Compensation Plan Breakage - Why and How

by Daniel O. Jensen

Breakage is defined as the commissions left unpaid each month compared to the theoretical maximum of the plan. If a compensation plan pays a maximum of 45% but the actual pay-out is 35% each month, then the breakage would be 10%. On the surface, one might suggest that breakage is unfair, unethical, or at the very least, misleading, considering a plan that represents itself as paying 45% but actually pays 35%. Upon further study, however, a plan which uses breakage wisely will reward the producers much more generously than one without Breakage. It allows a company that can only afford 35% for commissions expense to pay perhaps 45% or more to the distributors doing the greatest amount of work. Breakage can be a strong competitive advantage if it is used correctly and for the right reasons.

Objectives for breakage in a plan

Every piece of a good compensation plan has a specific purpose or desired result. With breakage, we want to:

- ♦ Keep the total commission expense at or below a target maximum. If we can only afford to pay 30%, with breakage we can often afford a plan which can pay out up to 35% to 40% (or more) to the productive distributors.
- ♦ Reward specific behaviors which are most desired by the company such as recruiting, retailing, building managers and leaders, and retention. (See my *Principles of a Successful Compensation Plan*)
- ♦ Reward those who exceed minimum levels of performance more than those who don't.
- ♦ Avoid rewarding distributors who fail to perform consistently.

The benefits of properly using breakage

Breakage is applied by imposing reasonable rules to qualify for commissions. If a distributor fails to perform at a desired level, the commission that he would otherwise receive is retained by the company. For example, if a distributor failed to meet his $100 minimum personal volume requirement, the company might keep his commissions instead of paying them to another distributor. This allows the company to pay more to other distributors who are meeting or exceeding the desired level of production. In essence, the company withholds commissions for lack of performance and increases the compensation of those performing well. The advantages are obvious:

- ♦ Distributors who meet or exceed expectations are rewarded more generously using commission dollars that would have been kept by distributors who are performing less.
- ♦ The company can afford to pay more than they could otherwise afford expanding the capacity of the plan to provide incentives for desired behavior. The company gets more of what it wants (desired behavior) and the performing distributor gets more of what he wants – compensation and recognition. Breakage can be a win-win deal for both company and distributor.

There are many ways to implement breakage and methods vary according to the type of plan used.

Example #1

Bob, a breakaway manager, fails to meet his minimum $100 personal purchase for the month. He would have otherwise received a 25% commission of $200 on his group volume. Rather than paying it to his upline, Bob's $200 is retained by the company. The company determines that about 1% of total pay-out is retained from unqualified managers like Bob each month. The company decides to put this 1% into a bonus pool paid to every distributor who sponsors at least three people in the month. For each new recruit, the participants in the bonus pool receive one share of the pool. The company happily discovers that redirecting the commissions into the pool has resulted in a 10% increase in recruiting and a 4% increase in sales volume for the fiscal year from those new recruits. Equally important, over $100,000 has been paid to those distributors recruiting three or more people in a month making a number of very happy and committed distributors.

Example #2

After a recent compensation plan change, the plan calls for a 4% first generation bonus to managers who achieve $100 in personal volume and $1,000 in group volume. If a manager achieves $2,000 in group volume, the commission is increased to 7%. When the 4% is paid instead of the 7%, the company retains the difference as breakage. The company has determined that about 25% of their managers achieve the $2,000 GV level, so they pay out the 7% 1st generation bonus about 25% of the time. The total 1st generation bonus paid is about 5%. In their old plan, the company paid out a 5% 1st generation bonus if the manager achieved $1,000 GV. In their new plan (4% - 7%), they pay out the same commission but have found a 50% increase in managers achieving $2,000 GV each month. They can afford to pay 7% to the higher producers out of the 1% obtained by lowering the original 5% to 4%.

Strategies for the wise use of breakage

- Don't set performance thresholds (GV, PV, etc.) too low. Breakage is only available when there is a gap between poor performance and desired performance. If you need to set low levels of performance, than offer graduated compensation opportunities for those who are willing to work harder. Low performance requirements produce low performance.
- Redirect the breakage into *new* incentives when possible. Increasing the 5th generation bonus from 5% to 6% may make a few leaders happier, but they may not do anything different to obtain it – bigger checks for doing the same old things (no wonder they are happier!). Putting another 1%, however, into a new 6th generation bonus (assuming the old plan paid only 5 generations) which is contingent on adding another 3 personally sponsored breakaway leaders will stimulate leaders to recruit and build more front line breakaways than before.
- If your plan uses titles or ranks like stair-step breakaway plans do, then always use "paid as" titles. Let distributors keep the highest title they achieve, but always "pay them as" the title they actually qualify for each month. To continue paying them based on performance that occurred months ago is wasting incentive dollars which could be applied to the better producers. It also reduces breakage opportunities.
- For group volume incentives (front end stair-step), consider rewarding the breakaway manager based on his actual group volume instead of his title. For example, if a plan calls for a breakaway manager receiving a maximum 25% on his group, consider adding a minimum volume level to receive the full 25%. If he falls below the minimum, then he would earn less, perhaps much less, than 25%. The difference between actual and maximum would be retained as breakage and added to other incentives in the plan.

- Never roll up volume from an unqualified breakaway to his upline. Rolling up commissions (called *compression*) is often desired, but avoid rolling up *volume* which would add to the group volume of upline managers. This results in creating phantom qualification volume for upline managers not related to any real performance and often rewards the poor performer who receives a nice check and wonders what he did to earn it. The net effect is to eliminate breakage and waste your incentive dollar.
- Distinguish between *active* and *qualified* when qualification levels are defined. *Active* usually refers to personal performance often measured in Personal Volume (PV). *Qualified* often goes beyond *active* adding group volume or sponsoring requirements. Breakage rules can be defined differently for *active* and *qualified*. For example, the company might keep as breakage some commissions for *unqualified* distributors who fail to meet their group volume requirements, but roll up commissions (no breakage) for those distributors who are not *active.*
- Grandfathering: A common technique when a company changes their compensation plan is to *grandfather* existing leaders and distributors into former (often lower) levels of performance requirements to "soften the blow" of the new plan. While this may be essential to winning their support for a much needed plan change, it is often unwise to offer these special arrangements for long periods of time. Wise companies often make grandfathering a temporary or transitionary arrangement. Grandfathering often reduces the breakage the company would otherwise receive due to poor performance. The net effect is that the producers are compensated less while the poor producers are compensated more.

Other sources of breakage

- Shallow company downlines: Companies that sponsor wide and new start up operations find a "windfall" in the commissions left unpaid because there is no upline to pay them to. Be careful, however, because as the downline grows and matures, this short term windfall diminishes.
- High end titles and ranks: Many companies implement plans where the top end ranks or titles are achieved so rarely that few, if any, collect the corresponding commission benefits. These unpaid commissions provide breakage until more and more leaders achieve these higher titles and collect the commission benefits.

Finding breakage opportunities in your plan

To determine where your breakage opportunities are, follow these steps:

1. Write down each type of commission your plan pays and what it's maximum pay-out could be. For example, if your plan pays out 5 generations in the "back end" of 5%, then your maximum generation bonuses total 25%. Try to identify each individual type of commission such as 1st generation, 2nd generation, group volume bonus, etc.
2. Determine how much each type of commission actually pays out. Jenkon's Summit V Commissions Module provides standard reports each month that provide this valuable information.
3. Subtract the actual pay out from the maximum for each commission type. The difference is your breakage.

Once you know where you already have breakage, you can also spot areas where you don't. Look at these areas and determine if you *want* to have more breakage and modify the plan accordingly.

Conclusion

Breakage can be a significant competitive advantage if you use it wisely and a terrific tool to reward the producing distributors more than you could otherwise afford. All plans have some breakage opportunities which can be tapped to make the plan an even more powerful motivator. As in most things, moderation is more prudent than extremes when applying the principles of breakage to your own plan.