Core principles of sales compensation: A 10-step approach

Historically, and over the course of the last 20 years, sales compensation strategy has been reflected in the same foundational principles. However, if this is the case, why do companies still find it challenging to manage their sales compensation programs effectively? Simply put, business changes, market segments change, competitor's change, and as a result, sales objectives change. Because of this volatility, it is even more important for companies to reexamine the core principles of sales compensation and how they align with corporate objectives and procedures.

This process can be consolidated into 10 steps.

Surveying the existing landscape

Steps 1 and 2 essentially urge businesses to evaluate current practices strategically to establish a baseline understanding of how sales compensation strategies are working.

1. Clarify business/strategic objectives

Each year companies go through planning exercises to define overarching corporate goals which then trickle down to the associated departmental objectives. To have an effective variable compensation plan, these objectives should be aligned closely with the desired behavior of the sales force.

2. Assess current plans

Once corporate objectives and sales force related goals have been clearly defined and articulated, plans can then be assessed.

At regular intervals, variable pay plans should be reviewed, assessed and monitored for effectiveness. A more focused and *strategic* assessment should typically be conducted when company business objectives are reset for a new year, or sometimes, after a new organizational change. For example, the acquisition or merger of companies. This type of assessment should evaluate how well the existing plans are performing or would perform against the newly defined business objectives. This assessment would provide the basis for any recommended changes to a plan design.

Assessing new year eligibility

Steps 3, 4 and 5 assess the new year eligibility. Once a company understands where it wants to be and where it has been (steps 1 and 2), objectives for the coming year can then be defined.

3. Define objectives of sales plan

Sales plan objectives should align strategically with the high level corporate goals. Too often this step is overlooked and results in great compensation plans with poor company performance or great company performance with a disenchanted sales team because the objectives of the plan and the company were misaligned.

4. Assess eligibility of jobs

Not all employees and positions should be on a sales compensation plan. It is important for companies to review, at regular intervals, to assess their sales staffing needs taking into consideration the objectives of a sale plan. By evaluating human resource needs with a sales plan in mind, companies can make strategic decisions about what roles are required and which will be eligible for variable pay and at what levels.

5. Establish compensation levels

Typically, Human Resources and Sales Operations collaborate to establish compensation levels. After roles have been defined, compensation levels can be determined based on a company's compensation philosophy, associated marketplace pay benchmarking and internal equity.

The mechanics of the plan

Steps 6, 7 and 8 comprise "the math" behind the plan. These steps are very rule-driven and formulaic and the metrics are very tangible.

6. Select performance measures and weightings

"Keep it Simple" might be an overused axiom but it is so critical for an effective compensation plan. High performing teams, whether in business, sports or the military are the ones that boast clearly defined goals and objectives with an unambiguous roadmap for success. In sales compensation terms, this means keeping the plan simple, particularly by significantly reducing the number of measures. A good rule of thumb is no more than 5 measures with 3 measures as an ideal. The more measures, the more likely it is to dilute the importance of any 1 element which can ultimately results in an ineffective plan. It is important that the plan measures align with the sales objectives, which in turn align with higher level corporate objectives.

7. Develop the formula(s)

Companies can add an additional layer of focus onto plan measures by developing the formula. For example, a compensation plan might have 3 core measures, but the company might want to avoid over achievement if not all components are achieved. A link or threshold could be integrated into the plan to put such controls into place. One or many elements can be considered when defining the associated formulas. Below are some examples. (It is important to note that *in developing the formula and adding sophistication, it is still critical that companies keep the plan simple and transparent*. Sales staff should be able to control the variables, the plan must have visibility, and the formula should be clearly articulated.) Below are some examples of various plan metrics for commission or bonus plans:

- Single or flat rate commission
- Individual commission rate (payout rate)
- Tiered (or "ramped") commission structure
- Adjusted (or "variable") commission rate
- Bonus: single/fixed, interpolated, step rate
- Modifiers
- Linkage
- Hurdlers
- Matrix
- Accelerators
- Caps

8. Determine performance measures and payout periods

This step addresses timing considerations. How frequently can the right data elements for measuring and reporting be captured? For example, a sales position that is highly leveraged on a 100 percent commissions plan will need to be measured and paid frequently, whereas a less leveraged position might be measured frequently, but paid out quarterly. Is each plan measurement tracked cumulatively or discretely? What controls or audits need to be in place for recovery, claw backs, errors, etc.? Companies need to make these determinations before moving to the next step.

Model and rollout

The company now boasts a fabulous plan, but now it needs to be tested – what are the associated costs; what is the earnings impact? Steps 9 and 10 enable companies to model and analyze the new plan's impact before the final roll out takes place.

9. Complete cost analysis and determine earnings impact

This is the point at which companies should model the impact of their new recommended plan changes and conduct an associated cost-benefit analysis. Ideally, this should be done with historical data, growth assumptions and other relevant financial planning assumptions taken into consideration. For instance, is the plan driving the expected behavior? Is it rewarding top performers appropriately? Can the plan cost be justified?

10. Finalize and launch plan

Too often, companies exert too much time and effort around the design and administration of the plan without any subsequent strategic communication effort. It is critical that the sales team understands the plan and the reasons why it is being rolled out. The best roll out processes are usually initiated at step one with the investment and participation of a cross departmental team. Companies that include influential sales leaders as part of the plan development and communication activities, see success in the plan adoption from beginning to end.

These core principles are relevant and should be embraced for design of all variable compensation plans in any organization. The real complexity and nuance lies in the individuality of each company.

Business models change, company strategies shift, there are mergers, acquisitions, spin-offs, de-centralization, centralization, external factors in the marketplace, economy, and various other internal initiatives and pressures – all of which converge in varying ways to impact corporate objectives and strategies. The design principles are not flawed – it is rather that businesses are constantly changing and evolving.

One theme is consistent with each company – they must be able to measure and evaluate performance to know if what they are doing is effective or not. The process of measurement and regular evaluation serves as a consistent benchmarking practice throughout the process of sales compensation management and helps ensure a more strategic alignment between sales compensation goals and overarching corporate objectives.

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