

# The Science of Sales Compensation

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Almost without exception—on a world-wide basis—sales leaders affirm that money is an effective motivator of sales personnel. Their own experience tells them that a well-constructed sales compensation plan can help drive the right sales results. However, on further reflection, most sales leaders will admit that creating effective sales compensation plans is often a “hit or miss” proposition. What seems like such a simple idea—pay salespeople according to their sales contributions—can often produce less than effective incentive programs. These unintentionally poorly constructed plans are plagued by complex rules, unworkable formulas and poorly executed quota programs. And further compounding the problem is an all-too-familiar underpowered tracking, reporting and administration system.

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? Absent any methodology, sales executives design sales compensation programs as circumstances present themselves. Often, an initial design will be effective. However, as sales objectives change, customers shift buying preferences and selling practices become more complex, the compensation program—attempting to keep up through tweaks and modifications—can travel into an unrecognizable state of complexity.

Yes, fortunately, there is a science to sales compensation. While market practices suggest certain patterns, a well-established conceptual paradigm allows sales management to select the most appropriate sales compensation design for sellers.

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

## What About Sales Compensation Programs?

Sales compensation pay programs reward sales personnel for achieving sales objectives. These performance earnings often represent a significant portion of the salesperson's total earnings; in some cases up to 50% of total earnings, and for income producers all 100%. Sometimes sales management will supplement the sales compensation program with short-term sales incentive plans, sometimes called contests and spiffs (Special Performance Incentive Field Funds). Sales management uses sales incentives (not to be confused with sales compensation) for short-term objectives such as a new product launch or other sales campaigns. The economic worth of these short-term sales incentives programs usually should represent between 2% to 4% of the total earnings.

Sales compensation programs serve many purposes. First, they align salespeople's efforts with company objectives. Second, they reward sellers for outstanding results while conversely providing limited earnings for poor performers. And, third, they help keep sales personnel focused on achieving goals.

The use of sales compensation is a choice. Like any other management system, it's a tool to help direct employee performance. Sales leaders use a variety of methods to motivate and direct sellers' efforts. Performance management systems, training investments and supervision all contribute to improving sales results. Sales compensation works in conjunction with these management levers to help elevate sellers' results.

## **Types of Incentive Plans**

Before presenting the rules for effective sales compensation design, a quick refresher on the types of incentive plans will help overcome any confusion regarding their proper application.

Variable incentive plans can be broken into two major categories: non-risk and risk plans. There are two types of non-risk plans and three types of risk plans. They are all in use today; they are valid and powerful.

The term "risk" refers to how much of the "expected" earnings is assured with a base salary or some other type of guarantee, and how much of the expected earnings are variable—tied to performance. Most define "expected" earnings as the market rate for the job, and for non-risk plans it is usually delivered in the form of base salary.

- **Non-Risk Plans.** The two most common non-risk plans are gain-sharing and add-on plans. Both have been around a long time and provide a suitable option for select situations.
  - Gain-Sharing Plans have morphed from their original design of providing a split of profit- or cost-saving gains to the employees. Today, most gain-sharing plans reward all employees for achievement of a set of corporate objectives. Gain-sharing payments usually range from 3% to 5% of base salary. These programs are excellent for instilling institution-wide awareness of company success.
  - Add-On Plans provide additional pay plan flexibility. These plans provide additional lump sum payments to groups or individuals for achieving specific goals. Normally the payouts range from 5% to 8% of base salary. And, add-on plans also provide the foundation for sales incentives such as contests, spiffs, campaigns and referral incentive programs. Annual funding for these types of programs typically averages 3% to 5% of eligible participant payroll.
- **Risk Plans.** Risk plans place a portion of the employee's competitive market competitive pay at-risk for incentive purposes. Use these high-power incentive plans to drive performance. There are three types of risk incentive plans:
  - 2x Capped Plans feature a target incentive that allows the individual to earn twice the target incentive amount for outstanding performance—capped at 2x the target level—and usually expressed as a percent of base salary. Most management incentive plans (MIPs) use this design. Often tied to multiple measures, they sometimes feature forced-distribution payout schedules.

- 3x Un-Capped Plans provide three times the at-risk component for outstanding performers, uncapped. In other words, the best performers (defined as the 90<sup>th</sup> percentile of performance) should earn 3x the at-risk component for their exceptional contribution. This is the most common design for sales professionals. Starting with market-based target pay, the base salary is reduced to reflect the degree of sales personnel persuasion. In most sales compensation plans, individual results drive the payouts. However, when sales personnel must work jointly to complete the sales transaction, use team incentives to reward these outcomes. Quotas are set so that two-thirds of the incumbents reach and exceed quota, and one-third do not. While payouts to the individuals can vary widely, the cost to the company is not variable; the summation of payouts should approximate the target incentive times the number of incumbents.
- Full Commission Plans have no base salary. There is no “target earnings” objective, only the industry known commission rate. Whatever they produce, that’s what they are paid. Commission rates are industry established. Payouts are fully variable and tied to production; costs are fully variable. Earnings are unlimited and can be substantial for “big hitters.” It’s a controversial pay methodology and not as common as many managers are led to believe.

All of these pay plan methods are found in all industries. They are neither good nor bad; they are simply different payout mechanics for use in different circumstances.

### **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% and 15% 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 or 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 with no base salary. 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. And, finally, an income producer's book of business is portable; they can take their customers with them when they change employers.

## **Sales Compensation Principles for Sales Representative Jobs**

While compensation programs for sales support positions and income producers are relatively easy to construct and manage, the pay plans for sales representatives present the most challenges. Typical sales representative titles include: major account manager, territory sales representatives and sales channel representatives. These jobs are in constant transition. Goals are a challenge to set. Objectives change. And, sales compensation plan complexity can easily overwhelm initial good designs. These sales compensation plans are easy to build, but the most difficult to maintain.

Use the following 12 sales compensation principles to design effective sales compensation plans:

1. **Design to Match Job Content.** Craft the sales compensation to match the job content. The number of unique sales compensation plans should match the number of unique jobs. Each job gets its own sales compensation plan using performance measures unique to the job.
2. **Establish Market Rates.** Sales representatives pay planning begins with determining the market rate for the job. Use published survey sources to identify market rates for the 10<sup>th</sup>, 25<sup>th</sup>, 50<sup>th</sup>, 75<sup>th</sup>, 90<sup>th</sup> percentile of the labor market. Adjust target pay levels to reflect company preferred market position. Do not use cost of sales or accept market commission rates as a starting point. Begin with target cash compensation.
3. **Set the Pay Mix.** Split the target cash compensation into two components: a base salary and a target incentive amount. This is known as the "mix" of the pay plan. Put more pay at-risk if the job has high customer buying influence. Put less pay at-risk if the job has less customer buying influence. A 50/50 (base salary/target incentive) is a "high" mix incentive design. A 90/10 is a "low" mix incentive design.
4. **Identify Plan Leverage.** The leverage of the pay plan provides the target "excellent" pay for excellence performance. Excellence performance is the 90<sup>th</sup> percentile of performance accomplishment. The top 10% of sales personnel should meet or exceed this number. Provide 3x the at-risk portion to those who achieve this level of performance. While 10% of sales personnel will exceed this number, a well-constructed formula precludes excessive payouts.
5. **Select the Right Measures.** Select no more than three measures. Measures must reflect what the salesperson can influence. Do not use corporate or compliance measures because they needlessly consume incentive monies. Use qualitative result measures. Do not use activity measures or other "input" measures like "number of sales calls made." Use profit type measures when sales personnel can influence profits through effective pricing or product mix.

6. **Weight the Measures.** Assign a value to each measure. The “weight” of all measures should total 100%. Do not allow any measure to be “worth” less than 15% of the target incentive amount.
7. **Calculate Payout Schedules.** Develop payout schedules for each measure. Divide the pay opportunities by the performance levels to determine the payout levels. This slope calculation produces a payout formula. If territories are dissimilar in size and sales management wants earning opportunities to be alike, use “percent to quota” as the performance basis for the formula.
8. **Define Qualifiers.** Use qualifiers such as thresholds, accelerators and caps as necessary. Thresholds define a minimal level of performance before sales compensation can be earned. Sales management often uses thresholds to avoid paying twice for the same sales production. When revenue continues from previous sales events, thresholds help preclude this “embedded” revenue from receiving additional incentive dollars in subsequent years. Accelerators increase the payout schedule for performance beyond goal. Cost the proposed accelerators to ensure that the pay program does not pay too much or too little at exceptional performance levels. Use caps to protect against unplanned sales events. “Mega orders” are unanticipated customer purchases that propel the salesperson’s results well beyond the outstanding level of performance. When not the result of seller influence, the incentive plan should place a limit or cap on what percent of these unexpected orders provide incentive monies through the sales compensation plan.
9. **Manage Performance Distribution with Quotas.** Quotas help set performance standards. Set quotas so that at least 60% to 70% of sales personnel can reach and exceed. When sales performance levels exceed this target, quotas are too easy. When sales performance falls below this level, sales quotas are too hard.
10. **Establish Sales Crediting Rules.** Carefully define when sales results officially count for payout. Also define when the sales compensation plan splits or double credits sales results among different sellers. Most legal challenges to sales compensation plans occur because of confusing, vague and misinterpreted sales crediting rules.
11. **Document Performance and Payment Periods.** Determine when performance periods begin and end. Determine when payouts occur. If payouts are to occur more frequently than the performance period, then preclude accelerators from becoming effective until the salesperson achieves the performance period goal. For example, if the performance period is annual with quarterly payments, then make quarterly payments on year-to-date results. Do not provide incentive accelerators for above year-to-date quota performance unless the annual number has been achieved. This precludes “spiking” of orders every other quarter to artificially optimize the payout accelerators.
12. **Use a Design Team.** Finally, use a senior management team of sales, finance and marketing to design the sales compensation program. Every year, this team should re-examine all sales compensation plans for effectiveness. Follow the rules provided here to guide the design decisions.

## **Closing—Pursue the Science of Sales Compensation**

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 2008 plans in preparation for 2009. Your sales force expects no less from you.

### **Bio for David J. Cichelli**

David J. Cichelli is Senior Vice President of the Alexander Group Inc, a sales effectiveness consulting firm. He is author of “Compensating the Sales Force” and a course author and instructor for WorldatWork’s certification course in sales compensation. He is a contributing editor to *Sales & Marketing Management* magazine. David is a frequent speaker and article author on sales effectiveness issues. In recent years, he has presented numerous programs on sales compensation in Dubai and Cairo.