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COMPENSATION

The two most common questions Chief Sales Officers ask involve hiring and compensating salespeople. This paper addresses compensation.

TERMINOLOGY

The following terminology is used in this document.

Compensation Period – the stated time frame during which the remuneration program will be in effect.

Sales Cycle – the average time it takes to convert a lead into customer. A customer may be defined as a signed contract, a paid invoice or any other measure.

Base Pay or **Base Compensation** – the income a salesperson receives regardless of their performance. As long as they remain on the payroll, they receive this remuneration.

Commission – additional income the salesperson receives during the compensation period for pre-determined performance criteria. For example, a percentage of each sale.

Incentive/SPIFF – additional income the salesperson receives for specific actions. These are usually short-term activities and do not endure throughout the entire compensation period.

Recognition/Reward – usually non-monetary rewards given to salespeople who meet or exceed specific standards. “Salesperson of the Month” and “President’s Club” are typical examples.

Risk/Reward Ratio – the relationship between the salesperson’s current compensation program and the proposed one. Whatever “risk” the salesperson is being asked to take, the potential reward must be greater.

> *It is even lonelier at the top for the Chief Sales Officer.*

Two Approaches

Consider two approaches when creating or updating your compensation plan: **Analytic** and **Subjective**. Most, if not all, of your sales compensation should be built on an objective analytic basis. However, you can also use a subjective measurement to reward specific behaviors.

> *Successful salespeople are highly competitive and want to "win". They want to know the rules and they want to achieve more than others based on the rules – a level playing field. Subjective recognition is difficult for them to embrace.*

An example of using a subjective reward happened when an insurance company decided that any general agent (selling sales manager) who had not made the President's Club in the past five years based on their production would be terminated. The objective was to have the best-of-the-best leading the salespeople. One general agent who had never made the Club was about to be removed when someone noticed that more than half of the Club's winners had worked for him in the past. In fact, many of the members of the President's Club had thanked him for their success. Thus, the company established the Lifetime Achievement Award to acknowledge this person's performance.

Cardinal Rules

The following cardinal rules in compensation are the foundation for developing any sales compensation program.

1. **Tie your compensation to your expectations**. Most organizations inadvertently violate this rule *(**see "Outcome" below**)*. People are paid for doing things the company does not want them to do. A common example is salespeople being paid when they are calling on the "wrong" accounts or selling the "wrong" products.

2. **Any compensation program can be manipulated**. Salespeople have a vested interest in making the compensation program work for them. The same traits that make them aggressive and successful in front of their customers are the ones that will cause them to seek the best outcome for themselves. Any compensation program that rewards one type of behavior over another will typically see more of the behavior with the higher reward. Often, the holes in the compensation program are not apparent until the program has been in place for a period of time. Be prepared for **unintended consequences**.

> *Salespeople have a vested interest in making the compensation program work for them*

3. **A compensation program is a contract**. Salespeople and their managers agree to a payment program tied to the performance of the salesperson. When the salesperson fulfills the requirements of the program, they are entitled to the agreed upon remuneration. Even when the activity negatively affects the organization, the salesperson has earned their money. On the other hand, if the salesperson's activities result in the organization benefitting to a greater than expected level, the salesperson's income is still determined by the program.

4. **The length of your program should be determined by the length of your sales cycle, not the calendar**. **Twelve-month compensation programs are dangerous**. A rule of thumb is that a compensation program should last from three to twelve sales cycles. For instance, if your sales cycle is one week, the compensation program needs to be reviewed once a quarter. If your sales cycle is typically one month, the compensation program needs to be reviewed at least twice a year.
    a. **Reason 1: markets change.** The rapid pace of change in technology and in customer expectations make it all but impossible to foresee what the buying influences will be many months out.
    b. **Reason 2: competitors change.** One of the assumptions behind any compensation program is competitive activity. What new products or programs will your competitors announce and how will you want your sales team to respond?
    c. **Reason 3: new opportunities present themselves** – or can present themselves. Your ability to serve your customers can change significantly when you develop unexpected capabilities. This can change your target market (or change another focus) and require a change in your compensation program that will drive the behaviors you are seeking.

5. **Rolling compensation programs are better.** Rolling sales plans are preferred over annualized plans. How can a salesperson determine in January what they will be selling in December? Since the sales plan needs to be a rolling one, the compensation program needs to roll as well. Consider having three months firmly set (and unchangeable) followed by three months that can have minor adjustments followed by another three months that are subject to review and then three more months that are in the planning stages. A process similar to this one will allow you to adjust for unintended consequences, market changes and competitive activities.

6. **If your salespeople are not saying, "Here we go again," you are probably not changing your compensation program often enough**. Expect resistance. Sales professionals have enough on their minds without having to unwind the new compensation program and figure out how to make it work for them. Still, changes in the compensation program drive changes in behavior.

Behavioral changes are needed when results need to be changed. Your salespeople will find the time to analyze the new compensation program

7. **The Golden Rule in compensation: when in doubt, overpay**. Give what you want to receive. Generous compensation programs bring out the best in the best sales professionals. Stingy compensation programs bring out the worst in everyone.

8. **When using base plus commission models, offer a starvation base and a BMW potential**. A salesperson who can live on their base pay is obviously not as hungry as you might like. One of the issues with base pay is that over time it can be incrementally increased to the point where senior salespeople are drawing a significant amount. This often coincides with a decrease in living expenses (mortgage is paid, kids are out of college) and so the most qualified salespeople have the least incentive to beat the bushes. The base needs to be insufficient for the salesperson to maintain their lifestyle while the potential commission needs to be sufficient for them to achieve their personal goals.

9. **Play to the 80**. Developing a compensation program that covers every possible scenario will result in a convoluted program few can understand (think about the United States Tax Code!). Focus on the 80% of your sales team. 10% will go out and sell effectively regardless of the compensation program and another 10% will not sell effectively regardless of the program. Focus on the 80%.

10. **KISS. Keep it simple**. The salesperson who cannot understand the compensation program cannot sell to it. You are developing a program that will drive the behaviors of your salespeople. They need to be able to understand the plan in order to sell to it.

#1 Error

The most common error found in compensation programs is tying the salesperson's compensation to revenue. Companies do not run on revenue, they run on profit. **Tie your compensation to your expectations.**

The push-back has been that salespeople do not control labor and raw materials costs and so they should not be compensated on things they cannot control. That is a reasonable argument for tying their compensation to the revenues they generate. However, does that model provide them with any incentive to focus on profits?

An alternative is **Sales Contribution to Profit or SCP**. It is a similar model to the one some manufacturers give to their distributors and rep firms. With this method, the salesperson is given a threshold number for a sale. Their compensation is based on the selling price they are able to obtain over and above the threshold. This causes the salesperson to participate in the impact of discounting at a higher level. When the corporate profits take a hit, so does the salesperson's income in a more direct proportion.

Example:

A Widget sells for $100. The salesperson can be compensated based on 10% of revenue or profit using SCP. Which works best when the customer demands a 10% discount?

Traditional 10% Commission	Using SCP
At full price, $100, the salesperson's commission would be $10. **Giving the customer a 10% discount would reduce their commission to $9.** Is it worth the salesperson's time to try and overcome the price objection?	The SCP threshold established by the organization for the $100 widget is $80 and the salesperson participates at 50% of SCP. When the salesperson sells at full price, their commission is still $10: $100 - $80 = $20 x 50% =$10 However, giving the customer a 10% discount would reduce their commission to **$5**: $100 – 10% = $90 - $80 = $10 x 50% = $5 Would that be more of an incentive to cause the salesperson to try and overcome the price objection or to negotiate a lower discount?

#2 Error

EXISTING	COGS (MATERIALS, MANUFACTURING, G&A, ETC.) same for both	SALES COSTS		PROFIT
NEW		SALES COSTS FOR NEW ACCOUNT	BONUS	PROFIT

So how do you use your compensation program to cause your salespeople to bring in new accounts?

Method One: *Consider using Recognition*. Your first-year sales costs are going to be higher. Determine how badly you want or need the new customers and then establish a pool of recognition funds to be used in a recognition program. Rather than establishing a program that will cause salespeople to focus primarily on new accounts, this will bring a balance in their selling activities. A new account will still return them the same remuneration as an existing account. If your compensation program is based on “account growth year-over-year,” your salespeople will focus on growing their existing accounts and thus generating stronger profits for the company. When it also includes a recognition program for new accounts, they will actively pursue them as well.

Method Two: *Use new accounts to boost commission rates*. For every new account (or multiple accounts), boost the salesperson’s commission rate on all sales. This typically drives sales in both existing and new accounts. Suppose you add 1% to the commission rate for sales to existing accounts in a month when a salesperson has closed a new account. They will become more aggressive in closing as much business as possible while the higher commission rate is in effect. You will be paying the higher commission on the more profitable accounts.

**May not apply to business models where new accounts normally generate ongoing, recurring revenues and can usually absorb paying extra for new accounts*

THE BEST LAID PLANS

Compensation programs alone are usually not enough. Compensation *and* incentive programs are better. So, there needs to be a mix of base plus commissions plus incentives plus recognition.

There are times when using a straight salary is appropriate for salespeople:

- When they are new hires, going through training and not yet equipped to sell
- When the sales cycle is extremely long

Developing a compensation model can become more difficult than imagined. There is no one-size-fits-all in sales compensation and every model is subject to change. Use the following examples to help determine what your compensation model should look like.

EXAMPLE ONE

Acme has a short sales cycle. Their customers invite bids from multiple vendors and expect to have delivery in a few days. “Low price gets it.” This is typical customer behavior in their industry. Most sales are fairly small but there are many of them each month from multiple customers.

Acme leadership needs to maintain margin and the current discounting mentality from their competitors is making that difficult. Acme decides that their salespeople need to sell closer to list price and/or make more sales each month. An increase in sales volume could reduce the fixed-cost-per-transaction and make each sale more profitable.

Here is how they might design their plan:

- Base pay will drop each year
- Commissions will be based on profit using SCP
- An incentive will be paid monthly. It will be calculated as 50% of SCP for each of the first 100 transactions; 70% for all additional. Since 100 transactions per month is doable, the salespeople have an incentive to push for additional transactions before month's end.
- Five salespeople will be selected for the President's Club based on Total Profit divided by Total Transactions (average profit per transaction). Members of the Club and their spouses are rewarded with a trip.

This program keeps the salespeople focusing on the two primary objectives: profit and transactions. Involving the spouse causes him/her to support the efforts of the salesperson more strongly since the spouse is included in the rewards.

EXAMPLE TWO

Baker Industries sells on a contractual basis with recurring revenues. Some of their senior salespeople have established accounts in their territories that automatically generate strong sales each month. The senior salespeople are not exploiting the other potential accounts in their territories because their sales are mostly on autopilot. However, there is a seasonality to many of their sales: some months are larger than others. This creates feast-or-famine scheduling issues for Operations. Some weeks the plant is paying overtime and other weeks, people are being laid off.

Baker chooses the following program:

- Base pay is frozen; cost-of-living increases may be considered
- Commissions are paid based on increase in revenue for the same month year-over-year
- A New Account Bonus is paid quarterly
- For the top 10% of the sales force, the company will donate to the salesperson's favorite charity in the salesperson's name

With this model, there is a huge incentive to grow their existing accounts while bringing in new accounts during the slow months. Rather than having months where their commissions are small, the salespeople have an incentive to find customers who buy during the slow months.

The company's profits for those new accounts will initially be small since the month-over-month increase will favor the salesperson. However, keep in mind that the new account will bring *recurring* revenue. Subsequent sales will be more profitable and the salesperson will have a higher threshold for the same month in the following year. Recognition extends beyond the company to the charities.

Let's say June is typically a slow month. The salesperson who averages $200k in monthly sales only sees $50k in June bookings. Last year the salesperson had $40k in June bookings so they will see a $10k increase in year-over-year and a 10% commission will bring them **$1,000**. What if they close a new $100k account in June? Their year-over-year increase will be $110k and their commission will be **$11,000**. That is well worth the effort. What about next year? The salesperson's June incentive will be based on $150k rather than $40k.

EXAMPLE THREE

Clark Company has been paying a straight salary to their salespeople. Now there are aggressive competitors who are paying base-plus and some even paying straight commission. Clark needs to move off the straight salary model but they are afraid many of their salespeople will resign. Over time some of the seasoned salespeople have approached six figures in salaries even when total sales in their territories declined.

- Clark will migrate to increasingly aggressive base-plus models
- Year one, base pay will top out at $80,000; year two $60,000
- Anyone meeting their quota will receive $25,000 in commissions
- Sales above quota will earn an increased level of commissions: an additional 1% up to 105% of quota; an additional 4% up to 120%; an additional 10% above 120%

With this model, the risk/reward ratio is covered. Senior salespeople will "risk" 20% of their salary but they can earn a reward of 25% just by meeting their numbers. The company will be issuing smaller monthly checks and can make up some of the additional compensation there. Also, the program will stem the tide of declining sales.

With this model, won't salespeople quit and look for a job somewhere else? Probably not. Where would they go? The compensation programs with the competitors are no better than the one they will have here.

CHOICES

Begin with **OUTCOME**.

What do you want or need to accomplish? Establish your sales priorities before making any decisions about compensation. Work from the end to the beginning. At the end of the selling season, what would you like to have accomplished? How will you measure success?

Who are the customers that will best meet your criteria? Qualify the critical mass. Are they new or existing accounts? Are they industry-specific or geographically similar?

When do you need to have the business? Sooner may cost more but it can also give you a competitive advantage.

How is the best way to use your compensation program to drive the behaviors of your salespeople? How will you combine Base + Commission + Incentive + Recognition?

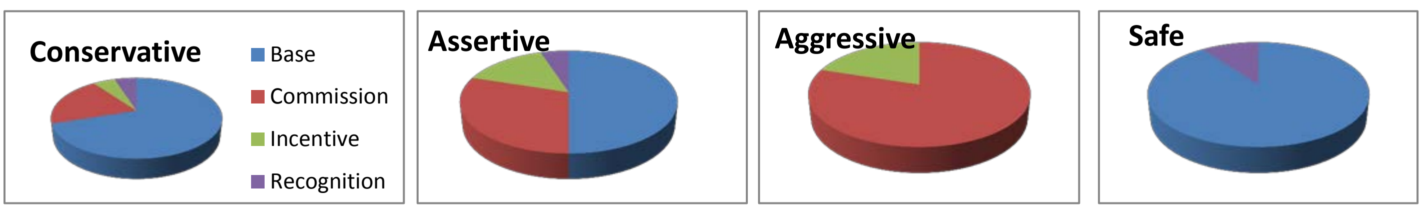
Keep in mind this is the plan for now. It will be used to drive behavior and results for the compensation period. The next period can focus on other priorities.

SUMMARY

You have options. There is no one right way to compensate salespeople and the compensation program will always be dynamic, not static. As the Chief Sales Officer, you will want to consider as many options as possible for using your compensation program to drive the behavior of your salespeople.

Once you have your plan, develop a tool, like an Excel spreadsheet, to run as many what-if analyses as you can imagine. If there are glaring flaws in the plan, they will emerge.

Just remember, tie your compensation to your expectations.



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