Sales Compensation Programs: Built to Last

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Fundamental design changes may be necessary to save a failing system.

Part 1: The Design Process

The executive team at an ailing company told a sad, familiar story: top-line growth was anemic, commission payouts were high and sales force turnover was unacceptable. Yet there was a glimmer of hope on their horizon. They had noticed that their fastest growing competitors were getting excellent sales results with what seemed to be state-of-the-art commission plans. They had convinced themselves that if they made similar changes to their own commission programs, improved sales would surely follow.

A disaster was about to happen. It was clear that although an ill-conceived sales incentive plan may have been part of the company's sales problems, it was far from the whole story. Tweaking the incentive plan design in that organization would be as helpful as rearranging the deck chairs on the Titanic.

This company finally achieved a turnaround, but the eventual solution was much more far-reaching than the executives originally imagined. It took a major overhaul of the entire sales organization and selling processes, not just its commission plans. The result, however, was a sales compensation program that was built to last.

This story is illustrative of the "change the incentive program and the sales will follow" syndrome that plagues many companies today. Their knee-jerk reaction to poor performance is to blame an improperly motivated sales force; because salespeople are motivated by money, the quick fix—and, not coincidentally, the easiest—is to change the commission programs.

This flinch reaction is almost a ritual at many organizations. In fact, most companies with a direct sales force will redesign their commission programs this year. This is not a bad thing in itself—it is important for companies to revisit their sales compensation program each year to ensure its fit for the business. Too often, however, these annual exercises in redesign are so misguided and ineffective that they virtually guarantee that the same executives will be back at the same table with the same task a year later.

Why do so many otherwise well-run firms fail when they redesign sales force compensation? In almost every case, the reason is the unfounded belief that all performance problems are motivational problems and that if you solve the motivational problems, you solve the performance problems.

Organizational Support Issues

Motivational alignment is certainly a critical objective of any compensation program, but it is only one factor among many. Just as important are the organizational support issues associated with implementing sales compensation programs. Companies that focus strictly on motivational strategy when designing sales compensation programs are doomed to repeat their efforts in ensuing years, and most of them do.

Motivating and rewarding a sales force effectively requires more than an elegant commission program design. Significant and enduring improvements can only be achieved when sales force compensation is considered in a larger context that includes business strategy, organization

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design, work processes, systems, controls and human performance—and their interdependence.

A number of leading companies achieved satisfying results by taking this holistic approach to sales performance. They position any move to improve the sales compensation programs as a broad change management initiative, with important implications not only for program design but also for the sales culture itself. In working with these companies, we saw the emergence of a set of leading practices that, taken together, consistently produced critical improvements in sales force—and corporate—performance. These leading practices address both the process by which the organization comes to grips with incentive plan issues and the program design itself.

The first part of this article describes the process improvements these companies are taking to ensure that design changes achieve their intended results. An effective process takes into account not only the sales force's motivational issues but also the real business issues that are the foundation of better performance.

Sales force compensation programs fail most frequently because the organization is poorly prepared to support them.

The Compensation Design Process

Sales force compensation programs fail most frequently because the organization is poorly prepared to support them. Conversely, the experience of leading companies demonstrates that their success is based on the strong organizational support systems that underlie the sales incentives program. The lessons from these companies can be distilled into the six leading practices described here.

Practice 1: The Plan Owners Steer the Redesign Process. Sales compensation programs are usually designed by sales management. On a day-to-day basis, however, finance, sales operations and IT probably "touch" the incentive program more frequently than either sales management or HR. The reality is that when a redesign takes place within the sales management silo, it almost always produces programs that cannot be administered effectively.

If finance, for example, does not participate in the process from the beginning, it may be unable to generate the information needed for the commission plan. If communications is excluded, it is forced to play catch-up at a later date to help manage sales force expectations, forcing management to go on the defensive about the impact of change. Without initial involvement, HR will be unable to bring the new program into conformity with existing administrative policies. To avoid these pitfalls, leading companies form a redesign committee composed of these key stakeholders of sales force compensation.

Consider the case of a multibillion dollar global consumer products company that wanted to realign its sales compensation programs with a new growth strategy. This company's sales organization supports three major divisions with hundreds of different products. Nearly 50,000 purchase records are processed each day across three different information systems, and the sales organization is supported by various corporate and divisional functions for tracking and administering sales compensation. By forming a cross-functional team made up of the major stakeholders in the incentive plan, this company ensured that the sales compensation program designers began the redesign process with a robust understanding of what approaches could be implemented and what could not, given existing process and system limitations. They were aware of any loose controls that were preventing the existing pay programs from achieving their objectives. They appreciated the different levels of support that would be required to handle the various design alternatives.

The result was an incentive program that not only looked good on paper but that worked in practice. Without the involvement of these key support functions, it is unlikely that the new design would have been as responsive to the company's organizational complexities.

Perhaps just as important as providing a multidisciplinary perspective, cross-functional steering bodies can also take the lead in socializing the new program into the organization prior to implementation. By bringing key leaders on board early in the process, the approach contributes to a faster, simpler, more successful rollout. Stakeholder involvement sets the stage for a program that meets the myriad organizational needs that must met to achieve maximum motivational impact.

Practice 2: Line Sales Managers and Sales Reps Own the Outcomes. Sales managers and line salespeople should be involved in all aspects of the redesign effort; their exclusion often results in alienating them even before the new program is introduced. Without this involvement, sales managers and the sales force adopt a "no taxation without representation" stance that casts the new program and the sales executive team unnecessarily as "the opposition."

On the other hand, by including sales management and sales reps in the process, the organization gets the benefit of their understanding of the market and their insight into design issues—including where the plan may be vulnerable to gaming. Even more important, their participation establishes ownership in the outcomes; they will work much harder to demonstrate the validity of their own ideas than to implement a system that is dropped on them from above.

It is wise to use high performers and opinion leaders within the sales force to review design alternatives. Besides generating the benefits of "street-smart" design and sales force ownership, field participation is a form of recognition that helps cement the loyalty of a key constituency.

Practice 3: Plan Governance Ensures Focus. Another typical flaw in redesign projects is the failure to establish clear guidelines defining roles and decision-making authority related to all operational aspects of the program (i.e., quota setting, quota changes, handling exceptions, etc.). Without these guidelines, the program may become unresponsive to the company's strategic needs because no one accepts ownership for driving change.

Alternatively, the company is vulnerable to "design creep," in which program changes and amendments "just happen," without appropriate checks and balances. In a particularly severe case of design creep at one company, in the course of a year, one in three sales reps received an upward revision to compensation (both base salary and commissions) through off-plan adjustments and/or loopholes in company policies.

To avoid these problems and ensure that the program design retains its integrity, some companies create an operating committee, typically comprising senior sales managers, whose role is to oversee the administration of the sales compensation programs and to adjudicate significant exceptions to policy. This form of "governance" allows the roles, responsibilities and authority of all the departments that interact with the sales compensation programs to be clearly defined. It clarifies the decision-making process—who makes them and when—around quota setting, quota allocation, negotiating reps' pay levels and so forth. And it specifies the timing for the milestone activities (like quota setting and allocation) that drive the program.

Practice 4: Pilot Test before Roll Out. Even the most tightly designed incentive program can produce unintended consequences in the field. Information thought to be helpful to the sales force might, in fact, lead them down a blind path. The systems changes intended to capture the right information to credit sales in fact do not. As a safeguard against such failures, leading companies build a pilot phase into the implementation plan of any new sales compensation program.

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For most compensation professionals, the idea of a pilot will probably raise some eyebrows or induce sidesplitting laughter because most redesign efforts never get mobilized until the last quarter of the fiscal year. At best, a perennial sales force complaint is working for weeks or months into the new fiscal year without knowing its incentives. Under that kind of pressure, there is little choice but to bypass a pilot and go straight to full rollout.

Yet the companies that use a pilot approach do so precisely because they were burned in the past when they rushed straight to implementation. They find ways to make sure that the program elements are tested before putting the full weight of the sales organization on them.

In rolling out a new sales incentive program that was designed to motivate more profitable sales, a mini-mill steel manufacturer conducted a pilot test of its new program in the first quarter of its new fiscal year. By the end of the quarter, the company learned that the program could be strengthened with better financial reports and increased rep participation in the quota-setting process. Changes were implemented in subsequent quarters, and these new elements were met not only with strong support from the field but also higher profit margins for the year.

A pilot will include a test period that prototypes the design recommendations in discrete markets for at least a full quarter. The test markets should be low risk, in which a new plan can be introduced without disrupting major business flows. Establish evaluation criteria for the pilots in advance, and provide adequate tracking systems. Use the test results to refine the design before organization-wide implementation. Not only will the program be stronger as a result, but also field participation in the tests builds credibility and support for the finished product.

Practice 5: Gather Competitive Data on Both the "How Much" and the "How" of Sales Force Pay. Most companies obtain competitive data on sales force pay levels (the "how much" of pay). This information is generally easy to obtain through published compensation surveys and trade magazines. Yet companies often rely on incomplete or anecdotal information about competitive performance standards and plan design features (the "how"); sometimes these critical elements are based on no external information whatsoever.

The reason for this omission is understandable: Quality information on competitive practices in commission plan design is very difficult to find. As a result, the commission plan redesign may generate competitive compensation levels, but they may be based on performance demands that are either too high or too low compared to the marketplace. Worse, the plan could include features that are inconsistent with competitive practice. Even if there are good reasons for these competitive inconsistencies, it causes major communication problems with the sales force when it appears that management is not aware of external practices.

This problem can be avoided by conducting a comprehensive compensation survey that focuses not only on the pay levels of relevant peer companies but also on incentive design features—quota-setting policies, productivity levels and performance metrics—as well. The resulting data provide a solid base for program design, cutting through the myths and hyperbole that often limit the usefulness of anecdotal information.

Practice 6: Communicate Frequently: What, How and Why. Many companies prefer to communicate only the outcomes of decisions to their employees. "You'll know as soon as we have something to report," is the mantra. But this "need-to-know" model fails to manage employee expectations. When design changes are not communicated until they are about to be implemented, the company risks losing control of its change management agenda. Presented with a fait accompli, sales management may refuse to endorse the program changes, and the sales force may resent them and resist buy-in.

Much better results can be achieved by involving a communications professional from the outset of the design process. Develop a communication strategy for achieving the desired responses from all stakeholders. Include progress reports in the communication plan to help manage expectations and provide information about progress and timing.

These lessons from leading sales organizations can be summarized in one piece of practical advice: Stop the insanity of the quick-and-dirty annual sales incentives redesign. However well intentioned these efforts may be, they generally condemn the company to repeat the same old story: an undisciplined sales force failing to achieve budget, followed by yet another postmortem focused on trying to fix the ills of the past.

Instead, look to the future. Understand the business and its financials, the sales force and its processes. Create a framework for a sales compensation programs based on that knowledge and it will be built to last. Within that framework, the program can then be fine-tuned as needed—not overhauled or discarded—to respond to the inevitable changes in markets and strategies. That is a game plan that delivers superior sales performance.

Part 2: Designing for Results

It was a simple question: "How does your sales commission program work?" The answer, provided by a sales manager who had been involved in the design, took two hours, six policy documents, a spreadsheet and three painkillers to answer. Apparently, the complexity was worthwhile. When the company's sales executives rolled the program out two years ago, they thought they created the perfect design. The program linked business strategy to rewards, focused on sales rep retention and created excitement in the field.

Two years later, turnover was down, excitement was up and the plan seemed to conform nicely with the company's culture and systems. There was just one little problem: Commission payments were at an all-time high, but financial performance was at an all-time low.

The first part of this article argued that there is much more to a successful incentive plan than program design. Leading companies focus first on getting the design process right, ensuring that the compensation plan will be appropriately supported after implementation. The six leading practices described combine to ensure that an otherwise excellent program design will not be sabotaged by flimsy systems, low credibility or unintended outcomes.

Process is critical. In paying long-overdue attention to process, however, it is important not to forget about the design. Robust processes that support an inappropriate design will create just as much havoc as the reverse—as the sales manager cited earlier can sadly attest.

With most executives instinctively paying more attention to the design of the sales incentive plan than they do to the underlying processes, it is surprising how many companies get trapped in a cycle of ineffective design and disappointing results. There is a way out: Six leading practices capture the design lessons that help avoid these frustrations. The rest of this article outlines these practices. Exhibit 1 answers a corollary question: After applying the leading practices to both the process and design of the incentive plan, how do you know when you have built an effective program?

Sales Compensation Program Design

Practice 1: Design Total Pay, Not Just Incentive Pay. Because the sales commission plan is such a powerful motivational tool, some organizations come to think of it as the only means of managing the sales force, to the exclusion of other important performance management tools. As a result, the incentive program becomes overloaded with features intended to drive every aspect of individual performance; this rarely adds to its effectiveness. Performance problems that would be better addressed through HR tools like salary administration, career development and training often become worse instead.

In assessing how to motivate the sales force, leading companies view commissions and bonuses as just one tool in the motivational toolbox. Salary administration, performance management, career pathing and recognition programs can also be powerful ways of producing and managing sales results. Companies that consider the impact of all these programs in the re-

EXHIBIT 1

A Good Sales Incentive Program: How To Know One When You See One

The body of literature on sales compensation programs is robust and generally provides sales compensation specialists with plenty of information on how to develop an incentive program. It offers, however, surprisingly little guidance on how to know if the job is done well.

Some general rules of thumb are widely used. Most companies want a majority of their sales force to meet or exceed competitive performance standards for the role. A typical "healthy" commission payment distribution would be as follows:

- 75% or more of the sales force achieving quota or better.
- 10% of the sales force achieving higher performance levels.
- 5% to 10% of the sales force achieving below-quota performance and receiving performance development coaching.

For this type of commission payment distribution, a company should expect to achieving its plan or slightly better than plan.

Most companies also expect—and some of them demand—a certain amount of turnover among the low performance group, generally about 5% to 10% per year. It is clear, however, that today's economy, with its reductions in force and fewer open positions, has caused lower than normal turnover levels at most companies.

These are the standard quantitative expectations. But are they enough? Some leading companies expect more from their sales compensation plans. These companies stretch the boundaries by asking questions such as the following:

- How well does our plan deliver the desired product mix and profitability levels?
- How effective is the plan in encouraging the right type of sales behavior (e.g., teaming, customer consulting and solution selling)?
- Does our program support or hurt our case as an employer of choice, and does it attract the type of sales person we seek?
- Are we achieving the kind of sales rep turnover (and retention) we need to keep our sales force fresh and hungry?
- Does the program support our career development strategy for the sales force?

If the results your sales force is achieving are at least consistent with the competitive norm and you can answer the above questions to leadership's satisfaction, your company is probably doing better than most. Although no sales compensation program is perfect, yours is at least founded on sound design principles.

design process are generally more successful in driving both short- and long-term results.

Consider the case of a footwear manufacturer and retailer that was emerging from turnaround. The company wanted a commission plan that would create a sense of urgency around results, build a spirit of teamwork and galvanize support for change. Rather than focus only on commission plan design, the company took a step back and implemented sweeping total compensation changes, including a base salary reduction and doubling of the incentive upside. In addition, the program allowed salespeople to exchange cash for stock options. The program was enormously successful with the sales force and had the added benefit of reducing cash flow and raising earnings per share. More important, the result was a total compensation strategy that had appropriate links to the business and HR strategies. This comprehensive approach ensured that all pay elements reinforced one another.

A more fruitful approach backs away from the easy fixes to look at the bigger picture of corporate strategy, competitive positioning, desired behaviors and results and administrative issues and constraints.

Practice 2: Start with Commission Design Principles, Not the Commission Design Itself. Many design committees cannot resist the temptation to jump right in to solve the commission plan's all-too-obvious problems. The result of such efforts is usually a commission program that promotes some, but not all, of the desired results. The program may contain tactical fixes, but it does not address long-term strategic issues.

A more fruitful approach backs away from the easy fixes to look at the bigger picture of corporate strategy, competitive positioning, desired behaviors and results and administrative issues and constraints. The holistic perspective that results from this effort pays off in a program that rests on a firm philosophical foundation.

A successful technique for creating this framework is to take the time to articulate core principles about the program at the very beginning of the process. These principles express the company's beliefs about key business fundamentals. They become the standards against which design alternatives can developed and evaluated. When well conceived, design principles also have ex-post utility of preventing any stakeholder group from derailing a recommended design by claiming it overlooks a key need.

Practice 3: Ensure the Systems Can Handle the Design. A common problem that sales organizations encounter is that their supply chain systems are not designed to support key strategic considerations in motivating the sales force. More often than not, companies launch a new commission program only to find that their systems will not capture the transaction details required by the design. This results in, at best, a series of workarounds and manual interventions that layer on more administration than necessary. At worst, the plan design is "dumbed-down" to accommodate the system limitations.

One of the most common areas where we see this occur is in the treatment of credit assignment. For example, consider the situation in which a sales rep is reassigned to a new territory and another rep assumes responsibility for any outstanding orders that have not already shipped. Assuming the company credits commissions at the time of shipment, who should get credit for the sale—the sales rep who wrote the order or the sales rep who made sure that the order in fact shipped?

The answer to this question hinges in part on how much value the salesperson adds to the process of getting booked orders shipped and what behaviors the company wants to motivate. Yet a number of companies that might otherwise assign partial credit to both reps often find that their order-processing systems are unable to accommodate this type of credit assignment. As a result, these companies often need to marginalize their plans because of a limitation of their supply chain systems.

In many cases, if the key stakeholders are represented among the plan designers, system limitations can be identified quickly. A prudent approach is to review plan alternatives with appropriate system resources as early in the process as possible. This way, system constraints can be addressed before the new program is rolled out.

Practice 4: Design to Support the Selling Process, Not Fight It. Some commission plans focus solely on key outcomes, neglecting to consider how those outcomes are obtained. When sales reps achieve target results in dysfunctional ways—including gaming the system—they can do more damage than good numbers are worth.

This problem can be avoided if the program design reflects an understanding of how the sales process works, from initial customer contact to order processing and all the way to order fulfillment. The compensation program should acknowledge both the results and the way those results are achieved, rewarding the key roles that influence the sale. For example, if the company is seeking to encourage teaming and cross selling, the use of referral bonuses or special incentives is usually just a superficial way of achieving these results. A more thoughtful solution could be in assigning cross-product quota targets—for example, a $1 million quota for a specific product plus a $500,000 quota of any other products—to reinforce that the company genuinely wants sales reps to do more than just focus casually on selling across product lines.

Leading sales organizations invest in learning what makes their sales force tick and how the sales process actually works. The payoff on that investment is an incentive design that addresses the critical behaviors that produce superior results, as well as the results themselves.

Practice 5: Align the Program Design with the Career Development Strategy. Because compensation is such a high-profile factor in sales performance, it is easy to think of it in isolation of less visible but highly important issues like career development. With the focus exclusively on pay, the incentive program overlooks skill development so that new reps fail to get the training they need and experienced reps are not groomed for sales management. Far-sighted organizations analyze the core skills, outcomes and behaviors required for each incentive-eligible role and design features into the plan to support the development of these capabilities.

For example, when a direct-marketing company analyzed its turnover statistics, it found that new sales reps typically left within the first six months. Exit interviews cited lack of training and attention from sales managers as the leading trigger of turnover. Interestingly, the existing sales compensation programs rewarded individual sales performance, even at the manager level. The company responded by implementing a new sales manager compensation program that decreased the focus on individual sales and implemented new performance metrics.

These metrics were focused on the performance of sales manager responsibilities, such as achievement of sales goals by new employees, year-over-year territory growth and the performance of other reps who were newly promoted to supervisory roles. These changes served to align sales manager pay with the position's priorities. Ultimately, they helped dramatically reduce new rep turnover and drive sales growth.

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Practice 6: Model Both the Economic Impact and the Accounting Treatment. Some program designs are effective in driving selected results but fail to make a positive impact on the company's financial statements. Most frequently, this problem manifests itself in selling costs that are not aligned with the recognition of revenue.

In the early part of 2000, companies were required to conform to the SEC's Staff Accounting Bulletin #101, which forced companies to recognize sales on the income statement more closely in line with when the revenue is actually received. This change had a dramatic impact on the technology community, where most sales involve significant, multiyear contracts, and particularly on those companies that paid commissions at the time an order was signed—an especially common practice among startup companies.

Companies that had employed creative accounting to recognize revenues for multiyear contracts up-front or before product was actually delivered to a customer could now only report a portion of these revenues. Their selling costs, on the other hand, reflected commission payments on the full contract value, significantly eroding profit margins. The result of this accounting change was devastating for many companies. In one high-profile case, a leading technology company missed a quarterly earnings forecast as a result.

Exemplary sales organizations understand the revenue, cost and profit recognition issues in their companies, as well as their accounting implications, before they implement a new sales compensation program. These critical factors can then be built into the plan so that results are never assessed outside the overall economic and accounting context.

Companies need to stop the insanity of the quick-and-dirty annual sales incentives redesign. The six process practices described in the first part of this article will help to create an enduring framework for effective incentive plan design.

The six design practices presented in the second part focus on the contents of the sales compensation plan itself. These design practices combine to build a whole program for the whole salesperson, a sales compensation program that will motivate sales while also shaping behaviors and supporting long-term career development.

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