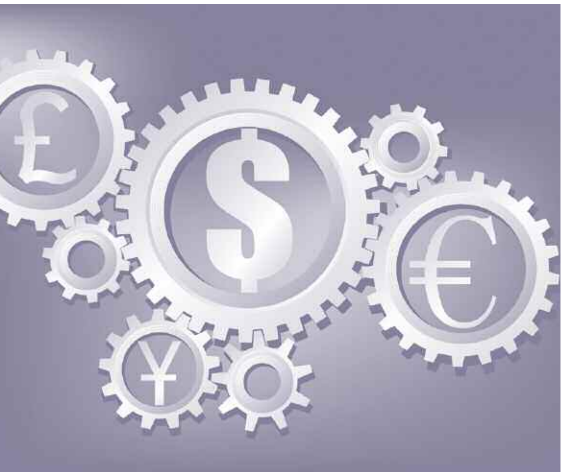

Creating a Winning Sales Compensation Plan

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Revenue in a capitalistic society provides the basis for the continuous existence of the organization. Achieving that revenue is based largely on establishing a thoughtful and realistic Sales Compensation Plan and subsequently executing on that plan. The matter of execution, while critical, is beyond the scope of this paper. Here we will focus on the development of the Sales Compensation Plan (the plan). The plan is the map that links the sales goals of the organization to the warriors in the field, and therefore is critical to communicating and ultimately obtaining successful organizational performance.

While compensation in the form of "pay for performance" would seem to drive the plan, it is only one factor for achieving successful sales performance. Some of the other pertinent factors include:

- The organization's sales goals and strategy,
- Strong executive and sales leadership,
- Sales force competency, and
- The quality and quantity of resources and support from the organization, especially from the marketing function.

Sales plan compensation design is complex, perhaps the most complex area in the broad field of compensation. The complexities come from both internal and external factors. There are so many variables involved in developing a plan, that each company has many possible combinations and permutations on how they mix and match their responses to these variables when developing their own plan. That's why you never see (or should never see) the same sales compensation plan in two different organizations. Each situation is different, and the plan should reflect those differences.

Some of the variables that affect the design of a sales compensation plan include:

- Different types of products will range from simple to complex, and in turn will require simple to complex knowledge in order to sell the product.
- Different prices on products can determine the effort required to make a sale. In addition, some salespeople have flexibility to negotiate price, which has to be built into the plan.
- Different sales channels require different sales efforts, too. You may sell the same products direct to customers, retail outlets, distributors, and in some cases, equipment manufacturers.
- Different types of customers will have a lot to say about the sales process itself, which will be different if you sell to the public sector or the private sector, or directly to consumers or to businesses.
- Different sales jobs and how the sales division is organized determine the level of pay, the goals assigned to each sales job, and the amount of incentive opportunity.
- Different sales cycles speak to the length of time between initial contact and when a sale is made. This affects when revenue flows into the company and when salespeople earn and/or when they are paid incentives.
- Different geographical locations mean different pay levels. This could vary plus or minus 30 percent in the U.S. depending on location, and there is generally less pay at risk for international jobs. No one leverages like the U.S.
- And finally, different compensation philosophies will have a great deal to say about the design of a plan, all the way from pay positioning versus the market to when a sales is counted for commission purposes.

And the list goes on. The challenge is to identify the driving factors facing your organization at a point in time and determine how each will influence the sales effort of your organization. And so while sales compensation plans may be similar, you must derive your own.

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Given all the variables that should be considered in developing a sales compensation plan, there are some guiding principles that if followed, will help to ensure a more successful plan design.

- First, employees need to understand what is expected of them and what the potential reward might be. In order to have a true incentive plan, the salesperson must know at the beginning of the performance period what the goals are in very specific terms and what the payouts would be given differing performance against those goals. Managers also must be able to communicate the plan to the sales force and interpret the plan as the need arises.
- Rewards should be relatively easy to calculate. In large companies there may be an entire section of people devoted to calculating commissions, but you should try to keep the administrative burden to a minimum. In some cases, you may have to compromise on goals like profit margin if they can't be measured easily or timely. In these cases, you may want to look for a surrogate for the goal, meaning measure the goal indirectly.
- Incentives should be paid as quickly as possible. Reward psychology says payouts should occur as soon as possible after the performance period ends to achieve the desired behaviors. One rule of thumb is that if payouts occur more than 30-45 days after the end of the performance period, then changes have to occur in the plan.
- Employees must trust the company and feel that they are compensated fairly. Now it's no secret that most salespeople think they should get paid more, but if payouts are clearly correlated with sales effort, they will be more accepting of the plan. Be fair and consistent in your decision, always paying attention to precedents you may set when doing exceptions.
- And all performance measures should be related to company financial and strategic goals, which could be such things as revenue, profits and market share. If they're not related, they do not belong and you have the wrong measures or perhaps the wrong sales goals.

And so with that background, let's dive into sales plan design. For convenience, we've divided the process into seven steps. You could combine or split up the steps, but here you'll find a generic process that has been successful for many organizations in a variety of settings.

Step 1: Determine Competitive Total Cash Target

The first step in designing a plan is to get a fix on pay levels and pay arrangements in the marketplace. There are a number of surveys that measure compensation levels for salespeople. Some even try to survey sales compensation practices, or essentially how companies handle certain aspects of sales plan design. When looking at survey data, actual incentives paid may be nice to know, but set your compensation plan up based on market incentive targets and not actuals. Targets don't tend to change much from year to year and actuals can vary quite a bit. In one survey, actuals were 124 percent of target in 2006 and 87 percent in 2007. So if you set your target incentive levels based on actuals, you will have to adjust your targets every year.

Consider whether other compensation components are given in the marketplace, as well as your own company. For example, if you don't give stock to salespeople and the market generally does, you may want to consider this in setting your compensation levels.

Focus on target cash levels (base + target incentive). To pay competitively, you want your salespeople to earn market total cash levels when they achieve 100 percent of their goals. How the target total cash level is reached, either through salary or incentives, is somewhat of an internal decision based on a number of factors which we cover in Step 2.

Step 2: Determine Total Cash Mix – based on Market, Product and Type of Sales Job

Market – If it's a new market where you don't know what to expect in terms of sales, and you're trying to sign up new business, you may prefer a combination of lower salaries and high commissions in order to explore the market yet decrease the impact of fixed expenses associated with base salaries.

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And if the market is mature where there are fewer opportunities for new business and the jobs generally consist of selling to existing customers, you may want to consider higher salaries and lower commission opportunity or even adopt a bonus type program.

Product – Another consideration in determining the mix between salary and incentive is the type of product being sold, including the sales cycle, sales volume and profit margins associated with the product. If the market data you are using can breakout the type of product being sold it will address this factor. If not, here are some considerations:

- Capital equipment sales, which are generally complex and require a long sales cycle, may be characterized by high salaries and small commissions.
- If you're selling consumable or disposable products, which are like commodity sales where they are generally smaller ticket items and require a short sales cycle, a large portion of total compensation paid out in commissions may be the appropriate way to pay.
- Sales of products which have high value, high profit margins and may require high product knowledge, may indicate the need for high salaries and high commissions.
- And finally, if you are selling durable goods which are of average complexity and require average knowledge to sell, the market may dictate a more even split between salary and commissions.

Type of Sales Job – How the sales division is organized and how the various sales jobs are structured also determines the mix between salary and incentive.

As shown below, most sales jobs can be placed on a continuum where on one end you have what is commonly referred to as the "Farmers" whose main responsibility is to support and sell additional product to existing customers. These people generally have higher salaries and lower commissions or lower leveraged compensation.

On the other side of the continuum you have what is commonly called the "Hunters." These are the people who almost exclusively sell to new customers. Generally, these people are characterized by lower salaries, but higher commission or higher leveraged compensation and typically higher overall compensation potential.

Farmers	⟷	**Hunters**
Existing Customers		New Customers
Lower Leverage		Higher Leverage

Step 3: Determine Type of Payment Scheme

Once you've determined the mix of pay for your salespeople, you then have to decide how these people are going to get paid given the targets you have established. The first decision you have to make is whether you are going to pay them on an individual basis, group basis or perhaps some combination. An individual plan is more common and is where the salesperson is paid based on their individual effort without regard to how well the group performs.

In group plans, the set of performance measures pertain to the group as a whole. Based on how well the group performs, a pool of money is created and then eventually distributed to participants based on a prearranged formula and /or their individual performance. You may also have a combination of these type plan designs depending upon the job and ability to measure important performance goals. For example, some sales efforts may require the salesperson to bring in a team to facilitate demos, product trials or technical discussions. In these instances it may be appropriate for the salesperson to be compensated

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both individually, as well as a team member.

The other aspect of payment scheme is whether you are going to pay a percentage of the revenue generated by the salesperson or group, or pay a percentage of target incentive based on performance against a quota. We see percentage of revenue in new market or startup situations and a percentage based on quota in developing or mature situations. One issue with percentage of revenue plans is that they are hard to move away from.

Step 4: Determine Performance Measures

Next, you have to choose the right measures for the goals you want to achieve – based on the principle that what you measure is what you get. And if you have more than one goal or performance measure, you need to be very specific about the priority or weighting of each goal. For best results, it is wise to minimize the number of goals you ask your sales staff to focus on.

Generally, the goals should be ones that can be influenced by the participants in the plan. The degree that they can influence the goal should be reflected in the weighting it is assigned.

Obviously you also have to be able to measure the goal with a minimum of administrative burden. Some goals are strongly desired by just about everyone, like profit or margin, but are notoriously difficult to measure in many cases.

Once the goals are determined, each company has to decide how different they want to make the payouts between below average, average and exceptional performance. Some companies are fairly egalitarian in their approach, and the actual payouts are lumped around the average. Other companies discriminate based on performance with some sales staff getting little or no payouts and some getting significantly greater than their targets based on results.

Finally, don't be afraid to use management discretion in certain situations. There is a tendency to want to quantify every aspect of performance measuring and incentive calculation; however, in many cases it is hard to quantify every aspect of your sales staff's performance.

Step 5: Determine Pay-Out Formula

Dimension	% of Quota Achieved	% of Target Incentive Paid
Maximum	130%, or above	150%
	120% – 129%	130%
	110% – 119%	115%
Target	100% – 109%	100%
	90% – 99%	50%
Threshold	80% – 89%	25%
	79% or below	0%

In Step 5, the Pay-Out formula needs to be developed. There are many variations on the theme, but the table above shows a common type of formula for a scheme where quotas and target incentive awards are used.

You'll notice that there are several dimensions to this formula. The first one is called the "Threshold." This is the point which specifies the minimum level of performance required to achieve any payment under the plan, in this case 80 percent of quota. The philosophy for thresholds is that the salesperson should at least generate enough revenue to pay for their salary, before the company adds additional compensation. However, some companies don't have thresholds; they essentially pay something to the salesperson starting at the first dollar sold.

The second and most important dimension in developing the formula is the "Target." Essentially all plans pay out 100 percent of the target incentive at 100 percent achievement of the target quota.

The third dimension is called the "Maximum," which is just that, a maximum amount that can be earned no matter what the overall performance; and often

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referred to as a "cap." In the example shown here, it has been set at 130 percent of quota or above. Where the maximum is set will vary from company to company, generally depending on how difficult it is to achieve the performance level. Many companies do not set a maximum, and as you might expect, most salespeople don't like maximums. Another alternative to maximums is to establish a maximum credit that can be granted from a single account during the performance period. Maximums are designed to protect the company in windfall situations.

Finally, you'll notice that the ratio of actual performance and pay out relative to target incentive varies based on actual performance. At target performance the ratio is 1 to 1, or 100 percent of quota. Below target, the salesperson receives less than a 1 to 1 ratio. Above target the ratio greater than 1 to 1. The term used to describe this type of pay out variable is an "accelerator." It's used to supply additional incentive to the sales person to achieve and surpass their quota.

Step 6: Determine How to Handle Staff Changes

In Step 6, every company needs to decide how they will handle staff change situations, or how they will administer new hires, leaves of absence, transfers, terminations and other personnel actions.

For new hires, because it may take a new salesperson time to generate revenue from a book of accounts or territory, the company may offer a draw on commissions for three to six months, or until the sales pipeline can be filled. Some companies will try to reconcile these draws with actual commissions, once commissions are earned. Other companies will call the draw a guarantee and not reconcile the amount paid.

For leaves of absence, each company must decide if and how they will prorate, and the proration may be done on the quota or the incentive target. For transfers between territories, sales commission plans or between incentive eligible positions and non-incentive positions, pro-ration is also generally used.

Most of the legal actions concerning sales compensation plans occur in how companies manage staff terminations. Some companies decide to pay on all sales made through termination date. Others say you have to be onboard when paychecks are distributed to earn an incentive. The key word here is "earn." You should clearly specify when a salesperson actually earns an incentive. You can do practically whatever you want to as long as everyone clearly understands the rule, and it is consistently applied.

Step 7: Write the Document

The final step in designing a sales compensation plan is to write the plan document. To write a good plan, however, is a bit of an art form. You need to state things clearly, concisely and in sequential order. Key words and phrases should be chosen carefully and should pertain to sales compensation and your organization's environment. Try to avoid a lot of legal jargon, otherwise you run the risk of salespeople thinking they need to talk to their lawyer before they agree to the terms.

This document should clearly state what is expected of each plan participant at the beginning of the performance period, what the reward possibilities are, and exactly how incentive awards will be calculated. Without these three components, the true incentive link will be lost. Each participant in the plan should receive a copy of the plan document. It also can be used as a recruiting tool for new hires.

Generally, the document should contain these major items:

- The company mission and compensation philosophy. It doesn't hurt to sell the sales compensation plan.
- The date the plan is effective and who is eligible, in very specific job title terms.
- The individual or group goals and performance measures effective during the performance period.
- Define the goals and performance measures and clarify what will be counted and not counted during the performance period.
- Exactly how incentives will be calculated based on actual performance – with examples.

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- In the Administration section you may want to include caveats that identify the final arbitrator under the plan, as well as the company's right to change or terminate the plan.
- The schedule for paying salespeople after the performance period.

Unintended consequences or backfire situations can happen in the best prepared plans. Be ready to adjust the plan as soon as you detect these type situations. Here are two examples to help make the point.

- Company A wants to emphasize new business development in the sales compensation plan. The company weighs incentive pay outs 80 percent toward new business and only 20 percent for sales to existing customers. Since salespeople go where the money is, the consequence is that the company does generate a record amount of new business, but also loses a record amount of existing customers. The net effect is a reduction in overall revenue.
- Company B's plan rewards equally for sales of any product, without regard to margin or profitability. Generally speaking, the most profitable products are the most difficult to sell. The consequence is that Company B generates a record amount of revenue but their profitability remains the same or even worse… declines. There is only one thing better than increasing revenue in a sales plan, and that is increasing profitable revenue.

In conclusion, most organizations with successful sales compensation plans and successful sales results review sales compensation plans in detail every year. They have to because the organization and its business plan are constantly changing as is the market environment in which they compete.

There may be changes to the products, pricing, or new products that have to be adjusted for. Sales departments are constantly restructuring and changing job responsibilities, which may change the target incentive levels, goals and goal weightings. The customer marketplace may be changing, including the needs of customers. The competitive compensation marketplace is always changing. There may also be changes in compensation philosophy, especially if there is new executive management or sales management. Lastly, track the questions, issues and exceptions that arise during the year that are not adequately covered in the plan provisions, and be sure to cover these items in the new plan document.

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