You say you want recurring revenues and you know that is the way to build equity in your business…yet you spend your time and energy on your product sales and somehow your service revenues don't grow as fast as you would like.

If more than 70% of your revenues come from transactional business (usually product sales) you are probably falling victim to the Transaction Trap and you will have to start managing your business differently if you want to drive a different result.

If you think about a business that has a combination of product and service revenues, the product sales are usually driven by need. Transactions are easier to sell than services because the customer wants and needs to buy the product. The customer is going to make the purchase and it is often merely a question of who they are going to buy it from.

As a result, sales are much easier on this side of the business….but margins inevitably are poorer as competition is more intense and there is often a very real urgency in these sales that can disrupt and even derail other longer-term sales.

The bigger picture is that more energy is spent on the transaction side of the business and what happens is that it takes up a disproportionate amount of time and energy as compared to the more profitable service sales that build equity in the business.

So many of the businesses that I deal with are caught in the Transaction Trap and the most common mistakes that I see being made are as follows:

- The product and service businesses are not measured separately
- Sales compensation does not reward service sales appropriately
- The same salespeople are allowed to sell both products and services

Getting out of the Transaction Trap requires some fundamental change in each of these areas and you will be stuck there unless you take proactive charge of the situation.

Measurement

One of the first things that you need to change the way you look at your profit and loss report and make sure that you report these two very different activities quite separately.

The characteristics of the product division are that you have a revenue line and an easily defined cost of sales resulting in a gross margin that is not terribly difficult to measure or particularly controversial. The concept of gross margin in this kind of business is easily grasped and well understood.

The characteristics of the service division are actually very similar, but this is not something that seems to be intuitive to managers. In any service business there is in fact a cost of goods sold that is very similar to the measurement in a product business. All you have to do is to take all of your service delivery expenses and use them to create your cost of goods sold.

This would include, obviously, all of your people who are directly involved in the service delivery, and you need to capture all of their costs. It never ceases to amaze me when I see a financial statement that has the direct salary costs allocated to a particular division, but the "fringe" (payroll taxes, benefits, 401k, training costs etc) captured in the overhead section.

It is easy enough to collect all of the direct costs of the people handling the servicing but this seems to be a challenge for many managers. Pull together the service division and report it in exactly the same way as the product division and call it the equivalent of the gross profit number – I like the term "direct profit".

When I have worked with people on this I have seen spectacular results. Creating a new profit and loss account can change an owner's perspective about his business, and it is a very powerful tool. The way to do it is to create separate profit and loss accounts for the product and service divisions and to take each of them down to their respective gross profit/direct profit level and measure the percentages.

After that, you can go to a contribution method and simply allocate overheads each division based upon whatever criteria you decide, or you can continue to refine the other costs that you think are attributable to each division.

Compensation

As I have observed elsewhere, you get the behaviors you pay for not the ones you say you want. This is nowhere more true than in the case of sales compensation. I have been appalled to see some compensation models where transaction revenues and service revenues are rewarded equally.

As noted above, transaction revenues tend to be at a lower margin than service revenues, and while they may often be at a much bigger ticket, they don't even begin to compare when you look at the equity being built in the value of the company by service revenues and the lifetime value of a customer.

The best way through this is to pay all commissions on gross profits and never pay anything based upon the top line. In a number of cases the businesses that I started working with were paying commission based upon gross revenues rather than gross margin. In most cases that was because they did not understand how to measure the gross margin in a service business, and that is obviously a very important starting point.

Once you have gone through the measurement exercise, creating the new sales compensation is not actually that difficult, as you can use similar commission reimbursements on both sides of the business.

Segregation

If you’re really serious about building your service revenues then you probably have to segregate your sales forces. The problem is that the talent needed to succeed as a service salesperson is very different than the talent needed to succeed on the transaction sales side of the business.

This was very true in my computer service business. We were excellent at delivering service and we also sold product. We were different than many businesses because we really were a service company that sold product rather than the other way around, and I started out with a sales force that was genuinely focused on selling service.

As we grew and started to sell more product, I found that it became a distraction for my service salespeople, and they started to try to sell product when they were in a sales slump. What I did to correct this was to tell them that they could sell product if they wanted to, but that it would not count towards their sales quota and that I would only look at the direct margin in evaluating their performance.

Ultimately, as we grew, I would not allow my service salespeople to sell products at all because I wanted them to stay exclusively focused on selling my high-margin recurring revenue business which built equity value in the business that I was running.

How far you decide to go down these roads is a matter of individual choice - but if you seriously want to avoid the Transaction Trap you need to do something.