can lead to greater profit under some circumstances but may lead to insolvency if the firm does not generate enough revenue to cover them. In any case, regardless of the state of the market, it would be useful to have an indicator to measure the amount of business risk in a company at any point in time. We will call this indicator the Business Risk Index (BRI), and it is very useful in evaluating the riskiness of business decisions. The BRI can be stated as follows.

Business Risk Index (BRI) = (Gross Income − Variable Costs) ÷ Gross Profit

Since gross income (100%) minus variable costs (as a percent) is what we call the contribution margin (also as a percent), the BRI can also be expressed as follows.

BRI = Contribution Margin (as a percent) ÷ Gross Profit (as a percent of total GCI)

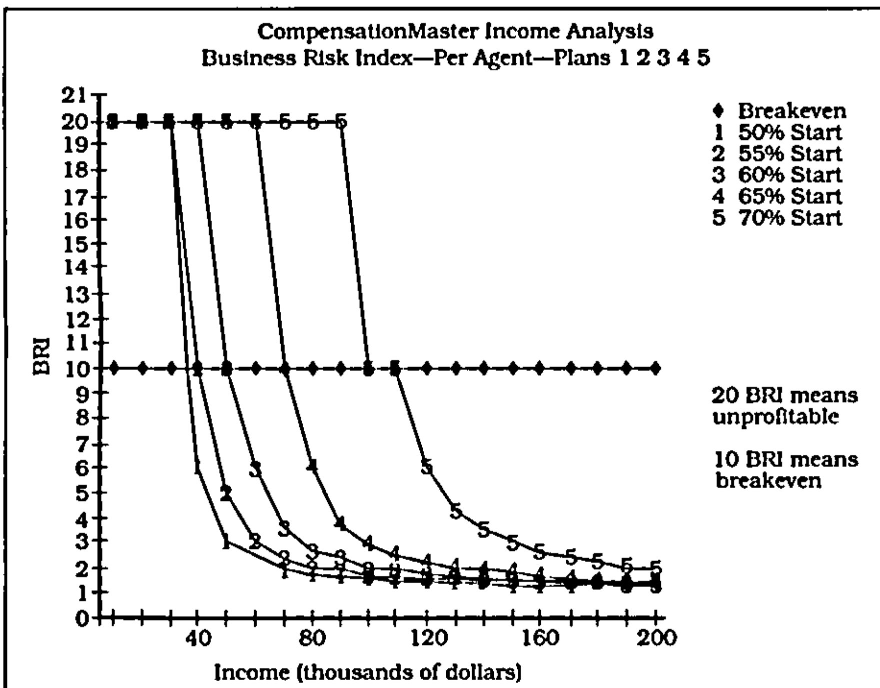
In the original example, with gross incomes of $1000 for both companies, the BRI for Company X was 2.0 [(100 percent − 60 percent) ÷ 20 percent] and that for Company Y was 4.0 [(100 percent − 20 percent)] ÷ 20 percent. Obviously, the higher the business risk in a company, the greater the possible fluctuations in profit. If the BRI had been known earlier, we could have quickly estimated the change in profit due to the change in gross income by using the following formula.

BRI × percent change in Gross Revenue = percent change in Gross Profit

Since Company X had a BRI of 2.0, a 10 percent decline in gross income caused a −20 percent (2.0 × −10 percent) decline in profit. For Company Y, the 10 percent decline in gross income caused a −40 percent (4.0 × −10 percent) decline in profit. The BRI is a multiplier that may be used to make these estimates quickly. Even though the above examples were highly simplified, it works the same way for real companies.

The BRI graph is used to illustrate the value of the BRI for a range of gross incomes in different situations. The horizontal axis represents gross revenue; the height above the horizontal represents the BRI. The BRI would actually approach infinity at the breakeven point, but because of space conderations, values between 10 and infinity are plotted as 10 and the value 20 is used for incomes which are unprofitable.

In this example, the graph illustrates how business risk increases as the agent's split increases. The graph plots the BRI for 5 compensation plans with split rates of 50, 55, 60, 65, and 70 percent. At any given income amount, the risk of dropping into unprofitability is higher for the higher splits. Breakeven (the point at which the graph drops to 10) is reached at a higher income for higher splits.

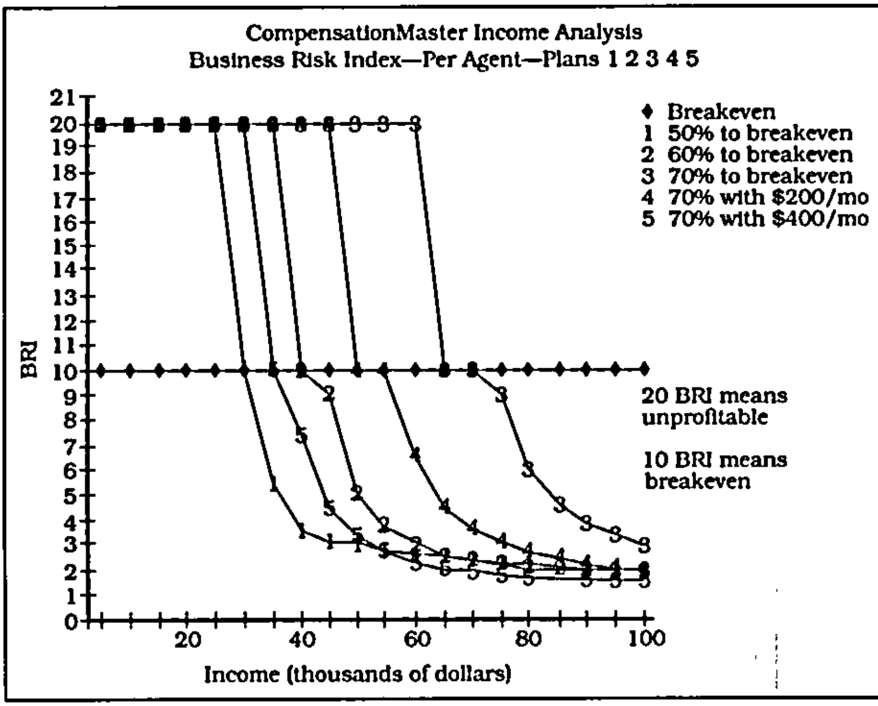


We have seen the impact that varying levels of fixed expenses can have on a company's profit margin. Now we will explore whether the actual size of a firm has anything to do with profitability. Indeed, as a recent study by the National Association of Realtors revealed, there tends to be an inverse relationship between firm size and profitability—larger firms usually have lower profit margins than smaller ones. This all ties into what we were just saying about the proportions of fixed and variable costs relative to gross income. Larger firms may generate much more revenue but, at the same time, they also incur significantly higher expenses than smaller firms. Not only do large firms tend to pay higher commission splits per revenue unit (resulting in high variable costs), they usually incur a higher proportion of fixed expenses (due to more expensive rents, bigger salaries, and so on). In the United States in 1991–1992, for example, small firms devoted 8 percent of their company dollar on salary expenses, while very large firms contributed 21 percent. (This is understandable because large firms require additional support staff for day-to-day business activities. Therefore a larger proportion of revenue must be used to cover this expense.)

The study also found that the net profit margins for large and very large firms averaged 2 percent and 3 percent respectively. These figures are low when they are contrasted with those for smaller firms who, despite fewer transactions and lower gross revenues, typically had net profit margins averaging 15 percent. Small firms tend to face significantly lower per unit costs—their ratio of fixed costs to gross income is proportionately lower than that of large firms. This is true partly because small firms tend to be located in less urban, lower cost areas. Also, small firms are often more efficient at monitoring spending and find it easier to identify and correct areas of excessive expenditure. It is clear to see how these factors translate easily into higher profit margins.

GETTING EACH AGENT TO BREAKEVEN

We've talked about the importance of the proportion of fixed to variable costs in determining the amount of business risk, and how the Business Risk Index can be used to help a company to predict whether or not it will hit its breakeven. It is equally important to know that the concept of business risk and the BRI can also be applied to the individual agents within a firm. This is useful in order to find at what point an individual agent achieves his or her breakeven, as well as for determining the relative amount of risk associated with various compensation plans.



This graph illustrates five incremental compensation plans. The fixed expense per agent is $10,000, with 15 percent variable expenses and 10 percent profit budgeted. Plans maintain their initial split up to the target profit point, and then go to 75 percent, which allows for 25 percent variables. The plans are as follows.

1. 50 percent to $40,000, then 75 percent
2. 60 percent to $66,667, then 75 percent
3. 70 percent to $200,000, then 75 percent
4. 70 percent to $152,000, then 75 percent (with $200 monthly charge-back)
5. 70 percent to $104,000, then 75 percent (with $400 monthly charge-back)

This graph also illustrates some important characteristics of the incremental plan. These five characteristics are briefly discussed below.

1. The higher the initial split awarded to the agent, the longer it takes for the company to reach the breakeven point.
2. The highest split awarded to an agent should not exceed 100 percent of the GCI minus the variable expenses and the target profit.
3. Charge-backs can lower the company's breakeven point.
4. Variable charge-backs allow a higher split.
5. The split schedule should not go to the highest level until the breakeven (including budgeted profit level—the target profit point) has been reached. Otherwise, any fixed expenses not yet recovered will have to be paid from the budgeted profit.

BUYING DOWN THE RISK (PER AGENT)

This is a fairly simple concept and can be explained as follows. When a broker is offering a large percentage split to an agent, a mechanism should be in place to reduce the company's risk in the event that the company is unable to recover its fixed expenses because the agent has not reached his or her breakeven. This can be done by either having a caveat on the contract, or by charge-backs and/or fixed expenses recovery. The degree of risk per agent increases proportionately as a company increases in size.

An agent receiving a high split may give the required company dollar towards the breakeven over the course of a year, but in the short-term, the company may have a reduced cash flow—putting it at risk. The impact of the high split can be reduced preferably by a fixed monthly fee or alternatively, a variable transaction fee.

MOST COMMON MISTAKES

Here is a list of the most common mistakes made when deciding on compensation plans.

- Using points or volume to raise the percentage paid to agents at different step levels
- Paying agents on money written (accrual basis)
- Not setting the breakeven correctly at the low end
- Allowing lower-producing agents to receive higher splits than will support their expenses based upon their productivity
- Not setting budgets for expenses incurred by the agent based upon the GCI received
- Creating rolling average and/or retroactive type plans with the wrong step level breakeven points
- Having a rolling average recalculation period over a long period of time (for example, having a six-month recalculation rather than quarterly, monthly, or daily)
- Paying a higher percentage at the top end than you can afford to pay based upon your variable expense commitments
- Not planning for profit as an expense item, therefore not including it in the breakeven point
- Not charging enough back on desk fee plans to cover your true fixed and variable expenses
- Not understanding the effect variable expense commitments have on percentage splits paid to agents and on the breakeven point
- Allowing agents to go from a high money contribution plan to a low money contribution plan when they are unable to reach the GCI required to support the change
- Going from a fixed expense recovery plan (desk fee plan) to a low money contribution plan (For example, on a sale with a $3,000 commission, a company receives a fixed fee of $1,000 from the agent to recover expenses. Then the company decides to switch to a variable (percentage of commission) expense recovery. On the same sale, the agent payout is now 71.25 percent (75 percent × 95 percent) of GCI, or $2,137.50, and the company receives the remainder—28.75 percent, which is only $862.50.)
- Not offering more than one option of compensation in an office
- Not having the capability to track expenses so that nothing gets wasted or slips through the accounting process
- Not willing to accept change as it occurs until it is too late

CHAPTER

3

Compensation for Agents' Assistants

There has been quite an increase in the use of agents' assistants in today's real estate industry, and with good reason. Top producers suggest that at a level of 25–35 units, an assistant is warranted and an immediate return will be realized. There are many benefits, including higher quality and greater consistency in service, additional quality time, and often a significantly increased income. If an agent can be alleviated of a lot of the time-consuming paperwork, administrative duties, and other tasks, he or she will usually be more productive, feel happier, and be more motivated. This is especially true of those personalities who savor the sale but may not be particularly adept at managing or balancing the more mundane tasks of business. Therefore, it is in both the agent's and broker's interest to find a method of utilizing the services of assistants as efficiently as possible.

There are a variety of ways to approach compensation for agents' assistants which, if done properly, can make for a productive office environment. The type of compensation must correspond to the type of assistant used—licensed or unlicensed, independent contractor or employee. These are important distinctions to make since they carry legal and financial implications. Make sure that an attorney and accountant review any contracts to check for legalities and compliance with tax regulations. As with everything else, try to chose a method that suits the needs of the company as closely as possible and test the plan against other scenarios to determine its profitability. By having agents pay for their own assistants, the company reduces its fixed expense. This allows the agents to be paid more and, at the same time, maintain a lower breakeven point on the agents' plans and on the company breakeven overall. The use of space and goods and services (heat, water, wear and tear, air-conditioning, telephone line usage, and so forth) consumed by the assistant must be accounted for since these costs have an effect on the bottom line. For example, if an agent is given an office for an assistant and is not charged for it, the company is deprived of the income that it may have received from another productive agent occupying that space. The different types of assistants most likely to be utilized in a real estate company are described below.

ADMINISTRATIVE ASSISTANTS

Secretarial assistance to agents can be one of the most valuable ways to compensate agents. Administrative assistants are usually salaried company employees unless they are from a contracted service.

With the multitude of compensation plans available, the way assistants are paid can vary widely. Assistants responsible for secretarial duties are usually unlicensed. When a company offers its agents the services of an office administrative pool, assistants are usually paid out of revenue allotted to cover fixed costs. Recall that earlier, salaries were included as a fixed cost.) Compensation then, usually consists of a salary (for example, \$8–\$12 per hour or going rate). This can be supplemented with perks and/or bonuses for high productivity.

There are a variety of ways for a company to recoup the salary expenses associated with assistants. One way is for an agent to purchase the time or duties of an assistant from the company as he or she would for any other goods and services. Under these circumstances, there must be a set hourly wage agreed upon in the agent's contract which will then be paid back to the company by the agent.

PERSONAL ASSISTANTS FOR AGENTS

This type of assistant acts exclusively for one agent with the idea that the agent's productivity will be increased significantly as a result. They may be responsible for a variety of duties as directed by the agent for whom they are working. Keeping track of appointments, paperwork, making cold calls, even showing homes and taking listings may be just some of a personal assistant's responsibilities.

Personal assistants may or may not be licensed and, in the latter case, may be earning some form of bonus or commission income on personal business in addition to the income paid as an assistant. It is essential that the services of personal assistants are justified in that they that allow additional business income in excess of the cost of their salary.

A broker or owner must be careful when dealing with agents' personal assistants, since there have been a number of recent controversies as to who exactly the employer is—the broker or the agent. In many cases, unless the agent contracts the services of an assistant independently and has a separate business license, then the broker is considered as the employer. The place of work and whether or not the assistant is paid directly from the commission income are also factors in determining who is legally the employer. Brokers should be fully aware of their legal position as regards to personal assistants if they want to avoid unexpected implications of employer liability. Who is considered as the employer will also determine who is responsible for training and monitoring of assistants.

Compensation for personal assistants, whether they work for the agent or broker, can consist of a number of items and depends on whether they are secretarial or fully licensed assistants. Compensation options can include the following items.

- An hourly wage (This wage should be based on the market value of what it would cost to hire a good, fairly experienced administrative assistant.)
- Traditional benefits, such as paid vacation time, time off for holidays, and so on

- Certain bonuses for the completion of set tasks or goals, such as for processing a set number of transactions

Licensed personal assistants may engage in a variety of additional activities not done by nonlicensed assistants and should be compensated appropriately. Compensation should be provided for the following tasks.

- Showing homes to prospective buyers
- Taking listings
- Any sales from open houses or similar duties

These are two common ways of finding assistants—using those from an office secretarial pool and having agents' personal assistants. There are, however, a variety of other options to consider. These options include having licensed assistants going into sales, using multiple assistants for one associate, having one assistant work for two or more agents, hiring full-time versus part-time assistants, and so on.

Remember, assistants' services, whether they are secretarial or one agent working for another, can be very useful to agents. If assistants are offered by a company, they should be offered as an integral part of the value package sold to agents.

CHAPTER 4

Compensation for Managers

Managers are paid a salary and/or percentage. Similar to the payment of agents, the size of a manager's salary is determined by the availability of adequate managers and what is needed to retain them. Therefore, the cost of management is directly proportionate to management availability and market competition. Compensation packages for managers, just like those designed for agents and agents' assistants, can vary from straightforward, simple plans to those that are very complex. Regardless of complexity, however, the most important objective is that the plan serve to motivate the manager to work through others in order to enhance the company as a whole. In addition, it must compensate him or her fairly for the time and energy invested while still providing incentive for growth. Compensation includes money that has been paid plus the value of any perks and specific benefits.

Although this chapter will focus on tangible (for the most part, monetary) compensation, it should be pointed out that nontangible factors can also play a part in the total "value package" offered to a manager. These nontangible items include the opportunity to gain experience, something extremely valuable to a person with limited or no management experience. The new experience may open doors in the future and can help build an impressive resume. The degree of experience also ties into the compensation package because any package should speak to the growth of the individual. Inexperience is definitely a cost to the owner of the company in terms of the time and training that must be invested, not to mention the increased potential for mistakes.

Career equity, or the possibility for a manager to see his or her position as an opportunity to build a valuable career rather than just a job, is a second nontangible item and should absolutely be part of a the "value package." To this end, management training incentives (such as courses) can also be included as part of the "value package" aimed at career equity. The goal of this part of the package is to encourage a manager to perform tasks that not only meet the current needs of the company but also the needs of the future. The opportunity for developing a career where a manager is empowered to make key decisions and has the loyalty and respect of agents does not exist in every company—but where it does, it should be an effective selling point and marketed as such.

Managers also should be compensated for their performance, or the degree to which their decisions influence the company and contribute to its success. (It is assumed that a potentially high financial reward will provide the necessary incentive needed for managers to produce desired results.) Here are some things for which managers should be rewarded.

- Reaching both agent and company profit objectives
- The amount of profit made
- Reaching company dollar objectives
- The amount of company dollar received
- Having agents reach breakeven/target profit point
- Successful recruitment and retention
- Good levels of support service availability
- Proper agent training and development objectives
- Building a long-term, successful operation

A manager whose scope includes recruiting, retention, agent development, and provision of support services (factors which influence company dollar) should be more appropriately rewarded with a share of the company dollar. When compensation plans provide a company with a larger share of revenues for the first part of a contract year or for lower producers, it would be appropriate to encourage managers to focus their energies on agents who are providing the company with a larger share of revenues—hence paying the management a share of the company dollar. If one considered giving a manager a financial reward for agents reaching their breakeven, which includes profit, this might influence managers to focus their energies on agents closer to their breakeven—rather than focusing on those who might be producing more GCI, but not necessarily company dollars. Hence, payment based on company dollar or profit would be better. Rewarding the manager through the company dollar instead of profit has the advantage of effectively rewarding all progress toward the profit point. Paying managers with a combination of company dollar and profit is, therefore, probably the best practice.

One also might consider rewarding a manager's performance with a percent of the GCI. This, however, risks encouraging the manager to better support the high producers who would more likely be on a higher split and thus little company dollar. Again, it is better to reward the manager on factors which more directly influence the company's profitability.

It is often found that management salaries are a large part of the company's fixed expenses. It is often difficult to allocate the necessary fixed expense per agent in order to support these salaries, while at the same time maintaining competitive compensation plans. On this case, it is also helpful to compensate management with a draw against a portion of the company dollar and profit instead of a fixed salary expense.

All management compensation plans (including the total "value package") must take into account the impact of the manager on the company revenue. Whatever management compensation plans are chosen, it is crucial that the plans reward the tasks contained in the job description. Therefore, when designing a compensation package, it might be helpful to consider the following points.

- The plan must be designed to promote the objectives of both the company and the manager. Clear goals should be established.
- Research what other plans are in use in the marketplace to see how your plan compares.
- Make sure the complete job description has been written.
- Ensure that systems are in place to measure the effectiveness of the plan.
- The company must be able to afford the compensation plan. (Again, computer software is extremely helpful in determining the long-term feasibility of a variety of compensation plans, while revealing the effects of any number of "what if" scenarios.)
- Make sure that enough "what if" scenarios have been tried in order to guard as fully as possible against unforeseen problems in the future.
- Make sure that the bookkeeping/accounting process is clear, manageable, and fully understood by those responsible for this area.
- Consider the potential financial effects of over- and underachievement.
- If the compensation incentives are based and paid upon the completion of long-term objectives, the manager must have the type of personality to work hard in the interim.

The following discussion will focus on a few of the management compensation options. While reading, keep in mind how the points above are covered in the examples.

SALARY ONLY

This is a recommended option only when the manager in question is also the owner of the company and, as such, has a vested interest in seeing the company grow regardless of his or her personal "take-home" financial share. This manager would be willing to work as hard for salary as he or she would under any other compensation plan. Often in this situation, the services rendered by the manager/owner are not compensated to their full value (as they would be in the open marketplace).

If applied in a nonownership position, salaried compensation tends not to work nearly as well. This is because the manager has little personal stake in the company and, by extension, he or she can lack the incentive to put in the hard work needed to drive a business forward. Granted, there may be instances where a dedicated manager, motivated less by financial incentives than by the satisfaction gained from running an office to its optimal potential, is willing to work as hard as if he or she were the owner. Generally, however, the case is quite the opposite—instead of providing hard work and creative guidance, salaried managers often end up as mere overseers who might pitch in with some clerical work!

The other problem connected with salaried compensation is that an incompetent manager can get a job based upon a past, biased recommendation, and can harm the company financially before it can correct the problem. This is especially true when there is a shortage of management in the marketplace and a company has no choice but to take on any available personnel.

BASE SALARY PLUS

In this method of compensation, a manager is paid a base salary plus an agreed upon "incentive," such as an override which may, for example, be a specified percentage of the Gross Closed Commission or company dollar. When this system of compensation is used, the salary generally reflects the marketplace value of the manager's administrative duties. For example, if administrative duties are expected to take up 60 percent of the manager's time, then it must be determined what it would cost for 60 percent of the annual salary of a full-time administrative manager in the open market.

This salary-plus style of compensation plan is widely used and, it should be noted, is also one of the most widely abused. The reasons for abuse are not necessarily intentional, so it is important to be aware of how and why it occurs. The abuse of this plan often begins because an owner feels that since he or she has paid a manager a salary, that manager is then obliged to do anything the owner wants. In the owner's mind, these services have been "paid for" already. The extra duties are justified by the owner because, generally, the manager will be earning additional income from overrides, bonuses, and other forms of compensation. The problem is that the manager, in an attempt to please the owner by fulfilling all the various tasks assigned, runs the risk of not having enough time and/or energy left over to give to the company to make it grow. This does not mean that clerical duties, personal production, and other "housekeeping" tasks shouldn't be part of the manager's job duties. However, for the sake of both the manager and the owner, the extent of these duties and the amount of time they are expected to take up should be specified as fully as possible in the job description.

In addition to the base salary, other components of "salary plus" compensation could consist of any (or all) of the following—perks, overrides, task completion incentives, bonuses, and similar benefits. These are described below.

➢ SALARY + PERKS

Perks have a tangible value, and should definitely be included as part of any compensation package offered to a company manager. Perks can, of course, take many forms. Some common examples are as follows.

- Receiving company commissions for personal sales
- Management training (when provided for by the company)
- Possibilities to sell certain services (for example, training) or products to agents at a profit
- Expenses related to attendance at conventions and other business functions
- Use of a company car
- Business cards and similar promotional items
- Day care provisions if appropriate

➢ SALARY + OVERRIDES

Overrides are often paid to managers as a specified percentage of a specified revenue. It is important, of course, to decide what is an appropriate percentage and on what revenue that percentage is based. (Note that the higher the revenue the override is to be calculated from, the lower the percentage override should be.) Overrides can be calculated from a variety of groups of revenue, as described on page 73. Modifications on any of these can be used of course, but be careful not to create an accounting nightmare! In addition, it is important that the manager understand clearly what will form the basis of the override—the less clear the manager is about what will contribute to the override, the less incentive the manager will have to work towards increasing it.

Gross Revenue

Gross revenue is the total income belonging to the company, including residential sales and all related commissions, rentals, commercial investment transactions, referrals, appraisal fees, insurance revenues, property management fees, and so forth.

Total Gross Commission Income

This is the total amount of commission income, including referral fees, rentals, and the personal production of the management/ownership team which will then (usually) be divided according to prescribed percentages between agent and broker.

Net Operating Income

This is what is left of the gross revenue once compensation payments and all off-the-top deductions have been made. Similar to the contribution margin, it represents the amount of money available for paying the cost of office operations and profit..

Earnings of Agents

This is the amount of money paid to agents through commissions, bonuses, and anything else specified in their compensation plans.

Profit before Taxes and Interest Have Been Deducted

This consists of the dollars available once everything else is paid. It represents the return on investment inclusive of taxes that will be paid. As the basis of an override payment to a manager, this revenue group is infrequently used and is not recommended unless the manager is in full control of the company.

In the above examples, overrides are usually specified as a percentage rate (for example, 3.5 percent of GCI to be paid quarterly). The fairness of this negotiable rate, as well as the impact it has on the company, should be reviewed regularly and, if necessary, renegotiated annually.

When an override is calculated as a percentage of GCI, the impact of poor sales by an agent or the company overall is not felt as dramatically by the manager as it is on the company dollar. For example, assume a 5 percent override of GCI. At 50 percent/50 percent up to breakeven then 90 percent/10 percent, the manager gets 10 percent (5% ÷ 50%) of GCI (5 percent up to breakeven and beyond). When the agent gets to breakeven, the manager gets more, 50 percent (5% ÷ 10%) of the company dollar and thus is rewarded disproportionately in relation to company dollar. Therefore, there is no incentive to protect the company against falling sales, as the manager has the most income protection of all.

Overrides may also be çalculated on fluctuating factors, such as agent productivity. This may create good incentive for the manager to encourage and help agents close as many sales as possible. It also should provide the manager with some incentive for recruitment and the successful retention of good agents. For example, a manager may be rewarded an override of between 1 percent and 10 percent of the GCI brought in by the agents that closed a sale the previous month. For example, if a 10 percent override is paid to the manager and the company retained 40 percent of the GCI, then the manager would get 4 percent (40% × 10%). (Overrides do not necessarily have to be paid when the commissions are paid to the agents, but rather may accumulate over a specified amount of time and be paid out monthly, quarterly, or at some other time interval.) Another example assumes that when override is based upon the percentage of company dollar, then the manager gets more at the better company split (50 percent) and less at the lesser company split share (10 percent). In this example, the manager gets 5 percent (50% × 10%) up to breakeven and then 1 percent (10% × 10%) of GCI. The manager is getting paid in an indirect proportion to the company dollar and is therefore being paid based upon the company's auditable income. Done in this way, the manager has an incentive to get agents to the breakeven point because he or she receives more money at lower splits. He or she will then focus on recruiting—also to get more income. This method also gives a disincentive to the manager who readily gives large splits or offers bad plans to agents because the manager is affected proportionately in relation to the manager's own income.

There is a note of caution when offering salary-plus overrides as compensation to managers. While it would seem that overrides would provide enough incentive for a manager to work hard, sometimes, due to human nature, complacency can occur. In addition, rather than actively seeking to recruit more agents to make the company grow, a manager might instead feel that more money can be made by relying on the efforts of a few high producers. As a result, much of the manager's energy is invested in the retention and motivation of a few select agents, often to the detriment of the company as a whole. Therefore, when overrides are used, systems should be in place to ensure that the manager's actions are accountable beyond the mere scope of a paycheck. If a manager is receiving a high base salary with overrides, there should be a solid condition (in place in the manager's contract) that monitors the manager's performance against recruiting, retention, and the company dollar, so the focus on profit for the company is not being overlooked.

Salary and override plans carry a high risk to the company. However, take the example of Ted, the manager of Company X. A salary and override might be just the answer for Ted. He has three small children, a wife, and a mortgage. He also has great aspirations to get a nice summer home. A salary and override plan would allow Ted to feel some comfort, knowing he has a steady paycheck to cover the necessities of life, and would give him the incentive to do better in order to achieve his goal of the summer home.

➢ SALARY + TASK COMPLETION INCENTIVES

When task completion incentives are offered in addition to salary, the manager is rewarded for the completion of specific tasks that are outlined in the job description. For example, in addition to the daily duties of managing an office, financial rewards might be made for successfully recruiting agents, offering training or coaching, increasing the percentage of productive agents, and raising the level of personal production. Task completion incentives could be given for any or all of the tasks mentioned above, with emphasis on those tasks from which the company would derive the most benefit. For example, a $500 bonus might be given to a manager when any one agent reaches his or her breakeven point. The tasks for which the manager will be compensated should be specified in the job description, as well as a clear statement of goals and compensation amounts. Examples of task completion incentive compensation include the following.

Recruitment

Successful recruitment of agents is often chosen as a task for which financial reward is an incentive to managers. Here, a flat rate is decided upon, often relative to the value of a new recruit. (Agents are often assigned different flat rate values which are indicative of their experience, since a company will most likely benefit more from the addition of a trained and experienced agent with a proven track record than from a newcomer to the business.) This sum is usually paid out to the recruiter in the form of regular payments when the new recruit brings in commissions (usually within a specified time period).

For example, assume that the value of a new agent just recruited by a manager to a company has been assessed at $750. The task completion incentive reward might be paid when the recruited agent reaches breakeven, thereby helping to eliminate a "body shop" operation from occurring. The payments might be based on the following conditions.

- $100 for getting the agent ready to work—the job description discussed and all required contracts signed, and the agent fully licensed
- $150 for the first commission paid to the new agent
- $200 for the second commission earned
- $300 for the third commission earned by the recruit, provided the third commission is earned within a year of the initial recruitment

Note: A specified time period provides the manager with additional incentive to make sure new recruits are active agents. There is little point in rewarding recruitment if new recruits are nonproductive! If the newly trained agent in this scenario doesn't close any sales within a year, the manager would receive only the initial payment of $100. Unfortunately, it should be ensured that the manager is not in some way feeding leads to new agents in order to benefit fully from the task completion incentive requirements.

When a manager is rewarded for recruitment through new agents' commissions while also receiving overrides, a company may choose one of two ways to compensate the manager for recruitment. In the first option, a new agent's commissions can be included along with all regular commissions when calculating overrides. This option actually compensates a manager twice—once for recruitment, and again when these commissions contribute to the override. The second option allows for a new recruit's commissions to be exempted from override calculations until he or she has contributed a predetermined flat rate within a specified time limit. The manager's job description should specify what option is to be used.

It should also be mentioned here that money paid to a manager as a bonus for recruitment should come when the recruited agent meets his or her breakeven point, thereby ensuring that the bonus comes from the profit built into the breakeven point. This will result in a sharp reduction in fixed expenses with a minimal loss of profit on the agent, so that maximum profit can be maintained.

Personal Production

It is generally of great benefit to a company (and its agents) when a manager maintains a strong customer base. Referrals generated by a manager tend to have a higher value to agents than regular referrals since there is a better-than-average chance of a closing the sale. Therefore, it is not unusual for a company to reward managers by providing incentives for personal production. This might consist of a preferred compensation plan on personal production which is in addition to compensation for regular management duties. For example, a manager may receive a standing referral fee of 30 percent on all business he or she refers to the company. It is advisable that the referral business generated by the manager is then reallocated by someone (for example, a relocation department) to others in the company. Otherwise, the manager can fall prey to the temptation to act alone—becoming less of a manager who refers business to others and more like a well-compensated agent who has a manager's title.

Increasing the Number of Active Agents on Staff

This basically provides and rewards incentive for increasing the number/percentage of active agents in the company. This compensation is important because it discourages the situation where a manager (and indeed, the company as a whole) tends to rely on the efforts of a few successful agents. It encourages motivation of all agents on staff, and helps to prevent preferential treatment of high producers.

Training

It is always good to have highly trained agents on staff, since not only does it help in keeping agents motivated, but more importantly, puts them "on top" in terms of understanding market trends and in keeping their skills up-to-date. Depending on the needs of a company, offering training as a task incentive might be a very profitable idea.

Managers can be compensated in many different ways for encouraging training. One option is they can be compensated with a flat fee for the amount of time invested—whether it be for additional management training or for further training of agents. Another option would compensate managers for encouraging agents to complete further training on their own. In this case, the managers would also complete the production tasks associated with the training. Often, this compensation rewarded to the manager is of little actual cost to the company, since the payment can be subsidized through collected training fees from the agents or built into the expenses (and therefore into part of the breakeven point).

➤ BONUSES

The promise of bonuses, similar to task completion incentives, also can be an effective way to provide managers with the incentive to complete specific goals. As previously discussed, it is imperative that a company reach the goals connected to achieving its breakeven and, of course, getting the agents to reach their individual breakevens. It is therefore appropriate to offer rewards when the various benchmarks that contribute to a company's overall stability and profitability are met. Some situations where it might be appropriate to reward a manager with a bonus are described on pages 79–81.

Achievement of Production Levels/Plateaus

Here, the manager is rewarded for reaching targeted production levels which have been set by the company. Production levels can be expressed in terms of sales, but are generally better benchmarks if specified in terms of dollars. (It's dollars that determine whether or not the breakeven has been reached—not the number of closings!) When certain plateaus are met, the manager is paid a bonus. This bonus (and when it is to be paid) can be stated in the manager's contract or may be discretionary.

For example, assume an office determines that $100,000 GCI represents a monthly benchmark which, if reached consistently, would allow the breakeven (including the target profit point) to be reached. Therefore, for any given month when this figure has been reached, the manager would be paid an additional amount or flat fee for any amount exceeding this figure. This would be conditional, however, on the overall target being reached. For this reason, it would be best to wait until end of the year before paying out the monthly bonuses.

Goal Breaking

This is similar to the idea of rewarding benchmarks, but instead acknowledges the arrival at the overall goal to which the benchmarks contributes. Recall the above example of rewarding monthly benchmarks of anything in excess of $100,000. In this case, there might also be a goal breaking reward for achieving the yearly target of 1,200,000 GCI brought in. Goal breaking rewards could, however, be given for targets other than reaching the company breakeven, such as reaching a certain amount of profit or increasing the contribution margin by bringing down the company's expenses.

Award Plateaus

This type of compensation is awarded to managers either when the company as a whole, or when individual agents, reach certain specified goals. These goals should be specified beforehand so that the manager is aware of what is required in order to receive the bonus. For example, a manager might be rewarded for having a certain number of individual agents reach their breakeven points. Besides attesting to the fact that agents are motivated and active, this plateau would mark one step on the way to ensuring that the company breakeven will be reached. In addition, by encouraging a manager to keep an eye on the progress of individual agents, a means is provided so he or she can more easily assess the success of individual compensation plans and work out strategies for improvement in the future. Similarly, a manager can receive a bonus for points when the office crosses certain thresholds of productivity, with the bonus increasing in value as higher thresholds are crossed.

Discretionary Bonus

Another form of compensation that exists is the discretionary bonus. This can be awarded "out of the blue" in recognition for quality work. Due to the nature of this type of bonus, it is probably best if it is viewed as a pleasant surprise rather than as an unspecified but anticipated event. If it is anticipated, it may become practically impossible for a manager to work towards something whose value and conditions are, at best, vague. In addition, in cases where a manager is expecting some type of discretionary bonus and then isn't awarded one, it is easy for him or her to feel disgruntled and dissatisfied, wondering what it would take to be considered for one. This type of bonus does not provide the same kind of incentive as bonuses that are clearly specified in the terms of a contract and, as such, it is recommended that discretionary bonuses not be mentioned as contributing part of a package sold to a manager.

➢ PROFIT SHARING

Another option to be considered when putting together a compensation package for a manager is profit sharing. This type of compensation is usually paid in regular monthly or quarterly periods. Profit sharing is, indeed, the sharing of profits. For example, such a plan may state that a set percentage of any profits retained by the company over a specified period of time is to be paid out to a manager in regular payments. Note that for this to be attractive to a potential manager, three elements must be in place.

- The manager who holds profit sharing as part of his or her compensation package should have access to all of the company's financial information.

- The manager should feel that he or she has enough influence in the day-to-day operations of the office that he or she has at least some opportunity to control the factors that determine the margin of profit. The manager should be rewarded for producing profit to the same extent that he or she can control both expenditure and company dollars. A manager who has the latitude to control all factors affecting an operation is more appropriately rewarded by profit sharing than by other compensation plans.
- There must be a business plan already in existence—realistic enough to convince a manager that the company has a reasonable chance of generating profit. This will also allow the manager some means of assessing the value of profit sharing as a type of compensation.

Care must be taken to ensure that managers do not adopt a short-term plan for profitability, thus sacrificing the company's long-term prospects. With this in mind, profit sharing should be conditional and contingent upon meeting objectives which are intended to maintain long-term profitability.

It should be mentioned that for profit sharing to work well—both for the owner and the manager—it is important that the company have well-controlled expenses and a generally stable economic situation. For example, if for economic reasons (even if they are beyond the control of the company), payments from profit sharing are reduced or unable to be paid, relations between the company's owner/broker and the manager may become strained. This risk is exacerbated when decisions affecting profit are beyond a manager's control and when they are not perceived to be in the manager's self-interest. A decision by the owner to use profit revenues (which would normally be shared) to complete renovations, in the process reducing the manager's share for that period, is an example of such a decision. In this case, it would not be good to use profit sharing as the sole compensation plan.

The preceding discussion about compensation for managers touches on the options most frequently used in today's real estate business. When a base salary is used in conjunction with one or a combination of these options, managers can be motivated to lead a company in directions above and beyond the daily operations of the business. In conclusion, the types of options used in a compensation package should not only be attractive to a manager, but should also be tailored to meet the needs of the company, providing incentive in those areas needing improvement.

For example, in the fictional Company Q, over the years the successes of a few high-producing agents have been sufficient to allow the company to exceed its breakeven. When deciding the kind of compensation package to be offered to the manager, the owner of Company Q looked thoroughly at how the company had been operating—pinpointing the strengths and, more importantly, the areas of risk and weakness. The owner discovered that Company Q, although consistently reaching its breakeven and making a profit, could get into financial trouble quickly if one or more of the high-producing agents chose to leave! Therefore, the owner decided it would be important for the manager to focus more effort in the following areas over others.

- Retention and recruitment—Efforts should be made to insure that the high-producing agents stay at Company Q. In addition, active recruitment is needed to encourage company growth while guarding against the company being left "high and dry" in the event of high producers being recruited elsewhere.
- Increasing the percentage of active agents on staff—This would increase all-around productivity and, as above, allow the company to continue running smoothly in the event of high-producing agents leaving.

Bearing this in mind, what would be an effective "salary plus" compensation package for the owner of Company Q to offer a manager? The combinations and permutations are many, but basically a task incentive or override system which would reward a manager for retaining high producers and increasing the number of productive agents on staff would be the best choice. For example, rather than offer an override connected to something such as gross revenue or net operating income, it would be more effective for the manager to have an override that changes according to a factor such as percentage agent productivity, where compensation is tied to the number of active agents on staff. In this way, recruiting and retention are encouraged. Similarly, the manager might be offered salary plus task completion incentives aimed at the same objective. Flat rates could be awarded for each agent recruited, with further payments for the manager once these agents began earning commissions. As far as encouraging production from all agents, the manager could be encouraged to focus effort in this area by being rewarded a bonus for each agent that crosses specific award/production thresholds.

Obviously, this salary plus compensation package would differ significantly from a case where the main problem facing the company was a low contribution margin due to relatively high expenses. There, the compensation package might consist of something aimed at increasing the net operating income through increased cost efficiency.

Some final notes about management compensation. It is imperative when designing a compensation package to consider a variety of "what if . . ." scenarios as well as the impact of the package on the company finances when the goals are met or exceeded. Plans should also be in place to accommodate unexpected factors, both internal and external, such as a sharp downturn in the marketplace, loss of staff, and so on. Finally, be sure that the terms of the compensation are clearly understood by all parties involved, and that they have been put in writing. In this way, you can better design and implement compensation plans that will give you the key to profitability—and success.

Glossary

BONUSES: These are amounts paid over and above the split amount. They can be negotiated in a contract or may be discretionary.

BREAKEVEN POINT: This is the lowest income amount at which there is sufficient income to cover total outlays or expenses (where total expenses are the sum of both the fixed and the variable expenses). Once the breakeven point has been reached, the company will begin to earn a profit.

BREAKEVEN = FIXED EXPENSES ÷ PERCENTAGE OF CONTRIBUTION MARGIN

BUSINESS RISK INDEX (BRI): This is an indicator used to measure the degree of risk in business decisions. It is arrived at by the following formula.

BRI = (GROSS INCOME − VARIABLE COSTS) ÷ GROSS PROFIT

CHARGE-BACKS: These are fixed or variable expenses charged to the agent for resources or services. These provide the company with a means of reducing the amount of expense which must be recovered through the company's share of GCI. Adding a charge-back may make the required difference for the company in terms of helping it to reach target profitability.

COMPANY DOLLAR/NET OPERATING INCOME: This is the part of gross revenue that ends up belonging to the firm before it deducts its cost of doing business.

CONTRIBUTION MARGIN: This is the amount of money, expressed as a percentage of GCI, that the company has available after paying variable expenses (including the agents' share of commission). It is the amount of money (net operating income) which is used to recover fixed expenses and then, once breakeven is reached, to begin earning a profit.

C.M. = GROSS INCOME (% GCI) – VARIABLE COSTS (AS A PERCENT)

DESK COST: This is found by dividing the cost of running an office and generating a profit by the number of agent positions.

FIXED COSTS: These are expenses that do not increase as business increases. They remain constant no matter how much or how little business a company does and typically cannot be avoided. Examples of fixed expenses include: rent of office space, utilities, value of owner's nonselling services, and salaries.

FRANCHISE FEES: These are fees charged to the holder of a franchise for the use of the name and trademarks. This can be also referred to as a royalty or service fee.

GROSS PROFIT/PROFIT BEFORE TAX: These are the earnings before interest and taxes have been deducted.

GROSS COMMISSION INCOME (GCI): This is the total amount of commission income, including referral fees, rentals, and the personal production of the management/ownership team which will then (usually) be divided according to prescribed percentages between agent and broker.

NET PROFIT MARGIN: This is a measure of profitability. It reflects the company's operating expenses as well as its associated costs.

OVERRIDES: These are payments paid above and beyond salary, consisting of a percentage of a specified revenue. (For example, a manager might receive, in addition to a base salary, an override of 4 percent of the total GCI per annum.)

PERKS: These are tangible and nontangible items that either may be given or offered at a reduced price as part of a compensation package.

REFERRALS: These are business opportunities given to an agent or company from another source, be it another agent, a company manager, or another company. A fee is charged against the potential earning or charged as a flat fee for the business opportunity and any future business that may result because of it.

SEMIFIXED COSTS: These are costs that are fixed only over a limited range of production. Examples of semifixed costs include the addition of office space, new equipment purchases, and the hiring of more support staff to accommodate an increase in business.

TARGET PROFIT POINT: This is a second "breakeven point" which includes a budgeted profit margin.

VARIABLE COSTS: These are expenses that increase or decrease in proportion to the amount of business a company does. They vary with each unit of production and, in fact, are caused by production. Variable expenses are usually expressed as a fraction or percentage of GCI. The relationship between the fraction or percentage and the GCI may be natural, statistical, budgetary, or contractual in nature. Examples of variable expenses include telephone charges, transaction fees or commission expenses, and advertising costs.

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- How To Design Attractive Compensation Plans for Agents, Agents' Assistants, and Managers
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