

# Common Software Requirements of a Direct Selling Company

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Every network marketing company provides a business opportunity to independent contractors (individuals) often referred to as distributors. They join for a reasonable fee (usually under \$200) and receive the right to purchase products from their host company at wholesale prices. When they sell these products to their customers, they keep the profit – the difference between their wholesale price and the price at which they sell the product to their customer. In the United States, the Direct Selling Association, the leading trade group for this type of business, reports that in 2004, annual sales were \$29.7 billion sold by 13.6 million distributors.

Recruiting of new sales people is essential to grow the business. Recruiting is done by distributors seeking to build a ‘downline organization’ of other representatives selling product who, in turn, recruit others into the business. As a distributor recruits a new distributor, he builds his downline organization person-by-person. His recruits, in turn, do the same causing his downline organization to grow deeper and deeper with ever increasing sales volumes on which he receives a small commission each month. In such a manner, a downline organization can grow exponentially with an ever increasing number of people seeking others to recruit under them to sell the company’s products to new customers. In some cases, a downline genealogy may number in the many thousands of distributors and extend many “levels” deep where a level represents one person sponsoring another. A distributor who sponsors five other distributors is said to have five people on his first level. If each of those five sponsor two others, then the original distributor has ten distributors on his second level, and so forth.

Commissions are paid to the distributor from sales that occur within his downline genealogy. He will also receive a commission from his own sales. Every company uses different rules that are designed to promote successful behaviors of the sales force. This set of rules is called the *Compensation Plan*. Every network marketing company competes with other network marketing companies based not only on the strength of their products, but also on the strength of their Compensation Plan. Indeed, a primary factor in the decision of a prospective distributor to join any one company is how generous their compensation plan appears to be. A company with a poor Compensation Plan will find great difficulty attracting new distributors to sell its products while another company with a very enticing Compensation Plan may grow dramatically as a result.

## Genealogy Management

The Compensation Plan uses the genealogy relationships (who sponsors who) to determine:

- Who receives commissions on any particular sale to a customer
- How much each individual in the upline (the sponsors above the distributor who makes the sale) receives as a percentage of the sale

- What to do in the event an upline distributor does not meet his minimum performance quota

If there are any errors in the genealogy linkages that reflect these sponsor relationships between distributors, the commissions will be incorrect and the sales force will lose trust in the company. When this happens, the company has great difficulty recruiting (distributors will not bring new people into the business unless they trust the company will take good care of them) and many distributors will look for other opportunities and leave (attrition). The distributors remain only if they want to continue working the business. Hence, the accuracy of the genealogy relationships is of paramount importance to the success of a network marketing company.

This downline genealogy imposes unique and challenging tasks on the host company who is charged with managing the many thousands of relationships with perfect accuracy. These relationships or linkages that reflect “who sponsored who” are subject to many changes that must be performed over time. These include:

**Sponsor Changes:** if a distributor is entered into the computer system using an incorrect sponsor (Fred Jones instead of Fred James, for example), this relationship must be corrected. Occasionally, a distributor will have a falling out with his sponsor and request a change of sponsor. Sometimes, a company will allow such changes to occur. Any change to the sponsor of a distributor requires the computer to not only change the sponsor reference in the distributor’s record, but also to change the sponsor’s list of personally sponsored recruits. The linkage works in both directions, upward from the distributor to the sponsor, and downward from the sponsor to the distributor. This bidirectional linkage must be kept intact with perfect precision or commissions will be incorrect.

**Termination:** when a distributor resigns or is deemed inactive by the company, they must be removed from the genealogy. The process of removal requires the software to realign all linkages so that there are no “holes” in the genealogy. If Fred sponsors Bob who sponsors Sally and Joyce, when Bob is terminated, Sally and Joyce must be reassigned to Fred. Again, the bidirectional linkages must be correctly updated.

**Reinstatement:** though a distributor may be terminated for various reasons, some will request to be reinstated. When reinstated, a distributor may be restored to his original condition including his rank or title, under his original sponsor (or maybe under a different sponsor), and with his original downline intact (or not, depending on the company’s policies). The software must manage this process with perfect precision and record all changes historically.

**Combining Two Distributorships:** in some cases, a distributor may be entered into the computer twice (or more) and have new recruits placed under each distributorship. In such cases, these two distributorships must be combined into one. In some cases, a marriage may require two distributors to be combined into one.

**Other functionality** of managing a genealogy includes:

All changes to genealogy linkages must be logged by date and time so customer service staff can respond to inquiries and challenges to changing downline relationships

Terminated distributors must never be removed from the database in anticipation of the possibility of reinstatement. Yet, a terminated distributor cannot appear on the genealogy nor be considered in the commission calculations. Their earnings history is also required for tax auditing.

Unlimited width must be allowed so that a distributor can sponsor one or thousands of people into his genealogy.

Unlimited depth must be reported so that the company or a distributor with a very large downline genealogy can see his full organization with all of the linkages of sponsorship correctly represented. This report capability is essential for a leader to manage his large organization.

## Commissions

As noted previously, every network marketing company has a Compensation Plan that embodies a unique set of rules and policies that are used to calculate commissions paid to the sales force based upon the sales that occur within each of their individual downline genealogies. Most Compensation Plans measure the performance of each distributor based on:

- Personal Sales
- Sales within their downline group
- Number of personal recruits
- The achievement level of their personal recruits
- The Personal Sales amounts of their recruits and others below them.
- Other performance measurements unique to the company

Based on the individual performance of each distributor, the computer software must calculate a commission to pay various distributors on every sale. This is paid through the “upline” genealogy linkages. If Bob is sponsored by Dan, and Dan is sponsored by Sally, then Dan and Sally are the upline of Bob. Many distributors will have an upline numbering ten or more people and the computer will follow the upline, person by person, paying out to each a small commission on the sale by the original distributor (Bob in the last example). Hence, a single \$40 sale to a customer may involve paying ten or more different people in the upline a different commission amount according to their individual level of achievement and current performance. The formulas involved are complex due to the different levels of performance of each upline distributor as well as the complexities of the rules involved.

Requirements of almost all companies in the network marketing industry include:

The commission calculation **process cannot interfere** with ongoing business. A company cannot, for example, shut down order processing because commissions are calculating. With web technology, each company must offer a 24-hour order entry web page and cannot, therefore, allow any internal process such as commission calculation to interfere with the ongoing business.

**Commission statement reports** must be prepared for each distributor showing them how their commissions were calculated to eliminate most questions or concerns. Considering that some distributors may be paid on hundreds if not thousands of sales in their downline genealogy, this commission statement may for some be quite involved.

**Exemption system:** managing thousands of distributors brings to the surface each month many unusual circumstances that must be accommodated in the commission system. When a human error occurs that affects the commissions of a distributor, in some cases it is necessary to exempt the distributor from specific performance requirements for the current commission month, or even longer. For example, due to an internal human error, a distributor might need to be exempted from meeting a monthly \$100 personal sales requirement in order to receive commissions (a rule that is very common). This Exemption system allows these exceptions to be done by corporate staff to maintain the integrity and trustworthiness of the company when the company is at fault in an error that affects the distributor.

**Overpayments** for orders placed by a distributor and paid for by check must be refunded to the purchasing distributor through the commission system. These small amounts are too small to justify creating a separate check.

**Underpayments** for orders must be collected from the distributor's commission earnings automatically.

**Balance Forward:** Most companies set a minimum check amount (\$10 is common) before they will issue a commission check to a distributor. This eliminates the cost of sending out hundreds of checks for nominal amounts. These earnings, however, cannot be erased. Instead, they are carried forward from month to month until finally a distributor exceeds the minimum check threshold and receives their earnings.

**Commission Adjustment System:** when errors occur or breaches of the company's policies, it is customary to adjust future commissions to "make right" the error or breach of policy. For example, if with intent to defraud the company a distributor purchases a large amount of product and thereby qualifies for a higher commission percent, but later returns the product for a refund, the original commissions earned by him and his many upline sponsors may be adjusted downward to reflect what they should have earned had he not purchased the large amount of product. Every network marketing company finds a need to process adjustments to commissions that will be reflected on the next commission check. Audit trail of each adjustment is required. Adjustments must be reported on the distributor commission statement.

**Automatic advancements and demotions** according to the Compensation Plan must be done by the software. Most Compensation Plans include a "career path" or series of titles or ranks of achievement. As a distributor achieves the next rank or title, their commissions are increased in some fashion. Achievement of a higher rank always involves an increase of performance by the distributor and his downline. With thousands of distributors moving up the career path each month, the software must compute the precise achievement rank for each person before it can determine the formulas to use in computing the person's commission amount. Similarly, demotions in rank are necessary so that a distributor who fails to maintain their level of performance

is not unjustly rewarded. All of these advancements and demotions must be done flawlessly on thousands of distributors in the company's downline genealogy according to the precise rules of the Compensation Plan.

An **audit trail of all commission calculations** is required so the company can validate the accuracy of the software's computations. The company's integrity is at risk when a commission check is sent to a distributor. If the distributor finds errors in the computations, the distributor will often resign and seek another company more worthy of his trust. Hence, every network marketing company requires a mechanism to audit and validate the accuracy of each distributor's commission calculations.

**Rerun capability:** When commissions are calculated and audited, it is common that the first trial run will bring to light errors or suspicious problems to investigate. Inevitably, some issues will require human correction or intervention (such as an exemption for a distributor), and then a rerun of the commissions will be necessary. Many companies find, in fact, the need to run commissions several times each month before they can finally approve a run. Once the commission calculations are validated, then checks and statements are prepared and sent.

**Qualifying and Commissionable Volumes:** Most products purchased by distributors will have commissions paid on the wholesale price paid by the distributor. Some products, however, have unique rules associated with their commissionable values. When a product is unusually costly to the company, the company may not be able to afford to pay out the full commissions on that product. In such cases, the company may elect to assign a lower basis for commissions often called the Commissionable Value. Commissions are then paid on the Commissionable Value rather than the wholesale price thus reducing the cost of commissions for that specific product. Similarly, the same product may have yet another value called Qualifying Volume (often expressed in points) which is used to add to the sales quota required of the purchasing distributor (and potentially his upline) instead of the Commissionable Value. Thus, if a distributor bought a 'widget' for \$20 wholesale, commissions might be paid on the Commissionable Value of \$15 and the Qualifying Volume might be 50 points. This is especially common with international companies. This, of course, adds significantly to the complexity of managing the commission system but is required when product margins vary widely on some products offered for sale.

## **Incentives**

Having worked with hundreds of network marketing companies since 1982, I am not aware of any of reasonable size who have not had special incentive programs to stimulate sales or recruiting in some fashion. Incentive programs work in harmony with the Compensation Plan to encourage a desired distributor behavior. Distributors who meet the requirements of the incentive are rewarded with prizes, trips, special recognition, or some non-cash reward. For example, if a distributor were to sponsor twelve new recruits in a specific six month time frame, and each of whom sells over \$1,000, then the distributor might earn a free vacation cruise with other distributors who did the same. The incentive programs change frequently in each company to keep the

sales force enthused about new opportunities. Otherwise, an incentive loses its excitement and power to motivate the participating distributors.

As an integral part of the strategy to motivate the sales force, an Incentives system is required to manage the complex criteria and performance monitoring of each of the thousands of distributors in the company downline genealogy. Requirements for such a system include:

**Incentive Program Time Frame:** Very few incentive programs correspond to the monthly commissions cycle most companies employ. Instead, most incentives span across several months while some last an entire year or more. Most incentives begin and end on odd days, i.e., one might start on February 20<sup>th</sup> and end on June 15<sup>th</sup>. This is often due to convention events, large training meeting schedules, a cruise schedule, or some other factor. For example, a company might have an incentive program starting on January 20<sup>th</sup> (the date of a training convention where it is announced) and ending on July 10<sup>th</sup> (four weeks prior to the next convention) to earn points toward the cost of attending the annual convention in Orlando, Florida. Earned points might be redeemed toward hotel costs, airfare, limousine pickup, entrance fees into local attractions, etc. Points might be earned by meeting personal sales volumes requirements during the qualification period, recruitment requirements, or even assisting your new recruits in their sales quotas.

**Overlapping Incentive Programs:** Many companies will often have several incentive programs running concurrently, each with its own set of rules and requirements for the accumulation of points toward the offered rewards. For example, one incentive might focus on earning points toward attending the annual convention while another incentive might be based on a February cruise to the Caribbean. Many distributors will earn points toward all incentives. The software must be designed to handle the complexity of multiple incentive programs running concurrently with different rules and requirements.

**Points Based:** as some incentives correlate with other incentives, earned points must be able to be combined together to earn a reward. Sometimes, points from one incentive can be carried forward to a subsequent incentive program if a reward was not earned or redeemed. Most companies use points to measure the success of a distributor toward earning a specific reward. This has proven to be an industry-best-practice.

**Redemption of Points:** as part of the Incentives System, a mechanism to redeem points for specific rewards is required. Historical information, audit trail of all redemptions, the ability to manually override points calculations (with audit trail), and the associated views and reports are required.

**Taxable Earnings:** The IRS requires that the value of awards given for incentive programs must be reported on the annual 1099-MISC form, but only one form can be provided by the company for each distributor. It is required, therefore, that the value of awards redeemed (not points earned) be combined with the commissions earnings onto a single form for the tax year. Failure to do this will result in stiff penalties and fines for the company.

**Parameter Driven:** As incentive programs will frequently change with new ones released from time to time, the company should employ a very flexible system whereby parameters can be defined for a new incentive program rather than writing new computer programs every time a new Incentive is desired.

**Reporting:** Results from the Incentives for each distributor must be available to them on the web and on their commission statement.

**Audit Trail:** distributors frequently challenge the computation of earnings and incentive points. The company must have a system that provides detailed audit trail of how the points are calculated to defend the accuracy of the points calculations. Otherwise, the trust and credibility of the company will be in doubt and distributors will stop recruiting and selling.

## Order Processing

On the surface, order processing would appear to be relatively straight forward. When one truly understands the network marketing industry, however, there are a number of very unique aspects to order processing.

**Sales Tax – 66,000 jurisdictions:** The network marketing industry has special rules and laws that govern it in respect to the collection of sales tax. States have universally required network marketing companies to collect the sales tax on behalf of their sales force and submit the collected taxes to each individual state (and sometimes counties). Tax is computed not on the price a distributor pays, but on the suggested retail price of the product in anticipation of the distributor selling the product to a local customer. Normal order entry systems do not support this complex requirement. With 66,000 different sales tax jurisdictions (state, county, city, metro-1, and metro-2) in the USA, this is an onerous task. In addition, the problem is often made even more complex due to the different rules of some states related to taxable and nontaxable products such as food, vitamins, dietary aids, etc.

**Multiple payments:** It is common for a distributor to pay for an order with multiple credit cards because one card has insufficient credit to pay for the entire order. Most order entry systems support only one payment per order. This would not work for a network marketing company.

**Automatic recurring orders:** Many companies with nutritional products provide a monthly automatic order service to distributors and customers who wish to place a 'standing order' which is shipped monthly.

**Overpayments and Underpayments:** Many companies accept personal checks as payment for orders. Unfortunately, distributors often make arithmetic mistakes when calculating the payment due. Often, the payment variances are relatively small, but when multiplied by the hundreds or thousands of distributors doing this, the total of payment variances can be quite large. Network marketing companies, therefore, usually have the capability to refund overpayments and collect small underpayments from the commissions system.

**Peak month-end volumes:** With most Compensation Plans based on a monthly cycle, personal sales quotas are often expressed in terms of monthly sales. This

monthly requirement results in significantly greater order volumes during the last few days of each month as distributors sprint to meet their sales volume requirements. Thus, any software system must support a huge spike in volume at the end of the month.

**Accounting Issues:** Unique to network marketing is the fact that an order is commissioned regardless of its shipping status. Thus, an order placed on March 31<sup>st</sup> will be commissioned in March, but when it is shipped in April, the company will book the sale as an April sale according to accepted accounting practice. This presents a great challenge to most order entry / invoicing systems because accounting practices generally would book the commissions in the same month as the sale. This is not possible for network marketing companies.

## **Order Processing – Party Plan**

Party Plan companies have special requirements in addition to those listed above. A “party” or “show” occurs when a sales representative finds a hostess willing to invite her friends to her home for a group demonstration of the company’s products. The sales representative coaches the hostess to maximize attendance and create an optimal selling environment. The hostess is motivated by the prospect of receiving free and/or discounted products when she places her order during the party. The nature of this group experience forces several unique and often complex software requirements to be considered:

**Group Party Orders:** During the party, the sales representative takes orders from each individual guest as well as the hostess. These orders must be submitted on a group order entry system because they are all linked together so the hostess rewards can be calculated correctly and the appropriate order discount (retail sales profits) also calculated for the sales rep. Each guest’s name and shipping information (optional) must be entered with their corresponding ordered line items. Some companies extend discounts to guests based on their individual purchase volume. This group order with individual guest orders is an extremely unique order entry process that must be designed specifically for the direct selling company. Software that caters to non-direct selling companies would never have such a system designed for order entry and the enhancements would be substantial and costly in virtually all cases.

**Shipping to Whom?** Companies must choose whether to allow shipping of individual guest orders to the guest, or group them together in one shipment to the hostess or sales representative. The choice usually depends on shipping costs, order fulfillment complexity and costs, and whether to trust a hostess to deliver the products to her guests in a timely manner. Shipping the guest orders to the sales rep may allow the rep to follow up with guests but it also adds considerably to the time she must spend on each party. Her costs also increase (gas and car mileage), thus reducing her dollar-per-hour profit which can be very detrimental to retaining sales reps.

**Hostess Credits and Gifts:** When a hostess does a party, she does so in hopes of receiving various incentive rewards such as discounted or free products. Based on the number of attending guests, the number who ordered, and/or the total sales volume

of the party, various hostess credits and discounts must be calculated and managed by the computer system. Commissions are usually not paid out on the discounted and free products purchased by the hostess.

**Sales Tax:** Advice must be obtained as to whether to charge sales tax based on the location of the party or the eventual shipping destination of each guest order. For the later, the complexity of charging different sales tax rates based on the ship-to location for each guest can be quite onerous for the sales rep to accurately calculate at the time of the show and submit on her order. If she calculates incorrectly, she may overcharge or undercharge her guests and these inaccuracies may affect the profit she makes on each party.

**Back Orders:** If two individual guests at a party order the same product but only one item is available, which guest will be shorted? What will you do to satisfy the guest who will not receive the product they ordered? Sales reps who must deal with guest backorders become discouraged and stop selling. Some companies offer vouchers to the guest, in some cases worth more than they purchased, as a credit toward purchasing another item directly. The company may need to allow the guest to purchase product directly from the company to replace the missing product as it may be impractical for the guest to attend another party in the future to place their personal order.

**Individual Guest Orders:** Guests may wish to place individual orders at a later time for additional product, replacement products, etc. The retail profits for such orders should automatically flow to the enrolling sales representative with her commission check.

## **Product Returns for Refund**

Every product order generates commissions to both the purchaser and his upline sponsors according to the rules of the Compensation Plan. When part of an order is returned for refund a few months after purchase, a company is faced with the challenge of dealing with the former commissions paid on the order in a previous month. Laws and regulations require a network marketing company to provide no less than a 90% refund to a distributor when they return product if the product can be resold, so the company cannot deduct the commissions from the refund. Instead, they must either absorb the cost of the previously paid commissions (which no company wishes to do) or have the software available to calculate precisely how much must be deducted from the distributors who originally received commissions. Needless to say, this is a very complex issue. Yet, if it is not addressed, the company may be forced to absorb many thousands of dollars in commissions paid on refunded orders.

It is not acceptable to simply calculate negative commissions on the refund by processing a negative volume order. The upline distributors who received the commissions on the original order may now receive a different percentage (but this time negative) than they originally received due to their advancement or demotion in rank or status since the original order was placed. For every network marketing company, this is a significant issue.

## Distributor Web Access

A distributor is considered a small home-based business. The information a distributor needs to manage his business, including his downline genealogy, is stored in the company's computer and not in the distributor's computer. A distributor does not have the capability to track sales and recruitment for other people without access to the company's computer. The company, therefore, must provide the means to the distributor to view the status of each of his downline distributors, where they are in relation to the requirements of the Compensation Plan, whether they have sold any product this month, etc. In short, a comprehensive set of web tools must be made available to the sales force allowing them to manage their business successfully. These tools include:

Real-time access to personal and downline status including personal and downline sales volumes

- Order entry (individual orders)
- Party Plan order entry (for party plan companies)
- Downline genealogy view
- Commissions information and statement
- Incentives points earned and status

In addition, many companies now offer **personal web sites** to their consultants with an integrated order entry system. This allows consultants to refer people to their 'personal web site' which is, in reality, hosted by the company.

## Summary

As one can see, the requirements of a direct selling company are like no other business model. They are very unique. It is the strongest recommendation of this author that only software providers who are registered supplier members of the Direct Selling Association ([www.dsa.org](http://www.dsa.org)) be considered to avoid the often costly and frustrating experience of developing software that has already been developed by other companies. DSA supplier companies in many cases (but not all) have acquired the unique expertise and understanding of these requirements and can, therefore, provide a much better product for less money.

## About the author

Dan Jensen is an industry consultant to the direct selling profession and has many years of experience in related software and compensation strategy development. He does extensive executive training and consulting work for many of the leading companies involved in this form of business.

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