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Why Sales Compensation Should Matter to Corporate Boards of Directors

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Get top leaders involved in your sales compensation program for better business results.

Should a board of directors care about sales compensation? The short answer: "Yes, it is too important to ignore." The health of the sales compensation program is a critical component of the company's revenue equation; and, the plans often disburse large sums of money. *Revenue equation! Large sums of money!* These conditions present an important oversight opportunity for board members to assess sales compensation on four factors: governance, alignment, outcomes and legality.

A board of directors (BOD) needs to make sales compensation a topic of interest and accountability. Board members need to ensure operating units are following best-in-class sales compensation conventions. The board of directors should require an annual sales compensation assessment report.

BOD and Compensation

Executive compensation is a well-known topic for board members. The board must comply with numerous U.S. Securities and Exchange Commission (SEC) regulatory requirements. For example, disclosure rules require the annual proxy statement to present both a summary executive compensation table and a narrative compensation discussion and analysis. Additionally, say on pay and clawback provisions were added to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Beyond regulatory requirements, the BOD compensation committee provides oversight to the types and levels of pay for corporate executives. The board votes on executive pay packages and changes for individual compensation amounts. The board can retain outside advisers and legal support to ensure pay practices are competitive and reflect shareholders' best interests.

Board-level requirements, as specified by the SEC for sales compensation of sales personnel other than securities sales, are generally nonexistent. However, this does not mean the board should ignore this mission-critical pay program.

Why Should the Board Care About Sales Compensation?

Sales compensation presents a unique duality: First, well-configured sales compensation plans can drive substantial performance improvement. Second, poorly designed programs can expose the company to substantial downside risks. When designed correctly, sales compensation plans can align seller efforts with corporate goals, motivating sellers to achieve and exceed company goals. Unfortunately, poorly designed and administered plans can drive the wrong behaviors, inflate costs and create legal exposure. Importantly (and fortunately), the board should not design the sales compensation plans. Instead, the board should review design principles and insist on an annual sales compensation assessment. Annual reporting on all sales compensation plans will provide the board members with a comprehensive evaluation to ensure optimal sales compensation application.

Sales Compensation — A Quick Tutorial

Sales compensation programs should follow best-practice conventions. The following observations provide a quick tutorial on sales compensation basics.

- **Type of sales job.** There are two major categories of sales jobs: producers and sales representatives. As a result, there are two major types of sales compensation plans. Producers have a book of business, which they often can take (or try to take) with them when they leave. They share the sales credit with the house. Examples of producers include real estate agents, life insurance sales representatives, traders, brokers, manufacturer representatives and independent financial advisers. They are often paid a commission on all sales, and earn little to no base salary, with perhaps a draw in advance of commission earnings. These plans are fully variable costs to the company. There is no target pay. The commission rates are industry standard, and the plans seldom change. Producers who sell to consumers often work within regulatory frameworks, which may specify sales compensation limitations and requirements.

Meanwhile, sales representative sales compensation plans are completely different from producer plans. Sales representatives do not represent themselves as producers do, but instead represent the company's value proposition: products, services and solutions. Sales representatives are paid for persuasion. Sales management fine-tunes the performance measures to achieve specific objectives. Sales representatives have a target compensation amount. This is the target pay for similar sellers in the marketplace. Although payouts vary by individual, overall sales compensation costs track labor market rates not sales costs, productivity or absolute sales force performance. Sales compensation costs are not variable to the company as is the case with producers. In essence, the funding for the high performers comes from the low performers.

Here are additional sales representative sales compensation conventions:

- **Number of Plans.** Each unique job should have its own pay plan with unique performance measures.
- **Pay Mix.** The pay mix, expressed as two parts of the target total compensation (base/target incentive), is set by the degree of persuasion evident in the job. High-mix plans (e.g., 50/50) have high-seller impact on customer buying. Low-mix plans (e.g., 85/15) have less impact on customer buying decisions.
- **Leverage.** The upside-dollar opportunity above target total compensation should not be capped. Best performers — those at the 90 percentile of performance — should achieve 3x the at-risk portion (target incentive). Management needs to confirm the 3x upside earning potential as being consistent with market data.
- **Measures.** Measures should be those that the salesperson can influence. Use output measures (e.g., sales results) rather than input measures (e.g., number of sales calls). Do not assign corporate measures, compliance measures or team measures when teaming is not integral to the job. Limit the measures to no more than three.
- **Annual Updates.** Sales compensation plans for sales representatives are highly tuned instruments that need constant realignment each year. More than 90 percent of all companies change their sales compensation program for sales representatives on an annual basis. Annual update changes are a virtue.

The Annual Sales Compensation Assessment Report — Four Factors

Board members, as well as sales operating units of the company, would benefit from undertaking an annual assessment of the sales compensation program. For larger companies, each sales entity, normally headed by a vice president of sales, would submit an assessment report for their program. Use the following four factors to organize this assessment report: governance, alignment, outcomes and legality.

Governance

It is a simple question: "Who is in charge of sales compensation?" Clarity of accountability provides the best insurance that the program will exceed company expectations. Unfortunately, governance is one of the most problematic elements of good sales compensation management. Why? Well, there are so many eager cooks in the kitchen: sales management, sales operations, finance, HR, product management and others such as legal and marketing. Table 1 delineates suggested accountabilities.

Table 1 | Sales Compensation Accountabilities

Sales Management	Program design, effectiveness and integrity
Sales Operations	Day-to-day plan management
Sales Finance	Calculation administration
Corporate HR/ Compensation	Company sales compensation design principles
Sales Compensation Design and Assessment Committee	Committee, including sales management, sales operations, sales finance, HR, business unit, annually to assess and redesign pay plans. This committee authors the annual assessment for the BOD. This committee has an assigned process leader.
Field Sales Management	Communication and incumbent encouragement
Internal Audit	Annual program review
Legal	Annual program review
IT	Automation provisioning

Alignment

The second factor to test during the assessment process is alignment. Sales compensation plans must align with many objectives:

- **Sales Strategy.** Test the alignment of the performance measures. The performance measures within the sales compensation plan must serve the current business objectives — the sales strategy.
- **Management Narrative.** The sales compensation plan must match how sales management leads the sales team. The management narrative defines the performance culture and the incentive plan must work in concert with this leadership narrative.
- **Market Pay Levels.** Use multiple and comprehensive, incumbent-based survey sources to confirm that the company's target total compensation levels are consistent with the company's preferred market pay position.
- **Sales Compensation Principles.** The corporate sales compensation principles feature policy statements on eligibility, target total compensation, mix, leverage, performance measures, quota levels, sales crediting and account assignment practices. The pay plans need to comply with these policies as authored by corporate human resources.
- **Motivation/Plausibility.** The plans must be motivational to the sales team. The payouts must be worth the effort. The plausibility of accomplishment should

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encourage dedicated efforts. Of the sales personnel, 60 percent to 70 percent should have a reasonable opportunity to meet and exceed quota and thus exceed their target total compensation earnings in a commensurate fashion.

- **Annual Review Process.** Each year, the sales compensation design and assessment committee needs to follow established protocols to assess and review current plans and update the incentive plans for the next fiscal year. An identified process leader shepherds this activity.

Outcomes

The third factor to assess is the outcomes. The sales compensation program lends itself to detailed analysis regarding outcomes.

- **Sales Results.** The most important outcome is sales results. Did the sellers produce and exceed the sales volume? Did they successfully support the incented objectives of product mix, account outcomes, profitability and contract terms?
- **Compensation Cost of Sales (CCOS).** CCOS provides the means to measure the sales cost per order dollar. The objective is to increase seller productivity at a rate that exceeds the increase in seller costs. Revenue growth outcomes should exceed peer competitors. The board needs to understand the scope of dollars set aside for incentive payments and ensure management effectively uses these dollars.
- **Distribution.** Seller distribution should feature at least 60 percent to 70 percent of sales personnel reaching and exceeding goal. Outcomes where only a few exceed quota — and most do not — indicate a malfunctioning job or sales compensation plan. Redesign one or both as needed.
- **Retention/Motivation.** Plot retention of the best performers. Ensure their longevity. Survey incumbents to test engagement and motivation. Track this information in a longitudinal fashion. Report year-over-year progress.
- **Leakage.** Have an internal audit test the administration/automation systems for compliance. Examine closely for potential cost leakage: goal relief, double sales crediting, account reassignments and program exceptions. Ensure full documentation of any variance to the plan policy with signature approval from the appropriate senior sales management.

Legality

Fourth, and finally, management needs to monitor the legalities of the sales compensation plans. While sales compensation does not have the SEC rules, there are legal elements to consider with sales compensation. Make sure the legal department has reviewed the sales compensation program documents for company and employee protection issues. Document and report all legal actions, state, federal or employee initiated. Management should consider any letter from a lawyer or an employee seeking sales compensation redress as a legal action deserving attention and resolution. Catalog all such occurrences. Ensure compliance with unique state laws such as the signed plan acknowledgment in New York and California. Avoid "holdbacks" in California where "an incentive earned is an incentive paid." Comply with Federal Wage-Hour application of exemption status. Only outside sales personnel are eligible for exempt status. Inside sales personnel are usually nonexempt jobs. Confirm exemption status with legal counsel.

Board of Directors — Sales Compensation Guidelines

Boards of directors needs to understand how sales compensation plans are functioning at their companies. Ask for an annual report on governance, alignment, outcomes and legalities. Sales compensation is a mission-critical pay program; the board need to ensure every effort to optimize the returns on this investment. ws

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