

*How to Design
an Effective
Sales Compensation
Program*



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A WELL-DESIGNED SALES COMPENSATION PROGRAM REINFORCES AN ORGANIZATION'S STRATEGIC PLANS

It is a truism to say that a well-designed sales force compensation program should reinforce an organization's strategic objectives. However, many organizations have never developed a well-formulated strategic sales plan. Developing such a strategic sales plan is step 1 to developing an effective sales force compensation program.

The strategic sales plan should act as a "road map" for sales achievement. The plan should take into account the external conditions affecting the company's ability to achieve sales results, as well as the type of sales techniques and approaches that are necessary to accomplish these results. Some of these conditions include:

- Market demand
- Market maturity by market segment
- Competitive conditions
- Economic conditions in the market
- Strategic objectives by market
- Types of sales effort/behaviors desired
- Current/desired sales structure
- Current/desired future skills needs, and
- Other factors which may impact on a company's sales effort

Without a well-formulated sales strategy, a company's sales efforts will be disjointed at best and highly ineffective at worst. Yogi Berra got it right when he said, "If you don't know where you're going, you're liable to end up someplace else."

The sales strategy and sales compensation planning activity is portrayed by Exhibit 1. This illustration displays the relationship between an organization's sales strategy, its people, and how they are paid. Sales people are competitors by nature, and they want to win. The sales compensation plan defines the rules of the game for the sales force.

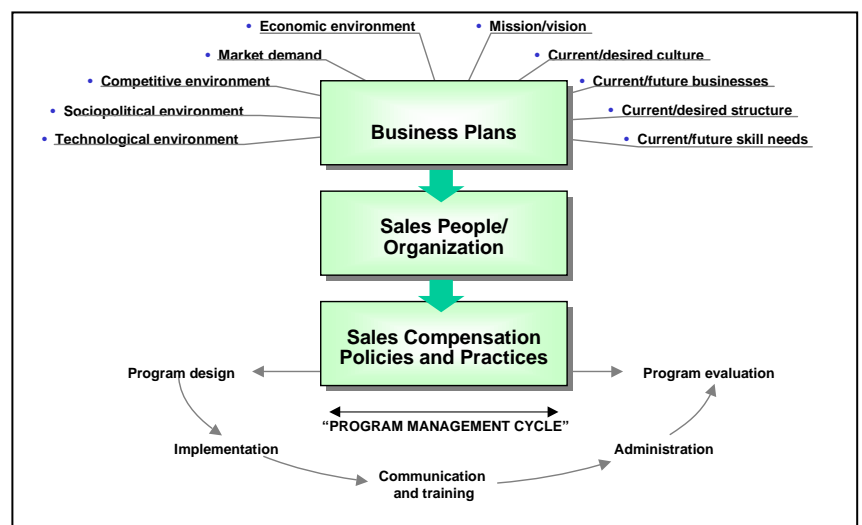


EXHIBIT 1

Sales people, in general, will play by the rules given them in order to make commissions and/or bonuses — in other words, “win.” The sales compensation strategy as it is driven through the compensation program is meant to keep the players running in the right direction and prevent them from scoring touchdowns on the wrong end of the field.

An example of a company which in the 1980’s did an effective job of tying sales compensation to its sales strategy is CompuMat, Inc. CompuMat elected to pay sales incentives primarily on the basis of sound planning and the quality of service delivered to customers, as opposed to paying sales people based on either gross sales or margins alone. CompuMat felt that by emphasizing customer service in the sale of computers and computer related products, it could differentiate itself from other computer resellers of the period, who did not place sufficient emphasis on customer service as a sales strategy.

CompuMat’s customer service strategy became the critical variable in its success equation. CompuMat’s incentive pay programs took into account the development and execution of long-term sales plans and customer relations activities to supplement its quantitative sales goals. Sales people under the CompuMat sales plan were rewarded for their sales numbers, but their rewards could be doubled (and in some cases tripled) if they also met planning and customer relations objectives.

It is axiomatic in the sales profession that it is easier to sell to the satisfied former customer than to the cautious prospective customer. Almost all sales organizations acknowledge that fact and target their sales and marketing activities accordingly. In practice, however, the relentless pressure in most companies to meet sales quotas inhibits the providing of service and the development of thoughtful sales plans. CompuMat knew that unless it rewarded its employees for such activities, planning and customer service would have been subordinated to the quest for generating new business.

CompuMat was rewarded for its foresight by sales growth and margins that were far above average for its marketplace (i.e., the greater Chicago metropolitan area). In 1990 CompuMat was acquired by a much larger organization in its industry, making its stockholders and founders very wealthy. However, during the seven years of its existence (1983-1990), it had grown from \$250,000 in seed money to being the largest computer reseller in the Chicagoland marketplace.

CompuMat’s actual sales incentive plans were relatively simple. The plans mixed qualitative measures (e.g., customer service/satisfaction) with quantitative measures (e.g., revenue, gross profit, etc.). However, a greater emphasis was placed on the qualitative incentive plan factors. This higher emphasis on qualitative factors helped the company achieve important objectives which ultimately led to its great success. These objectives included:

- Supporting the company’s strategic business plan
- Emphasizing repeat sales (i.e., it’s easier to sell to satisfied customers)
- Keeping sound planning and quality service in the forefront, and
- Keeping pure sales dollars from being the overriding force

CompuMat managed to differentiate itself from its competitors through its sales incentive planning process and thereby achieve success. The CompuMat story illustrates the fact that no company achieves great success simply by copying the next guy. The way a company makes sales should differentiate it in some way from its competitors, and the sales incentive program can help in achieving this goal.

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A WELL DESIGNED SALES COMPENSATION PLAN ANSWERS FIVE VITAL QUESTIONS:

- ◆ *Who should participate?*
- ◆ *How much pay is appropriate?*
- ◆ *For what performance?*
- ◆ *When should they get paid?*
- ◆ *In what form should they be paid?*

The answers to these questions become critical to the successful development of an effective sales compensation plan. A useful tool to consider when attempting to answer these questions is the sales approach pyramid illustrated in Exhibit 2.

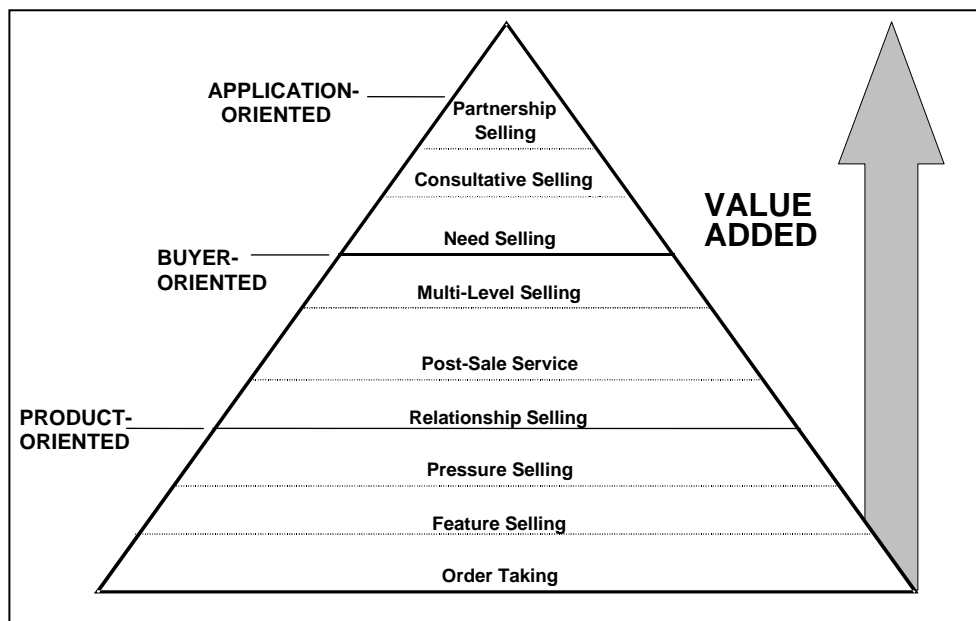


EXHIBIT 2
The Sales Approach Pyramid

The sales approach pyramid describes different types of sales approaches from “order taking” on the bottom to “partnership selling” on the top. When you go to McDonald’s, you experience order taking; the customer simply peruses the options and selects which item(s) he or she would like. When Boeing sells its aircraft to an airline, partnership selling is involved; Boeing has a limited number of large customers to whom it sells its product (i.e., jet airliners), and the customer has input into the product design from the development stage. This process helps to ensure that the customer’s requirements/specifications are met and that the customer will ultimately buy the product when it is produced. Other examples of sales approaches include:

- **Feature Selling** – furniture, electronics
- **Pressure Selling** – automobiles
- **Relationship selling** – insurance, stocks
- **Post-sale service** – office equipment, copiers
- **Multi-level selling** – computer systems
- **Need selling** – determine the customer’s need and supply products to satisfy them
- **Consultative selling** – determine customer’s goals and build or well product to enhance business

In general, the higher a sales approach resides on the sales approach pyramid, the more people are involved in making a sale. For example, if a company was selling a high grade of newly conceived plastic pipe to a city or county to replace its deteriorating concrete and steel sewer, the engineer’s primary role in the sale would be to persuade a zoning commission that the company’s plastic pipe was as or more durable than the steel pipe previously used for the sewer lines and, therefore, that zoning ordinances should be changed to permit the use of the new high-grade plastic pipe.

In this situation at least two people are involved in a consultative selling process (i.e., the sales person and the sales engineer), and both are integral to making the sale. The sales incentive program in such a case should tie these two people together with the common goal of selling the new product line. Therefore, when considering the question, “Who should participate?” (in the sales incentive program), the answer will relate to the number of people involved in the sales process.

The sales approach pyramid in Exhibit 2 also provides a basis for answering the question, “How much pay is appropriate?” Clearly, the more sophisticated the sale (i.e., the higher on the sales approach pyramid), the greater the pay opportunity should be. This is generally true because higher-level sales approaches will involve paying for the talent and skills of more sophisticated sales/support people.

The sales approach pyramid can provide insight to help answer the other essential questions in designing a sales incentive program: “For what performance?” “When should they get paid?” and “In what form should they get paid?” However, there are other factors to take into account when answering these questions. When developing a sales compensation plan, a company should be guided by two key principles.

First:

External factors — not common “salary administration” measures — help to determine:

- The value of the sales position to the company
- The appropriate level of compensation
- The right mix of compensation, and
- The type and nature of the variable component

This principle implies that before developing a sales compensation program, we need to look at the world around us to determine the level of effort/creatively that the selling process requires and the scarcity of the available talent to make the sale.

Second:

A good sales compensation plan increases the company’s return on its investment in its sales force; the plan should focus on asset creation and management, not on cost or liability management.

Sales plans that encourage people to work toward higher levels are effective. Sales plans that focus heavily on controlling expenses fail to motivate appropriate behavior and often annoy the sales force, which is never a good idea. We are not suggesting that expense control is unimportant, but rather that the sales compensation plan, in the eyes of the sales people, should be seen as motivating positive behaviors and not simply as a mechanism that protects the company from every negative situation, no matter how trivial.

Therefore, perhaps the most vital issue to be addressed in the sales compensation plan is the question, “For what performance?” Sales compensation should be tied as closely as possible to performance and should encourage the sales force to strive for ever higher performance levels. One way of looking at potential sales compensation opportunities is illustrated in Exhibit 3.

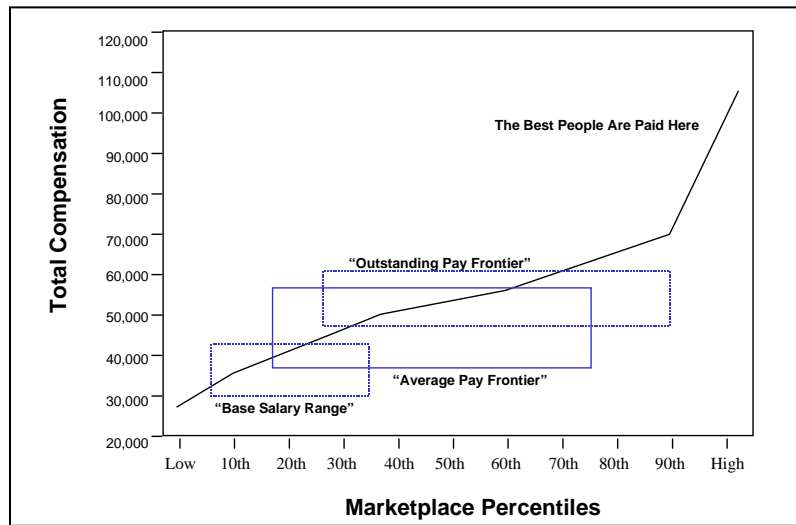


EXHIBIT 3
Sales Compensation Opportunities

It is usually a poor idea to cap the commission/incentive opportunity of outstanding sales people. Very few people ever achieve this level of performance relative to the other members of the sales force on a consistent basis; therefore, the few who do so are extremely valuable. One key toward building an effective sales compensation plan is to develop a program which encourages the outstanding performers to strive to be truly extraordinary. A pay structure that allows the “most outstanding” sales people to be paid in an extraordinary fashion accomplishes several positive things:

- It encourages those who can be extraordinary to be extraordinary
- It sets an example for lower-performing sales people, and
- If developed so as to avoid the trap of unprofitable selling, it promotes a win/win relationship between the company and its sales people

It is important to avoid the “Ross Perot trap.” In his youth, as a member of the IBM sales force, Mr. Perot was one of the company’s star sales people. One year, as the story goes, he had achieved his yearly sales quota in the first quarter. Ross went to his boss and asked, “If I sell more, will I be paid more?” The reply was “no”; he had already reached his bonus maximum/cap. Ross listened to this response — and then spent the rest of the year laying the groundwork to establish EDS (a multi-billion-dollar computer service firm). The rest is history.

In no way, however, are we advocating “giving away the store.” Some primary objectives of any sales compensation plan should be:

- Keep selling costs in line with results
- Control and direct sales force activities
- Attract and retain representatives with desirable sales attributes
- Improve the strategic market position of the company, and
- Stimulate maximum “profitable sales”

However, achieving all of these objectives is not easy; it requires careful assessment and planning.

3

SALES COMPENSATION DESIGN INVOLVES DEVELOPING THE WINNING FORMULA WITH A 25% POSSIBILITY OF SUCCESS.

If something goes wrong in the design of an executive compensation program, a company’s reputation may be negatively impacted; the failure to appropriately link pay with executive performance or other factors can place the company in a poor light. However, if we can refer to the risk in designing an *executive* compensation program as “You bet your reputation!”, then we must describe the risk in designing an effective *sales force* compensation plan as “You bet (the survival of) your company!”

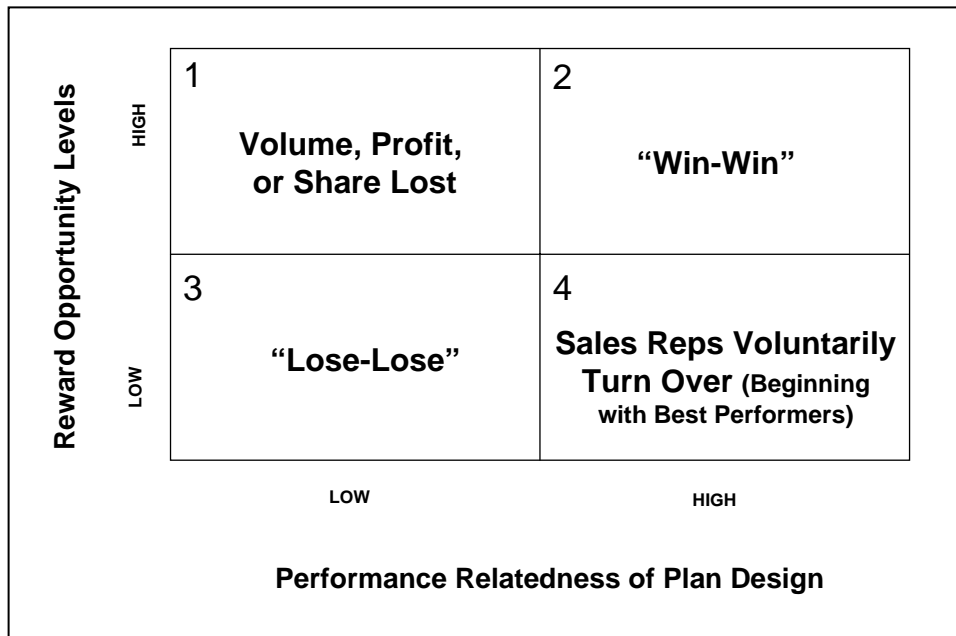


EXHIBIT 4
The Sales Compensation Design Challenge

It is important in the design of a sales compensation program to ensure that “reward opportunity” levels and the “performance relatedness” of the plan are aligned. Exhibit 4 depicts the relationship between four possible outcomes of sales compensation plan design:

1. If reward levels are high but little effort is required by the sales person to make “big bucks,” then the company is probably losing revenue volume, profit, market share, or all three.
2. If there is a direct relationship between the level of performance required to make sales and the reward opportunity for the sales representatives, then everyone wins. The company becomes more profitable, and the sales rep is becoming successful in his/her own right.
3. If reward levels are low and the plan does not encourage the sales representative towards behaviors that achieve appropriate results, then the sales rep and the company both lose: the company loses profits, and the sales rep loses a career opportunity.
4. Quadrant 4 represents possibly the worst outcome of all. If reward levels for the sales representatives are low, but the performance relatedness of the plan design is high (i.e., the plan encourages the right behaviors on the part of the sales reps but does not pay for those behaviors appropriately), it is highly likely that the company will become a training ground for its competitors’ sales forces. The company will have trained its sales people in the skills, attitudes, and energy required to sell its goods/services, but the sales reps will then leave for more pay in a competitor organization.

One method of determining the level of performance/effort that is necessary to sell your goods/services is to consider the level of creativity required in making the sale. For example, it takes a more creative “sales team” to sell a jet airliner than it does a sales person to sell a hamburger; the customer’s sales needs in the case of the airliner are much higher than in the case of the hamburger.

Exhibit 5 provides a map of the level of creative salesmanship involved in making the sale. It is a useful exercise to map your company’s products and services on this grid before making a decision regarding the pay opportunity for your sales representatives.

It has also proven useful to map both a company and its products/services against the normal business life cycle curve when determining the level of creatively necessary to make sales.

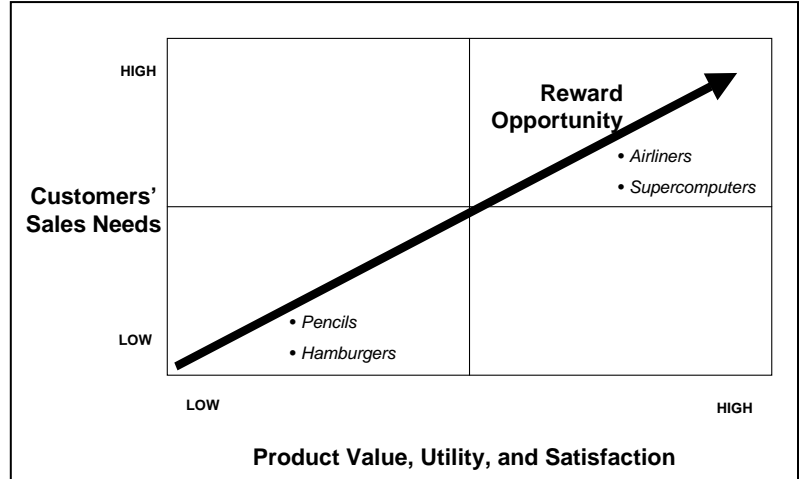
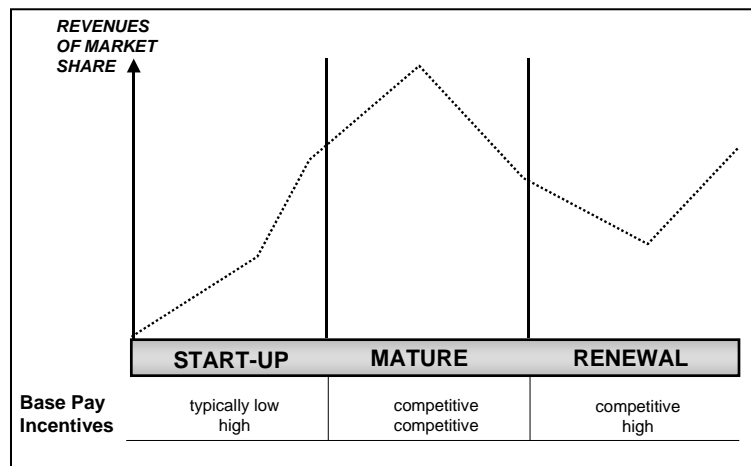


EXHIBIT 5
Creative Salesmanship

Exhibit 6 suggest some possibilities for different pay strategies during either a company’s or its products/services’ historical existence. The pay strategies suggested need to be tested in each new situation. For example, selling automobiles is a relatively mature business, and so we might want to offer our sales people a competitive (i.e., average) base pay and an average incentive



opportunity; for while it is necessary to differentiate our cars from the competition’s, the car itself is a well-known product to the consumer, who is already aware of its utility /usefulness.

EXHIBIT 6
Rewarding Creative Salesmanship

Exhibit 7 provides a more sophisticated example of the use of the business life cycle when making pay plan decisions. It suggests not only pay possibilities, but also:

- Stage of growth
- Business objectives
- Performance measures to be used
- Financial characteristics of the sale
- Role of compensation
- Variability of pay, and
- Other factors that should come into play during sales compensation plan development

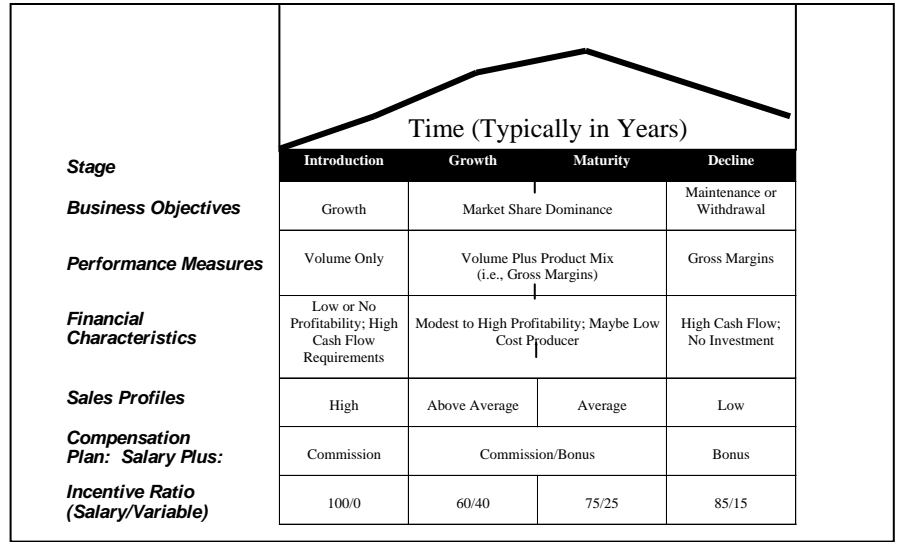


EXHIBIT 7

Appropriate Mix Changes Over Product/Market Life Cycle

The development of an appropriate compensation mix (base/variable pay, long term incentives, etc.) to promote the sale of a company's products and services should begin with a thorough mapping of the company's products/services against the business life cycle, as well as a marketplace comparison of pay against the company's competitors. If this mapping is done well, determining the appropriate compensation mix between base pay and incentives becomes relatively easy, as Exhibit 8 suggests.

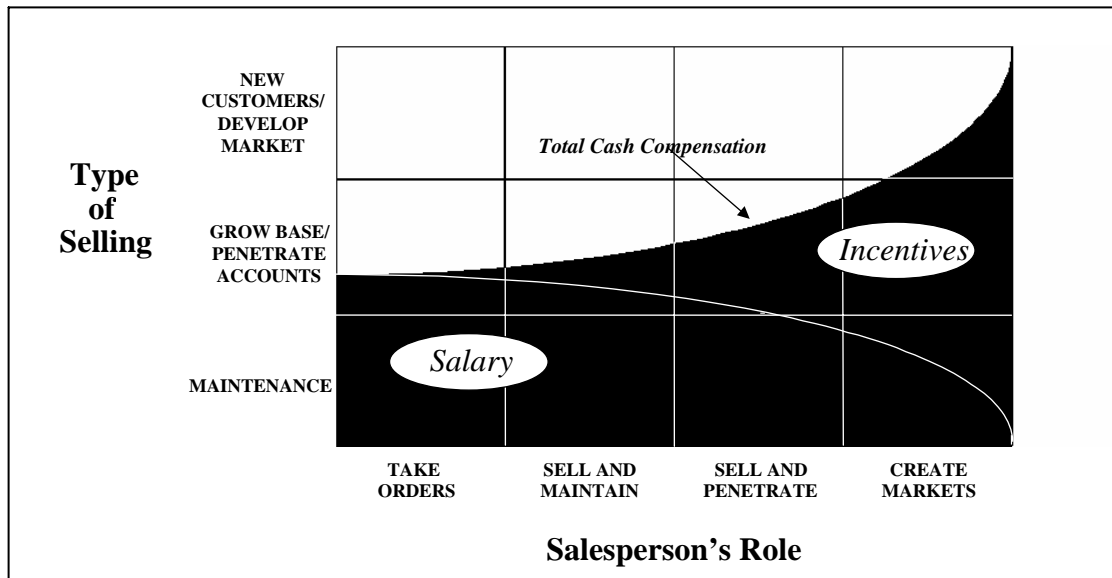


EXHIBIT 8

Compensation Mix – Base Salary Incentive Relationship:
Dollars at Risk Should be Compatible with the Selling Role

There are a variety of ways to mix base pay and variable compensation elements. Exhibits 9, 10 and 11 present three possible approaches, with some general suitabilities and limitations of each.

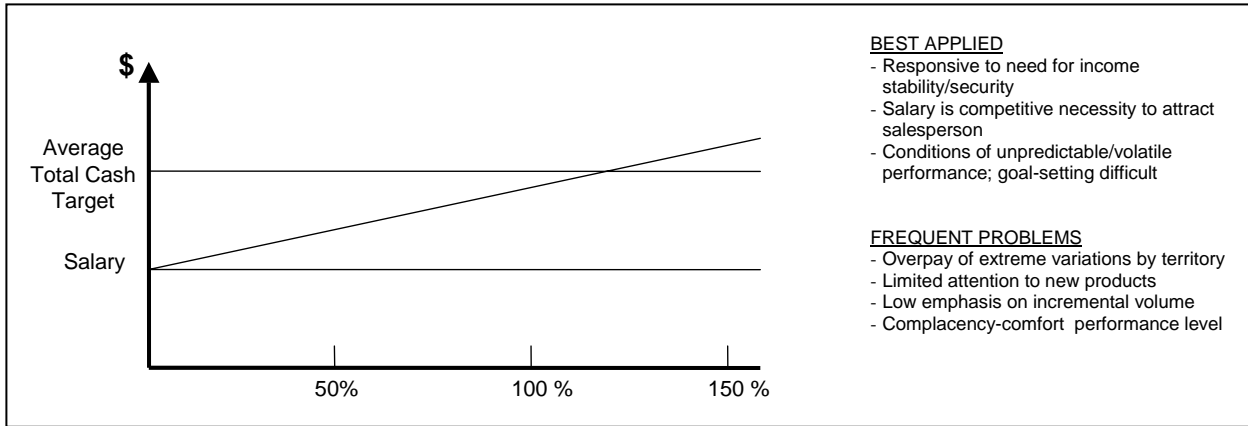


EXHIBIT 9: Payout Options – Salary Plus Commission



EXHIBIT 10: Payout Options – Salary Plus Commission Above Threshold

		GROSS PROFIT CONTRIBUTION					
		X%	X+1%	X+2%	X+3%	X+4%	
SALES VOLUME	\$X	\$5,000	\$10,000	\$15,000	\$20,000	\$25,000	Incentive Payout \$
	\$X+5%	\$10,000	\$15,000	\$20,000	\$25,000	\$30,000	
	\$X+10%	\$15,000	\$20,000	\$25,000	\$30,000	\$35,000	
	\$X+15%	\$20,000	\$25,000	\$30,000	\$35,000	\$40,000	
	\$X+20%	\$25,000	\$30,000	\$35,000	\$40,000	\$45,000	

BEST APPLIED

- Results can be planned and measured
- Predictable performance ranges exist
- Measures are interdependent

FREQUENT PROBLEMS

- Poor goal-setting
- Limited control over key performance measures
- Wide payout variation

EXHIBIT 11: Payout Options: Salary Plus Incentive Payout Matrix

Exhibits 9, 10, and 11 present a limited number of compensation mix options which are available when developing a sales compensation plan. Each of these options is no more than a tool. Just as a skilled and experienced carpenter uses the appropriate tools when building a house, we must use the appropriate tools when developing a sales compensation plan. No one would use a hammer to cut a board or a saw to drive a nail. The sales mapping process described above will help you select the right compensation tools, and use them in the right situations, to develop your company's sales compensation plan.

4

A PROCESS FOR REVISING A SALES COMPENSATION PROGRAM

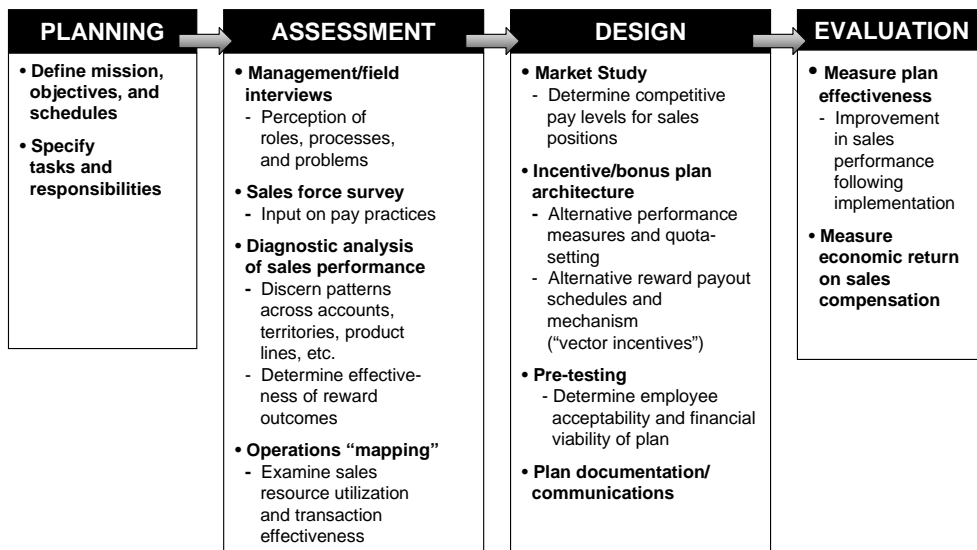


EXHIBIT 12

Exhibit 12 describes a process for planning, assessment, design, and plan evaluation to be used when developing a sales force compensation plan. Comparison with Exhibit 1 reveals that this process, with the exception of "Implementation" and "Administration," is consistent with the "Sales Compensation Policies and Practices" portion of the strategic compensation program chart.

As Exhibit 1 implies, the process of continually aligning sales compensation with sales strategy never ends. This is necessarily so, because the world around us and our competitive environment continue to change. Nevertheless, if a company works to ensure the ongoing alignment of sales compensation strategy and practices with its strategic objectives, it will be rewarded with increased "profitable sales" and ongoing success.