Sales Compensation

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Abstract
Sales compensation plans cover employees who are fulfilling sales jobs. Such plans have four fundamental elements: the range of cash compensation opportunity, the mix of base and incentive pay, the extent pay-at-risk is leveraged, and the selection of pertinent incentive goals. This document provides an introduction to sales compensation and then discusses the basics of sales compensation plan terminology and design.

Sales compensation can be distinguished from other employee pay programs because salespeople have a direct and measurable impact on the company’s revenue productivity. This impact creates the opportunity to directly link a salesperson’s individual performance as it relates to developing a positive impact on the business by:

- Supporting the company’s marketing and selling plans,
- Communicating performance expectations,
- Influencing the efforts and behaviors of employees engaged in the selling process by rewarding based on performance outcomes, and
- Contributing to the culture of the sales organization.

This document proceeds to introduce the terminology of sales compensation plans and then discusses the design elements of such plans.

Basic Sales Compensation Terms
There are four sales compensation terms that are basic to plan design:

- Target cash compensation,
- Mix of base and incentive pay,
- Pay-at-risk leverage, and
- Selection of sales incentive goals.

Target Cash Compensation
Target cash compensation is the amount of base pay plus incentive payments that are made available by the sales compensation plan for eligible employees who achieve expected performance results.

Eligible employees are those that fulfill customer-facing jobs that have a direct impact on sales results, and therefore, can be assigned a measurable sales quota.

The amount of cash compensation to target for the purpose of attracting and retaining the caliber of sales talent needed to achieve company revenue goals is influenced by job content and scope of responsibility, competitive pay philosophy, portion of the sales and marketing budget allocated for sales compensation expenditures, and internal equity of payments to sales employees.

Job content and scope pertains to understanding each sales role by the breadth of responsibility, degree of accountability, focus on customers, and influence over financial goals. Consider, for instance, how a sales manager’s job may differ from a sales representative’s job. For instance, a sales manager’s job has more administrative responsibility.

A competitive pay policy articulates an organization’s strategy for competing within targeted labor markets to recruit the employees it needs to achieve business success.
Consider the availability of capable employees within your recruiting markets to determine your competitive pay policy. Targeting a compensation level at the 75th percentile of competitive pay practices may enable a company to be more selective of their employees than another employer that targets the market median pay level. (Please refer to a separate white paper on this topic for more information.)

Financial resources that a company can avail to execute its sales and marketing plan includes the expenditures it expects to pay the sales force for achievement of the plan. Sales compensation competes with other expenditures to produce company revenues.

Sales compensation plans must be designed to ensure that pay levels are commensurate with performance results. Assuming that goals are credible to the sales force and meaningful to the success of the business, internal equity occurs when top performing sales employees receive higher pay relative to average performers.

Mix Of Base And Incentive Pay
Mix, in sales compensation, is the relationship of fixed and variable cash, where the fixed portion is base pay and the variable portion is incentive pay. Compensation mix is expressed as a percent of target cash compensation. In practice, mix represents the ratio between fixed and variable compensation in the targeted cash compensation value at expected (i.e., planned) performance.

The ratio is expressed with the first value representing fixed compensation and the second representing variable. For example, a mix expressed as 25:75 means that target cash compensation is composed of 25% base salary and 75% incentive. For instance, a target cash compensation amount of $100,000 would be composed of $25,000 base salary and $75,000 incentive.

The basis for incentive payment can vary. The incentive opportunity is typically expressed as a percent of base salary or target cash compensation for bonus plans. For commission plans, the incentive is typically expressed as a share of each occurrence such as for each profit dollar, each revenue dollar, or each unit sold.

The extent to which a salesperson can influence the customer’s decision to buy is the primary factor used to determine pay mix. Incentive opportunity tends to correlate with the role of the salesperson to impact the customers’ decision to buy. Generally, the more a salesperson has to rely on influencing skills to produce a sale, the higher the incentive opportunity in the mix proportion.

Pay-at-risk leverage
Leverage is the rate at which incentive compensation is enhanced for degrees of performance improvement. The maximum incentive opportunity is added to base salary to determine cash compensation at the established level of optimum performance.

“Double leverage” means that the target incentive for expected performance is twice that amount for optimum performance achievement. “Triple leverage”, follows the same logic. Double or triple leverage are typically used to motivate the sales force to achieve optimum performance.

Leverage is important because it defines the point at which optimum performance is achieved and rewarded. Leverage also links the value of additional sales over targeted goals to the amount of incentive opportunity. The extent to which incremental sales are valuable to the business determines the amount of leverage the company will offer its sales force.

Figure 1 demonstrates a comparison between an incentive plan with the same mix of base salary and incentive for target cash compensation, but different leverages.

<table>
<thead>
<tr>
<th>Target Cash Compensation = $50,000; 50/50 Mix</th>
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<td>Base Salary</td>
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Selection Of Sales Incentive Performance Measures
The sales and marketing strategy plus the product distribution channels determine the suitable performance measures for sales compensation plans. All sales compensation plans should incorporate a production goal. Additional measures, such as product, customer, and milestone measures can be used in addition to the production goal. The following are the four categories of sales measures with sample goals:

- Production (volume)
  - Revenue: total, new, renewal, price, margin
- Products (includes services)
  - Units sold, product mix, up-selling
- Accounts (customers, channels)
  - New, retained, expanded, satisfaction
- Milestones (events and activities)
  - Threshold achievement, contract commitment
When designing sales compensation plans, select performance measures that support the organization’s business objectives. Volume is commonly used since the core responsibility of most sales jobs is to expand the company’s market share, develop new business, and grow the customer base. Changes in sales volume are the best way to measure the successful production of the business.

Incentive goals must consider the accountability of the salesperson to impact the performance measure. The incentive goal must have a basis for being measured, and the number of different measures should be limited to three.

Several business factors must be considered to determine the fundamental strategy for sales compensation design:

- **Business growth stage** – If the business is a new start, there may be zero cash to pay a sales representative a base salary. Product delivery may be dependent on influencing prospective customers to purchase a product to fund that product’s development. In such a case, the sales representative would be paid purely by incentive (a 0/100 pay mix). If the business is more mature and established, then performance will be more predictable and target cash compensation may consist of a mix that includes a base salary and an incentive that is based on a quota.

- **Sales territories** – Geographic territories must offer equivalent sales potential to the sales force. If designing a sales compensation plan around geography, study dimensions such as territory size and demographics.

- **Marketing focus** – the plan and the selling role will have greater complexity if the company is concentrating its product to market efforts in many markets as opposed to fewer.

- **Application of thresholds** – thresholds are minimal levels of performance that must be achieved before an incentive is paid. Thresholds are used to cover the fixed costs of base salary, to establish a minimum performance standard, and to recognize a margin for quota-setting inaccuracies. At least 90% of sales personnel should meet or exceed the threshold performance level. Thresholds may be determined based on historical customer buying trends or break-even volume.

- **Application of maximums** – maximums are total compensation that may be earned and are otherwise known as a “cap”. Generally, sales incentive plans are designed without a cap so as not to limit the performance capabilities of top producers. The rational for caps would be to limit earnings to profitable levels of sales volume, to control costs, and to overcome erroneous quota setting (e.g., windfalls).

- **Salesperson influence** – The degree to which demand for company products must be created, versus satisfied, by the salesperson.

- **Quota allocation** – The degree to which sales quotas can be reliably and accurately determined is compromised if the business is very dynamic such that setting quotas is difficult.

- **Sales event** – An occurrence when a sale may be counted for compensation purposes. Management must consider the point at which sales credit is assigned because once assignment occurs, the salesperson will no longer be concerned with the sale.

- **Windfalls** – A major sales event may result outside of the salesperson’s normal influencing role. Maximums and other techniques are sometimes imposed to control for windfall events.

- **Shortfalls** – A sales result significantly below expectations which are not influenced by the sales representative may be addressed by adjusting the quota downward, providing a guaranteed incentive payment, changing the mix to emphasize the base component, or adding a bonus component with a predetermined incentive goal.

- **Payment timing** – A performance cycle is a period in which performance can be measured (i.e., monthly, quarterly, annually). Determining the timing of sales incentives depends on how the sale is made such as size of the sales transaction, number of transactions, length of the sales cycle, forecast accuracy (quota setting reliability), and the desired sales force behavior.

- **Draws** – A plan designed with a draw feature is for new salespeople that are accustomed to a relatively stable compensation cash flow. A draw is a compensation that is paid in advance of performance and is used to provide temporary cash flows to the salesperson until she begins earning incentive pay. There are two types of draws:
  - A “recoverable” draw provides for a minimum cash flow that is paid-back when actual earnings exceed the draw. Payback typically occurs at the next payment.
  - A “non-recoverable” draw provides compensation guarantees to new salespeople that expire at a predetermined time. No compensation needs to be paid back if sales performance doesn’t create earnings that meet or exceed the draw.

**Basic Sales Compensation Design**

There are four basic sales incentive plan designs:

- **Base salary only plans.**
- **Commission only plans.**
- **Base plus bonus plans.**
SALES COMPENSATION

- Base plus a combination of commission and bonus plans.

Base salary plans pay total cash compensation in the form of base salary only (mix is 100/0). These plans are rarely used in sales compensation unless supplemented with non-compensation methods to encourage desired salesperson behavior. Base salary only plans may also be appropriate where quotas are impossible to set and there is a complex multiple year sales cycle (e.g., commercial aircraft).

On the other hand, sales compensation plans can have a pay mix that is 0/100, meaning that no salary is paid and salesperson earnings are 100% at risk. These are called pure commission plans and compensation paid to the salesperson is either a percent of the sales revenue or a flat dollar amount for each unit sold. Commission only plans reward the individual effort of the salesperson to deliver sales results by focusing on increasing product volume, and to ensure variability of the compensation expenditure. There are three types on commission plans:

- Flat – Whereby cash is paid on a volume rate that doesn’t vary.
- Ramped – Whereby the rate changes after an objective has been met. The ramp may be progressive whereby the commission rate increases, or regressive whereby the rate decreases.
- Variable – Commission rates in the incentive plan may vary depending on the salesperson’s performance or on the particular measurement used.

Combination plans (i.e., base salary plus commission and/or bonus) are commonly used because quota’s can be difficult to set or management wants to reward specific behaviors using a bonus. The rules for calculating a bonus payment are the same as for a commission plan. The difference is that commission plans provide a fixed rate of earnings for each sales event, whereas, bonus plans provide a varied rate of earning based on individual quota for each sales event. In other words, commission plans act as an absolute calculation method whereas bonus plans act as a relative calculation method. Figures 2 and 3 exhibit commission and bonus plans.

Plan Implementation Considerations

A plan document must be written to state the terms and conditions of the plan. The plan document states the purpose of the plan in a way that avoids confusion should unexpected outcomes arise to protect both the company and the employee. The plan document specifies eligibility criteria, performance measures, and timing of awards, among other matters such as termination of the employee or the plan. Company leadership should review plan documentation with legal counsel before implementing the plan.

Once the plan terms and conditions have been decided, communicating the compensation program to the sales force may begin. The new plan must be communicated with positive influence over salespersons for a smooth transition to occur. Senior and field sales management must own the plan design and communicate it to the sales force. Face-to-face (superior-to-subordinate) communication is preferable. Communication must not stop after the initial plan introduction. Management will gain significant advantage through ongoing communications. Salespersons will gain advantage by monitoring their achievement toward established goals.

Finally, testing the plan before initial communication and subsequently (after implementation) is critical to determining if a sales compensation plan is an effective one that is operating as planned. Annually evaluate the plan from two perspectives:

- The employer’s perspective considers cost versus plan budget, observation of desired behaviors among the sales personnel, quota distribution against actual results, sales outcomes versus established goals, and competitiveness of earnings generated by the plan.
- The sales employee’s perspective considers the equity of a pay-for-performance plan (e.g., do top performers earn the top awards), quota and goal attainment difficulty, total pay levels versus expected pay levels, and perceived competitiveness of the company’s sales compensation plan.

Conclusion

Sales compensation designers should assess the current incentive plan to confirm and validate the following areas of interest:

- Is the structural design of the plan appropriate; does it properly apply the principles of sound compensation design? Three areas to assess include:
  1. Consistency with the job content and scope of responsibility
  2. Competitiveness with pay levels, mix and leverages (i.e., is the plan attracting and retaining the desired talent?)
  3. Comparison with common plan practices to assess whether the calculation method, commission or bonus, is consistent with recruiting market competitors.

To determine whether the plan contributes to business success, assess the plan’s alignment with business and human capital management objectives, pay-for-performance results, sales talent results (i.e., ability to retain top talent) and the competitiveness of sales compensation in the relevant recruiting markets.

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Figure 2
Percentage of Sales Volume Opportunity

- **Optimal Pay-for-Performance** $80,000
- **Targeted Pay-for-Performance** $50,000
- **Base Salary** $40,000

Sales Volume:
- **Threshold Sales** $800,000
- **Target Sales** $1,200,000
- **Optimal Sales** $1,600,000

Predefined Sales Volume Performance

Figure 3
Percentage of Bases Salary Per Percentage of Quota

- **Optimal Pay-for-Performance** $80,000
- **Targeted Pay-for-Performance** $50,000
- **Base Salary** $40,000

Quota:
- **Threshold Sales** 75%
- **Target Sales** 100%
- **Optimal Sales** 125%

Predefined Sales Volume Quota