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Developing a successful sales compensation plan involves a seven-step custom-tailoring process. The result should be a "win-win" situation: when the salesperson wins, the company wins.

How to Develop a Sales Compensation Plan

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The ideal sales incentive program directs and motivates the sales force to achieve the company's goals. It helps the company meet its short-term profit and return-on-investment targets and implement its long-term developmental strategy. Simultaneously, it helps to attract and retain outstanding sales talent by providing competitive pay.

Creating such a program is an ambitious goal. To reach it, the company must solicit open and active participation from individuals with different viewpoints at many different levels in the organization. Who should help design the sales compensation plan? Sales and marketing executives and compensation specialists should play active roles. In addition, financial executives, information systems managers, and line sales managers and reps should participate. The response, "That's not my department," cannot prevail, if the designing process is to be meaningful.

Moreover, plan designers must take into account several seemingly irrelevant factors: the corporate culture, for example, senior management's perception of the sales force (asset or liability?), the company's credibility in the eyes of its salespeople, sales force morale, and the strengths and weaknesses of the product line. All these elements affect the company's ability to develop a plan that will achieve its intended objectives.

The company should not take a patchwork approach when structuring its sales compensation program. Such an approach is ineffectual at best—and can be detrimental. The new plan will be successful only if it is carefully constructed from the foundation up, step by step. The results of such an approach will more than justify the time and cost involved.

Steps in Plan Development

Exhibit 1 illustrates the seven steps necessary to develop a successful sales compensation plan. Although the steps are sequential, they are interrelated and overlapping. Different organizations—or different individuals within an organization—will find different steps relevant to their particular needs. Steps 1, 5, and 6 are tied closely to the company's internal environment, objectives, and strategy; steps 2, 3, and 4 focus on the collection, analysis, and application of external data. Step 7 is often done after plan implementation, but it is integral to the development process and to the plan's success.

Step 1: Define the Sales Role

The sales compensation plan should direct the salesperson's contribution to the company's overall marketing effort. Therefore, the plan should define in detail what that contribution should be. What are the salesperson's obligations and responsibilities? What influence does he or she have, and over what? The sales role includes what the salesperson does, to whom, how, and how much—in sum, how the salesperson "makes a difference."

Senior sales and marketing executives, field sales managers, and salespeople themselves should all participate in defining the sales role. Plan designers should interview salespeople and make actual sales calls with them to verify whether management's strategy is being or could be achieved. In addition, sales data by markets and by products should be analyzed for background information to aid the role-definition process.

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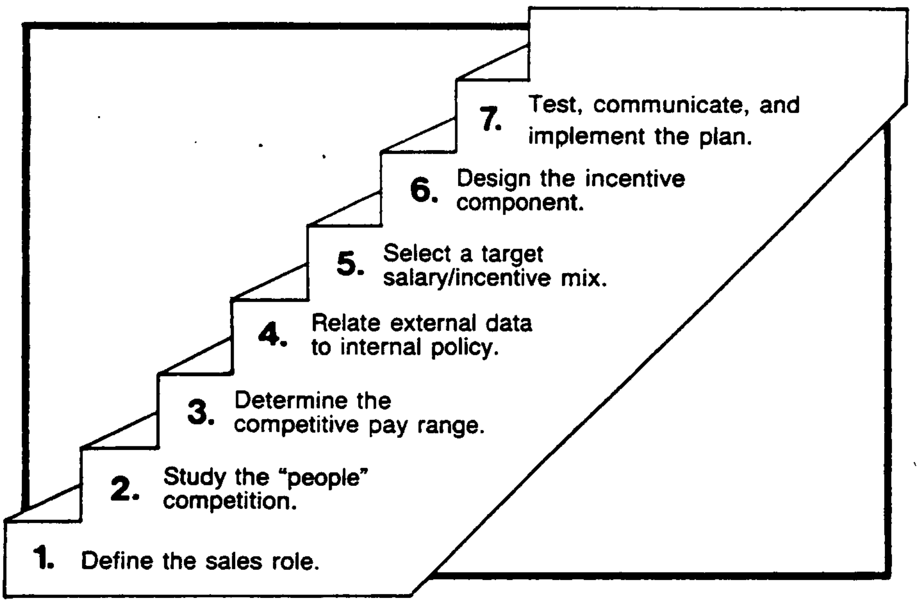
Exhibit 1
Steps in Plan Development



Step 2: Study the "People" Competition

Asked to describe the competition for salespeople, managers often respond by naming the company's competitors. This is too narrow an approach for sales compensation planning. The key question is: What companies' sales jobs – regardless of products sold – are equivalent to our own? In which companies do salespeople have similar responsibilities, need similar intellectual and persuasive skills, and have a similar amount of influence on product placement and specification and on the buying decision?

A good way to compile such information is to conduct a "Where got? Where gone?" analysis of the company's own sales force. Regional or distinct sales managers should report all hirings and firings to a central office including the names of the companies from which talent was recruited and to which talent was lost. This would include information obtained during entrance/exit interviews about the competitors' pay packages – notably base salary and W-2. By combining these reports, a useful profile can be developed of the competition for salespeople. This becomes a handy frame of reference for designing the compensation plan.

Step 3: Determine the Competitive Pay Range

Step 2's "Where got? Where gone?" analysis will provide some information on what competitors pay their salespeople. Other sales compensation data can be gleaned from published survey reports, as well as from occasional articles in the business press. But such information is sparse. It takes a sharp eye and a serious effort to collect sufficient—and accurate—data.

The objective in this step is to determine the *overall pay range* offered by the competition. The idea is *not* to collect specifics of competitive pay plans: how the bonus or commission works, for example, or what the salary-bonus/commission mix is. Such information is interesting, but it can tempt the company to make its sales compensation plan a carbon copy of a competitor's. Just as companies differ in their approaches to product quality, pricing, promotion, and physical distribution, so they should design their compensation plans to meet their own individual marketing needs. In theory, the data collected should be a statistical distribution of the total cash compensation of the sales force of each competitor. In practice, such complete data are usually unobtainable; however, by taking whatever data are available—highs, lows, medians, averages—it is usually possible to assemble a representative composite, create a cumulative frequency distribution, and compute the total competitive pay range.

Step 4: Relate External Data to Internal Practices and Policy

Once the total competitive pay range has been determined, it should be segmented according to the number of categories in the company's own sales force. For example, if the total range is $20,000 to $40,000 and the company has three categories of salespeople (say, entry 2 level, junior, and senior), the segments might be $20,000 to $28,000, $25,000 to $33,000, and $31,000 to $40,000. Thus the median total cash compensation for each competitive segment would be $24,000, $29,000, and $35,500. This calculation provides a starting point for setting the company's own total compensation objectives.

Next, management should decide where it wants to position the company along the competitive pay scale. Does it wish to pay average or seventy-fifth percentile? Perhaps it wishes to pay average for its entry-level salespeople but above average for those higher up. Management must decide how much higher or lower than the competitive medians the company's own medians should be.

Step 5: Select a Target Salary/Incentive Mix

This process is not as arbitrary as it might at first seem. What's needed is a salary high enough to attract talent and an incentive sufficient to motivate. The mix is usually influenced by the "barrier-to-entry" concept—that is the higher the technical expertise, education or industry experience demanded, the larger the portion of total pay that should be provided by base salary.

Field sales managers should be well aware of the base pay each market requires to attract the kind of talent needed. They should also have a strong idea of how much incentive will motivate the sales force, given the nature of the sales jobs and the degree of influence of each individual salesperson. This influence can be direct (such as securing product placements) and indicated by volume; or it can be indirect and shared with other company personnel (such as increased penetration in shared accounts). The influence may be immediately observable, or it may be manifested only after repeated calls on a series of decision makers in customer organizations. The more direct, immediate, and observable the salesperson's influence, the more the incentive will vary with performance.

A typical industrial target mix falls somewhere between 85% salary/15% incentive and 70% salary/30% incentive. The numbers alone, however, may be quite misleading; an understanding of the specific workings of the particular plan is needed to reveal the true amount the salesperson has at risk. To illustrate, an 85% salary/15% incentive plan where the incentive is activated at 100% of sales objective is much more risky for the salesperson than a 70% salary/30% incentive plan where the incentive is activated at the first dollar of sales. Moreover, the salary range for salespeople can be narrower than the range for nonsales employees. The range width (from minimum to maximum) usually needs to be only 130% or 140%, due to the variability of the incentive and its effect on total compensation.

Step 6: Design the Incentive Component

Now comes the fun of sales compensation planning—designing an incentive that fits the unique situation of the company. Basic design issues are: the form of the incentive, i's threshold for activation, its limits or restrictions, the salary/incentive mix, the incentive period, and the performance measures.

The salesperson's importance and the market's characteristics dictate the form the incentive will take. The plan can offer a bonus (either a specified dollar amount, a percentage of salary, or salary midpoint); a commission (essentially a percentage of a result); or some combination of the two. The variable element can be a fixed formula (for example, 2% of all applicable sales dollars or $200 for each percentage of objective achieved over 70%), an accelerating formula (2% up to a certain level and 3% thereafter), or a declining formula (2% up to a certain level and 1% thereafter).

As noted earlier, a key question in any plan design is the threshold that activates the incentive portion. Often companies have preset notions: For example, 80% of objective or 90% of objective is a meaningful threshold, or perhaps no incentive pay should be forthcoming below 100% attainment. There is no such simple formula.

Whatever threshold will make 85% to 90% of the sales force active players in the sales compensation game is the proper threshold to use. If a threshold is set so high that it excludes most of the sales force, it will not motivate the overall sales effort effectively. After all, an incremental dollar of sales is worth the same profit increment whether it comes from an average achiever or a superior one; if the sales incentive plan inspires only superior achievers, it may well be counterproductive.

Another important decision is whether any maximums or caps should be imposed on the amount of incentive that can be earned. Again, management often has strong feelings on this issue that do not take into consideration the company's specific situation. The idea is to stop or minimize windfalls, without discouraging extra effort. Putting maximums on individual accounts is one alternative to overall sales caps. Or a company may take a "perforated-ceiling" approach which lets some portion of the windfall flow through to the given salesperson. This approach can decrease the windfall potential without demoralizing the sales force. In fact, some companies find that the feeling that "someday-it-could-be-me" makes an occasional super-high payout worth its weight in publicity.

No rule dictates that a plan must be uniform across the country for the entire sales force. On the contrary, the sales compenstion plan should be responsive to differences in product lines, market segments, and geography. A plan with variations need not be overwhelmingly complex; it can retain considerable structural uniformity.

The realities of business cycles and the calendar mean that incentives are calculated monthly, quarterly, semiannually, or annually. A company need not use the same time frame for all of the plan features, as long as the combination selected is not too confusing or complex. And, of course, a longer-term program may have progress payment features.

An incentive period is the proper length if it fits the natural rhythm of the particular business. The period must be short enough for quick impact, yet long enough to make each payment significant—not just a tip.

Company-specific situations create other issues incentive designers must confront. These include:

- Split credits: How many splits should be allowed? Only two? Or more?
- Special windfall situations.
- Promotions and transfers—how to provide for a smooth and financially protected transition period.
- Treatment of house accounts.
- Definition of a sale: Is it after booking, shipping, or billing?
- Plan eligibility.
- The incentive plan's retirement payout provisions.
- The plan's treatment of termination and resignation.

- The plan's implications for medical and life insurance.
- Provisions for special assignments or sales relationships with special customers. (This is essentially an alternative pay scheme for particular individuals.)
- Sales contests — that is, miniversions of sales compensation plans that offer great incentives to develop custom-tailored regional programs and build sales-management skills.

Among the performance measures regularly used for sales incentive plans are the following:

- Overall territory volume.
- Segmented volume (key accounts or major products).
- Market share.
- Product placements.
- Number of new accounts.
- Product mix.
- Gross profit.
- Pricing (based on an absolute or peer-ranking percentage of list-price attainment).
- Consistency of sales results (by time frame).
- Bad debt/returned goods.
- A team-based result.
- Training activities.
- Expense control.

Many other measures exist, but most are company specific. The key is to be open so that the most appropriate measures can be chosen.

To be successful, the majority of the sales force must perceive the incentive plan as being fair. But that is not enough: When sales leaders stand up and applaud a new plan because it will reward them well for outstanding salesmanship — that's when the plan will win enthusiastic support companywide. Finally, in designing the incentive component of the compensation plan, a company should always keep in mind the "win-win" goal: Only if winning behavior is in line with corporate objectives will the company win when the salesperson does.

Step 7: Test, Communicate, and Implement the Plan

Unfortunately, once the fun of sales compensation design is over, planners frequently ignore the final step of the planning process, sometimes with disastrous results.

Any plan needs some testing to verify its reasonableness. There are three ways of testing: on paper (past periods vs. assumptions for current periods), by computer (analyzing "what if" scenarios), and pilot projects in restricted geographical areas.

Also, the company must choose a method of conversion. Will it adopt the new plan right away in its entirety, or use certain grandfathering procedures during a conversion period?

Often treated as an afterthought, communication is the most neglected aspect of plan implementation. Poor communication can leave a relatively straightforward plan looking so complex and confusing that it loses its motivational value. A good communicator who has not been involved in the design process is often the best individual to present the program to the sales force. The presentation may include audiovisual materials as well as written and spoken text. And in this era of the personal computer, individual printouts for each salesperson that illustrate what he or she would have earned under the new plan can be a useful communication tool. In addition to group presentations, individual meetings should be held with sales managers to explain the plan in detail. In preparation for such meetings, it's a good idea to develop a list of all the questions that are likely to be asked and to have the answers ready.

Having communicated and "sold" the new program, the company must administer it properly. It is very important to have a key person available who can answer questions and handle all complaints about late or faulty payments. If this aspect of plan design is ignored (and it very frequently is), low morale and poor attitudes can result.

The best-made plans will still require periodic review. A sales compensation plan cannot be forever, as it is only a reflection of the marketing strategy and the competitive scenario at a given time. Consequently, every few years management should review the program's strengths and weaknesses. Is it still able to direct and motivate performance? Does it still link the individual salesperson's success with company objectives?

Concluding Thoughts

Readers who hoped to find in this article an easy, foolproof guide to designing the optimum sales compensation plan are undoubtedly disappointed. If the goal is a credible plan that communicates company goals, directs salespeople's efforts successfully, has an accurate measurement system, rewards competitively, and links individual performance objectives to company objectives, the plan must be custom tailored to each organization. It must be carefully designed to fit the company's marketing strategy, personality, and philosophy and to respond to the dynamics of its competitive environment. The task is demanding, but the results fully justify the effort.

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