Effective Sales Incentive Plans

Customers> Revenue > Profits > Value

In this value chain the sales force is one of the most important assets that any company can possess, and ensuring its effectiveness is one of the key differentiators between superior and average performing companies.

Plan design is most successful when everyone involved has an open mind and is willing to take a step back and think about the strategy of the company and the sales process. And understanding both the product and the sales process are critical to determining the appropriate compensation arrangement.

Is the product a commodity?

A product similar to the competition is more difficult to sell and may require a more aggressive sales compensation plan. How fast does the company need to grow? If there is intense pressure for rapid growth, the company may need more representatives and a more aggressive compensation structure. How about the lead-time and time required to make a sale?

Sales compensation should reflect the level of difficulty to close a sale, the skills required to sell a product (e.g., someone with technical or scientific skills in addition to sales skills would be paid higher) and the profitability or margin involved.

Key Questions

Our clients raise the following questions relative to sales compensation and sales incentives which are somewhat universal and require all plan sponsors to consider and address:

1. **Do I have the right individual's in the job?**
2. **What is the relationship between sales and marketing?**
3. **What is the right value proposition between the compensation paid to sales professionals and the revenue they generate for the organization?**
4. **What are the right competitive benchmarks for the sales force?**
5. **How do I establish attainable goals?**
6. **How do I balance plan simplicity with plan sophistication?**
7. **What elements of plan design impact attraction, retention and motivation more effectively than others?**

Each of these questions is challenging and must be addressed in evaluating the effectiveness of existing sales compensation and sales incentive plans, as well as in redesign efforts.

Key Issues

Here are some warning signs that your sales compensation and incentive programs are inefficient and could be causing your organization to lose sales:

- **The payment of the incentive is consistently late.**

- **Participants cannot trust the numbers used in the calculations, so they spend their time verifying the numbers by maintaining their own scorecard.**
- **The first feedback received by participants concerning their progress is after the incentive check arrives.**
- **Participants do not understand how their plan works and what the company expects from them.**
- **The sales manager has a budget to compensate participants for mistakes in incentive compensation payments.**
- **The CEO talks about the importance of a company-wide focus on new business, but it is not reflected as an opportunity in the incentive compensation plan.**
- **The plan's measure of performance is not in sync with the sales process and the corporate and sales division's goals.**
- **The plan is not flexible enough to change quickly. For example, a competitor made a big announcement that has an impact on your company's sales strategy, but it took a few months to respond with a change to the sales incentive plan.**
- **The compensation plan has not been reviewed for necessary changes for at least three years.**
- **Your company has a higher than average turnover among sales reps, and your current sales reps are also thinking of joining the ranks of the departed due to better opportunities elsewhere.**
- **The CFO questions the relative cost of the sales compensation program in comparison to financial results.**

In determining the appropriate sales incentive measures, it is critical to first understand the entire process

Step 1. Evaluate Business Economic Value Drivers – Every sales force is impacted by the marketing strategy and how senior management communicates it. The sales force is also directly impacted by how the business is organized, how it is managed and by its unique value drivers.

Relative to value drivers, does the company have the best product, best price, best delivery, and best market coverage or does it rely heavily on the business relationships maintained by the sales force?

Relative to business operations and culture, how realistic are management's sales goals and marketing strategy?

Is there enough inside sales support and investment in promotion and marketing?

Do sales people feel they have the freedom to adjust their approach to various situations, or are they required to use the same strategy for every customer?

Step 2. Analyze Current Plan Effectiveness ·

Is the current incentive plan working as well as management would like? It could be that there is significant turnover in the sales force. Perhaps the commission or salary structure is creating problems. An excerpt of an effectiveness checklist shown in Figure 2 reviews both the strategic, financial and tactical aspect of the current sales incentive plan.

Figure 2 – Sales Incentive Plan Effectiveness Checklist (1=Best, 4=Worst)

Strategic	Achieves marketing goals					
	Fits marketing life cycle					
	Externally competitive					
	Internally equitable					
Financial	Balance between sales incentive					
Tactical	Reflects Individual effort					
	Meets career income needs					
	Simple and action-oriented					
	Seen as fair					

	Balances sales rep risk and				
	Provides for territory variances				
	Provides for territory				

This check list can also help identify issues and problems with the existing sales compensation plan.

Keep the following issues in mind:

• The sales incentive plan must support the marketing strategy and the long-term continuity of the sales force.

• If the Return on Investment is negative or marginal the program should be reevaluated.

Tactical issues revolve around avoiding the following:

- **Over or underpaying the sales force**
- **Ignoring new business development**
- **Resisting management and "doing my own thing"**
- **Gaming the goal-setting process**

These issues indicate problems with the incentive plan that need further analysis before a new plan can be effectively implemented.

Step 3 Part A. Determine Pay Strategy –

What is the current pay strategy?

What level of pay and performance is required to reach the 50th or 75th percentile of the market?

Are there unique industry characteristics that require sales people with special scientific or technical skills?

Sales compensation should be designed so that it is planned and predictable. It is a variable cost that fluctuates as sales change. A sales incentive program should never be designed to cause a lower or higher expense than planned. The pay strategy should be supported by outside market data and be internally equitable, i.e., all sales people with the same responsibilities should have the same total compensation opportunity.

Step 3. Part B Plan Design – Companies that are in different stages of maturity typically have different products and unique strengths and weaknesses. Plan design will follow those characteristics. For example, in certain instances a pay system may be dominated by a commission schedule. In others it may be a traditional salary plus incentive structure, and yet in others it may follow a hybrid of the two, where the base salary level and cost is built into the sales expectation.

This latter approach is interesting because it communicates that base salary levels have sales expectations built into them and incremental compensation is only achieved by exceeding those expectations. Most important, however, is the goal- setting process.

Goals must support the organization’s strategy and be understood and agreed to by top management and both sales and marketing management. In the past, sales incentives were often based exclusively on giving sales people a percentage of their sales, but it is critical to tailor specific performance measures to the overall company’s strategy and financial goals in order to maximize plan effectiveness.

The most common goals used are sales revenue, gross profit and number of units sold. A number of organizations use gross profit or net profit as the sales incentive performance measure. This encourages not just sales, but profitable sales. It takes pricing into account and discourages low margin sales.

Some companies try to focus the sales force on new customer development rather than just maintaining existing customer relationships.

Here are some other goals to consider:

- **Product mix (selling a certain amount of specific products in a given territory).**
- **Cross-selling different products to existing customers**
- **Territory market share**

Companies can use more than one performance measure; however, more than three measures can be confusing and reduce the emphasis and impact of key measures. In addition, different weights can be assigned to different measures.

For example, if three measures are used, the weighting does not have to be 1/3rd for each measure. A more critical measure could have a weighting of 50 percent, with 25 percent allocated to each of the remaining two measures. Figure 3 illustrates a typical performance measure/weighting model.

Figure 3

1. Territory Gross Profit	50%
2. Territory Total Sales	25%
3. Territory New Customer	25%
Total Weight	100%

Performance measures and weightings can be changed each year or as needed to reflect changing business conditions and strategic initiatives. Performance measures should be easily measured and well understood by everyone. The financial reporting system must be able to provide monthly reports that show how everyone is doing relative to the plan's goals.

Step 4. Payout Modeling –

What is the payout under various situations: below budget, at budget and above budget? Is the plan capped or uncapped?

Does the commission rate increase after the company reaches various performance levels?

Payout modeling is intended to ward off the effects of 'unintended consequences." You do not want to design a plan to reward a specific performance outcome only to have people act in a totally different manner.

The law of unintended consequences, often cited but rarely defined, is that actions of people—and especially of government—always have effects that are unanticipated or "unintended." Economists and other social scientists have heeded its power for centuries; for just as long, politicians and popular opinion have largely ignored it.

It is also important to model the pay mix. Pay mix is the amount of "leverage" or the ratio of base salary to incentives. A pay plan that has a 60/40 mix provides 60 percent of the total pay package in base salary and

40 percent in incentives. A sales compensation program can range from 100 percent commission to a plan that is all base salary; **there really is no across-the-board "typical" sales compensation design.**

The most effective plans are only implemented after multiple scenario payout models are run. In real-world conditions, the plan can produce unexpected financial results. To avoid the problem, model the plan design and test a wide range of scenarios using a time period of at least five years.

Make sure the model includes the costs of both sales compensation payments and the costs of employee turnover when payments are too low.

For example,

What happens to your sales compensation payments when you sell five times as much as you planned, such as during a new product launch?

What happens if you sell half as much, such as when a hot new competitor leaves you spinning your wheels in the dirt?

What are the effects on employee turnover and the costs associated with turnover if this occurs?

The sales compensation modeling process, shows how compensation is affected by changes in unit sales, product pricing, cost of goods sold and gross profit.

Companies also use the modeling process to test the amount of leverage, which should vary with the company's maturity.

For example,

start-up companies would typically hire aggressive sales people that can grow the business with a low base salary/high incentive mix. Mature companies that are trying to maintain market share and customer relationships would typically have higher base salaries and lower incentives.

The type of industry and the cyclical nature of an organization's business should also have an impact on the type of pay mix used. A company whose financial performance varies widely with general economic conditions may want to reduce wide swings in incentive pay and retain sales people during economic downturns by providing competitive salaries.

Even though some cyclical companies try to smooth out the bumps in sales compensation, they typically rely on incentives to make sure that in weak sales periods compensation declines but layoffs are prevented. Some companies with unpredictable forecasts change individual goals each quarter to reflect the nature of their business.

Along with industry characteristics, companies should also evaluate the degree to which individual effort affects the sales process.

Do customers buy because of product advertising and promotion, or is the sale based on the effort of the sales person?

More commission or incentive is used in industries where sales are highly impacted by individual sales efforts, such as insurance.

A first dollar commission plan to a plan having a sales minimum that must be reached before commission payouts begin.

For example, in order to cover its overhead, one company requires a minimum level of sales before the commission plan kicks in. Alternatively, the company could offer a first dollar commission at a lower commission rate and pay out the same total dollars. **The choice between the two plan designs depends on the maturity of the**

industry, the culture of the sales organization, past practices and the desired pay strategy.

A more complicated but common approach is to use a payout table.

This type of approach lists specific payouts for each goal at various levels of performance.

Step 5 Administrative Guidelines and Communication – The actual payout for sales incentive plans is typically monthly or quarterly. The frequency of the payout helps to tie specific sales events to specific cash payments, thus keeping the sales force motivated.

All incentive plans need a plan document that outlines the purpose of the plan, how it works and what actions will be taken to address unforeseen circumstances. Plan documents should clearly state the managers responsible for approving any changes to the plan. In order to prevent accusations of plan bias, it is a good policy to provide copies of the plan document to all participants in the sales compensation plan.

A good plan document should cover the following issues:

- **Timing of payouts**
- **Price changes**
- **Windfalls or disasters**
- **House accounts**
- **Goal setting**
- **Territory transfers or splits**

Many plans fail because of poor communication not poor plan design.

One salesperson summarized plan communication this way: "If I can't easily explain it to my spouse, it is too complicated. If we do not understand how the plan works, how can you expect it to work?"

Management must take the time to meet with the sales force to explain the sales compensation plan and answer any questions that are asked.

Conclusion

In practice, most companies develop unique plans to fit their business.

This step-by-step design process is intended to help you develop a sound program while keeping in mind the many intricacies that must be addressed along the way.

Is sales compensation worth the effort to regularly analyze and improve?

Sales incentives help drive sales and sales drive business value.

Developing new business, retaining existing customers and producing growth when prices increases are limited is challenging work. The sales incentive plan should be reviewed regularly to make sure it is supporting the strategy of the organization.

The support of top management is critical, both in how the plan supports management's specific business objectives, and by the amount of time management spends communicating the program to the sales force. The sales force should provide input, but should not control the design process. Management must determine what is best for the overall business, not just for the sales force.

There needs to be a rigorous modeling of various performance scenarios to make sure the program does not produce any windfalls or shortfalls that could cause unwanted turnover or embarrassing situations.