Whitepaper

Sales Compensation: Rewarding Sellers for Sales Performance

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Sales compensation works. Almost without exception, sales executives, compensation professionals and business leaders affirm that money is an effective motivator of sales talent.

A well-constructed sales compensation plan can motivate sales personnel to drive the right sales results. However, most will admit that creating effective sales compensation plans is often a “hit or miss” proposition. What seems like a simple idea—pay salespeople according to their sales contributions—can often produce less than effective incentive schemes. Initial designs that were once effective may require updates due to rising complexity caused by shifting product, revenue and profit goals, and evolving customer buying preferences; all compounded by tweaks, modifications and underpowered administration systems.

Is there a science to sales compensation design? Or, are these pay programs so situational that they preclude any type of classification system or design protocols? Fortunately, there is a science to sales compensation. While market practices suggest certain patterns, well-established principles allow sales reward stakeholders to select the most appropriate sales remuneration program to reward sellers.

By following the simple and proven rules presented here, incentive program leaders can create and sustain effective sales compensation plans.

WHAT IS SALES COMPENSATION?

The short answer: Sales compensation is additional variable pay for sales performance. On the surface, it suggests that sales personnel should receive incentive pay for producing sales results. Why make it any more complex than that? When examined more closely, sales compensation reveals itself to be much more than a simple pay-for-performance transaction system.

Consider the following list of objectives:

1. The pay plan must attract and retain the right sales talent.
2. The incentive needs to motivate incremental sales efforts.
3. The pay program must reward the company’s business objectives.
4. Incentive pay attributes should be consistent with the company’s management philosophy.

Now, consider the constraints:

1. The pay plan must be fiscally responsible.
2. The plan must be easy to understand.
3. The compensation plan needs to be internally equitable.
4. Quota setting, account assignment and sales crediting must align with the reward system.
5. The cost of administration should be minimal.

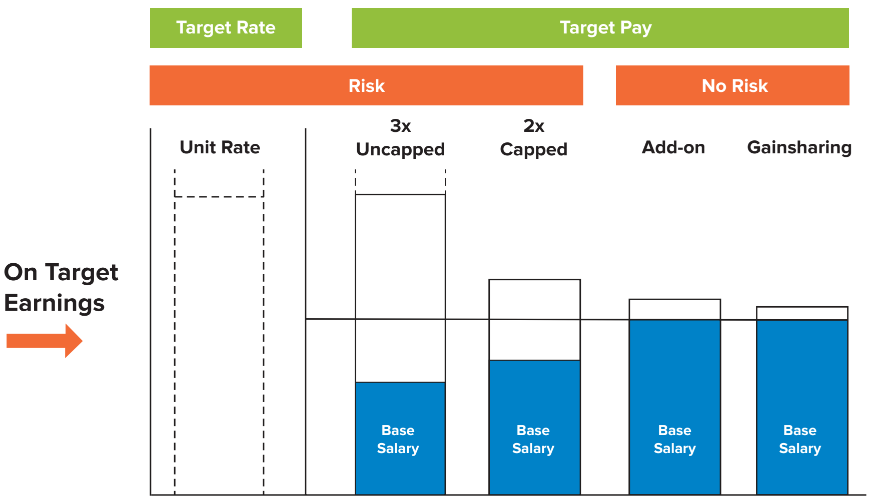
It is often a challenge to balance these competing objectives and constraints.

A BRIEF TUTORIAL OF INCENTIVE PLANS

If you gather as many sample sales compensation plans as you can find, what do you notice? A seemingly varied catalog of pay programs: Some are partially brilliant, some are partially incoherent, most are kind-of working, and many have flaws but, forgivingly, most all have good intentions.

There are two major classes of variable pay plans: Target Rate Plans and Target Pay Plans. Target Rate Plans do not have an On Target Earnings (OTE) amount. Instead, they have a fixed rate where the producer (seller, in this case) earns a percent of revenue production. Target Pay Plans have an OTE. There are four types of OTE incentive plans: 3x Uncapped, 2x Capped, Add-On and Gainsharing.

TYPES OF VARIABLE COMPENSATION PLANS



Types of Variable Compensation Plans

("Cap" means a finite limit to earnings regardless of performance.) Together, these five incentive categories act as labels for grouping different types of incentive plans. Sales compensation plans use three of these five approaches, including the Unit Rate Plan, the 3x Uncapped Plan and the 2x Capped Plan.

Unit Rate Plans are reserved for income producers. A Unit Rate Plan does not have an OTE. Instead, there is a well-known, industry-wide commission rate paid on all sales revenue. In other words, whatever the salesperson sells, he/she receives that commission rate on all sales revenue from the first revenue credit, including all recurring sales, often indefinitely.

Examples of income producer jobs include life insurance, stockbrokers, currency and bond traders, mortgage origination and real estate agents. More importantly is the nature of the sales job. In essence, the company's product is a commodity and the value is created by the income producer's relationships with customers, often called their "book of business." A confirming test of an income producer's status is his or her ability to take customers when they leave.

Sales representatives are sales personnel who represent the company's value proposition and service offerings. Management assigns accounts to sales personnel for sales development purposes based on the preferred product configuration, pricing and service levels desired by the company.

Target Pay Plans begin with a market rate for the job, called OTE. At-risk plans pay a reduced base salary when compared to On Target Earnings and feature no base salary in the case of Unit Rate Plans. The 2x Capped Plan provides a target bonus, e.g., 20 percent of base salary, with a maximum earning of 2x that amount, or 40 percent of base salary. The payouts are capped. Companies most often use this design to reward management level personnel (directors and above), and this approach is occasionally used for select sales jobs, such as consumer packaged goods and pre-sales technical support jobs.

The most common pay program for sales representatives (not income producers) is the 3x Uncapped design. In these programs, management divides OTE into two components: base pay and target incentive. The target incentive is available for those achieving their sales objectives with incentive earnings rising as sales personnel progress against their expected performance goals.

Sales personnel, who exceed expected goals, continue to earn additional monies so that the best performers (the 90th percentile) should achieve a total of three times the target incentive. These plans are not capped. A few number of sellers (less than 10 percent) will exceed this 3x leverage, but not by excessive amounts.

The no-risk plans include Add-On and Gainsharing. "No risk" means management has not reduced the base salary below the OTE for the job. Any incentive earned is on top of this fully market competitive base salary amount. Gainsharing Plans usually provide a target payout of 3 percent to 5 percent of base pay for performance on (usually) total company performance. Add-On Plans are popular when wage inflation is low. Add-On Plans are worth 5 percent to 8 percent of the base pay and provide rewards to individuals or small teams for exceptional contributions. Target Pay "No-Risk" Plans are seldom used to reward sales personnel.

THE BEST APPROACH: BEGIN WITH THE RIGHT JOB DESIGN

When management knows something is not right with the sales compensation plan, leaders will often struggle to untangle the existing plans while trying, at the same time, to craft features to serve new and emerging go-to-market strategies. Try this next time: Pretend that nothing existed; no sales jobs, no sales personnel and no current or lingering past practices. Now, answer this question: What do you really want your sales jobs to do, and what do you want the incumbents to accomplish? How would you prefer to pay them?

Freed from past practices, you might find that you need to make substantial changes to your sales coverage model. For example, you might want to specialize your sellers by type of customer—products purchased, revenue size, level of support or profit profile. You might also want to have different sellers covering tax-supported entities versus commercial, industrial and retail outlets. Or, you might want to divide your customer contact personnel into three functions: hunters, farmers and customer service resources. Alternatively, you might want to deploy income producers who own a list of accounts or a geographic area. Regardless of the approach, successful sales organizations carefully structure and define sales jobs. Each unique job gets its own sales compensation plan.

Note: As required government regulation, engage with any worker rights' representatives to advance program alignment. When appropriate, create new jobs and recruit existing personnel to exit their old job and pay plan and adopt the pay practices designed for the new job.

SALES JOB CATEGORIES AND INCENTIVE PLANS

There are three types of customer contact jobs and each uses a different type of incentive plan mechanic:

Sales Support Positions work with selling resources to help secure orders or retain existing business. Not to be confused with customer service personnel, these jobs have an assigned responsibility to influence customers' purchases. Some companies provide either Add-On Rewards or 2x Bonus Plans for these sales support jobs. Often, the target award is between 10 percent and 15 percent of base salary.

Sales Representatives work for a corporate entity selling the company's products and services. Sales management gives these individuals assigned territories, either a geographical area, a list of accounts or some combination of the two. This is the most prevalent type of seller. Often, sales management assigns sales goals as a quota. Performance to quota activates a proportional payout of the target incentive earnings. Performance below quota pays less than the target incentive monies. Performance above goal pays more than the target incentive monies. The most common pay system for the sales representative job is a 3x Uncapped, at-risk program.

Income Producers occupy jobs that are well known but frequently misunderstood. An income producer is an agent who has unique access to a customer population. Often, income producers sell ubiquitous products such as insurance, real estate and securities. Or, they trade commodities such as energy, future contracts and currencies. Through their frequent transactions, they produce an income stream that is "split" with the company (sometimes called the "house"). The most appropriate pay system is, of course, a commission paid on all sales. These are not complex systems and the commission rate is normally an industry standard. Occasionally, highly prized income producers can negotiate a better commission rate to join a rival firm. Finally, an income producer's book of business is portable; they can take their customers with them when they change employers.

SALES REPRESENTATIVE VERSUS INCOME PRODUCER

No sales management decision is more important than determining how to manage your sales jobs, either as sales representatives or as income producers. The entire sales ecosystem and sales management infrastructure of these types of jobs differ dramatically, including the incentive compensation plan.

Use the income producer model if you see the sales personnel as partners owning their accounts and the company providing the back office service/production/support to their business efforts. Pay them a flat commission on all sales.

However, if you deploy your sales jobs to accomplish specific objectives against select customer segments, use the sales representative model. More than nine out of 10 sellers are managed as sales representatives. Accordingly, the income producer model is a relatively rare way to manage (and pay) sales personnel.

THE HEADWATERS OF SALES COMPENSATION DESIGN

The starting point of sales compensation design begins with the job—not what others are doing, not what you have done in the past, not what the salespeople want and not what finance requires. Yes, each of those voices will play a role in shaping the final solutions, but the starting point—the headwaters—for sales compensation design is the job.

Your first task as a sales leader is to ensure that you have constructed specific, definable, accountable jobs. The more focused the job, the better. The sales job should be so clear that three or fewer result measures describe the expected outcome of the job. Not coincidentally, you will use these three or fewer result measures in the sales compensation plan. Conversely, if you have blended sales jobs (too many dissimilar tasks) or corrupted sales jobs (loaded with competing goals), you will fail your sales force and your company.

TYPES OF VARIABLE COMPENSATION PLANS

The sales department can use various types of compensation programs to reward seller performance. Two major variable compensation categories exist: Target Rate Plans and Target Pay Plans. Target Rate Plans provide a payment-per-transaction. Actual pay levels depend upon sales production. Target Pay Plans establish a target payout for expected performance; a configured payout schedule rewards goal accomplishment.

UNIT RATE

Unit Rate Plans establish a rate per transaction based on performance. For example, a commission rate of "6 percent of the selling price" is a unit rate of this number.

3X UNCAPPED

As with the rest of the target pay plans, 3x Uncapped incentive programs begin with the target market rate for the job. This is sometimes known as On Target Earnings (OTE). The upside potential, uncapped, states that the 90th percentile performer should earn three times the at-risk component added to the base salary. Less than 10 percent of job incumbents will exceed—and not by much—this number.

2X CAPPED

2x Capped Plans provide upside earning of two times the at-risk component; however, these plans are capped.

ADD-ON

Add-On Plans begin with no pay at risk. Often in lieu of annual merit increases, these Add-On Plans provide additional earnings for either individual or team performance.

GAINSHARING

Gainsharing Plans are normally offered to all employees based upon company performance featuring a modest annual bonus payment for achieving objectives.

YOUR NEXT STEPS

Sales compensation is a powerful and complex management device. Its main purpose is to help ensure strategic alignment between product divisions and customers. It is not the exclusive domain of the sales department. Others must contribute to this effort: marketing for strategy, finance for cost effectiveness, HR for competitiveness and IT for administration. Use the principles presented here to test your current programs. Commit to a full assessment of your plans each year.

Follow These Steps & Apply These Principles

Here is the logical method for designing sales compensation plans. Follow these steps and apply the principles for each job to develop the right plans for your company.

STEP 1

DEFINE THE JOB

Ensure you have devised focused and well-defined sales jobs. Avoid blended and corrupted sales roles. Decide if the job is a sales representative or an income producer. If the job is an income producer, ignore all of the following steps; use the industry standard commission rate. Pay no base salary. Use a flat commission rate from first dollar. Do not vary the commission schedule among the different types of sales outcomes: new revenue, renewal revenue, profitability and product mix. However, if you have sales representatives, then continue with the following steps.

STEP 2

SET ON TARGET EARNINGS

Collect market data. Determine the price point of the job. This is the total dollar amount you expect to pay for expected performance. And, yes, you can modify this number to reflect your circumstances.

STEP 3

DETERMINE PAY MIX

Split the target cash compensation amount into two components: base pay and target incentive (base/target incentive). No need to go deeper than a 50/50 plan. Most direct business-to-business sales jobs have a 60/40 to 70/30 pay mix. Follow this principle: The more influence that the salesperson has in the customer decision process, the deeper the pay mix. The less influence, the more shallow the pay mix will be with a higher base pay component.

STEP 4

SELECT THE LEVERAGE

The leverage is the upside earning opportunity expressed as a multiple of target incentive. The most common leverage is 3x. This means the best performers (90th percentile) should be able to earn a total of 3x their target incentive. The plan would be uncapped. Use a 2x Capped Plan for field helpers and pre- or post-sales support personnel. Inbound customer service can use a 90/10, 2x Capped Plan. Outbound telephone sellers should be on a 65/35, 3x Uncapped Plan.

STEP 5

PICK AND WEIGHT THE PERFORMANCE MEASURES

Select business result measures. Use no more than three. Do not select compliance or corporate entity measures or any other measure the sales personnel cannot influence. Do not reward activity measures. Avoid Management by Objectives (MBO) measures whenever possible. Weight the performance measures according to importance. Sales production should always be weighted more than 50 percent when compared to the other measures.

STEP 6

DETERMINE PERFORMANCE EXPECTATIONS

For each weighted measure, determine the minimum (10th percentile), expected (50th percentile) and outstanding (90th percentile) performance expectations.

STEP 7

SELECT THE RIGHT FORMULA TYPE

Use a commission calculation when territories are equal. Calculate the commission rate by dividing the incentive earnings by performance expectations.

If territories are dissimilar in size, use a bonus formula tied to a quota. Pay out the incentive element as quota is achieved. Calculate the incentive formula by dividing the incentive dollars by the percent to quota expected. Use hurdles when two or more measures are important and one measure (the “hurdle”) must be accomplished before favorable payouts can be earned on the second measure. Use an incentive modifier when two measures are important, but one measure significantly dominates the important, but less significant second measure. Calculate the payout for the first measure and modify the payout (positive or negative) by the performance on the second measure. Finally, use a matrix (bonus grid) when two measures compete with each other (such as revenue growth and profitability), which allows the salesperson to balance these two objectives.

STEP 8

SET UP THE QUALIFIERS

Define when revenue or other performance is recognized for incentive purposes. Establish quota and account assignment adjustment rules. Define sales crediting rules. Establish a mega order cap, if necessary. Establish thresholds if you do not plan to pay for recurring business.

Follow these steps for each job, and you will develop a contemporary and powerful incentive plan.

ABOUT THE AUTHOR

David Cichelli is Alexander Group's Principal Thought Leader regarding sales effectiveness challenges and solutions facing sales organizations during different stages of growth. David is a frequent speaker, author and instructor on sales management issues. David helps clients develop sales strategy solutions that ensure alignment between corporate sales objectives and sales resources.

Additionally, he is the firm's sales compensation practice leader and a nationally recognized expert in sales compensation. David is author of "The Sales Growth Imperative" McGraw-Hill (2010) based on the Alexander Group's experience working with successful sales entities, and the bestseller "Compensating the Sales Force," McGraw-Hill (2004), now in its expanded and revised second 2010 edition. David developed and teaches the one-day class on sales compensation for WorldatWork, the association of compensation professionals.

David has been with the Alexander Group for over 20 years. His previous experience includes field sales support for an industrial chemical company and sales compensation practice manager for a large human resources consulting firm. David has a BA from Pennsylvania State University and a MS from Michigan State University.

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