Sales Compensation Planning: Principles of Successful Design

THE CHALLENGE

In a recent paper[1] Doug Chung and his colleagues point out that sales force costs are the single largest marketing expenditure for many firms, accounting for, on average, 10% of sales revenues and up to 40% in certain B2B industries[2].

Each year, US organizations alone spend more than $800 billion to manage their sales forces, with $200 billion devoted solely to compensation—an amount on par with the estimated $208 billion spending on media ($98 billion) and digital ($110 billion) advertising[3,4].

But despite these huge investments, compensation plan design and management remain a challenge. As Jason Angelos and Mark Wachter from Accenture pithily comment[5]:

> "It's a shame that popularity and importance don't equal effectiveness."

They estimate that there is typically 20 percent gap between what businesses achieve and what they pay for – and that poor quota setting causes companies to spend 6 to 10 percent more than they should.

As a specialist sales transformation and sales enablement performance consultancy, we focus on the end-to-end sales journey and what it takes to make each stage a habit.

We've always understood that improving sales performance means more than just up-skilling – sustainable change requires a holistic approach to skills, systems and sales motivation.

The sales compensation plan is a critical component of the sales motivation system, so it's essential that it is well aligned with other elements of the sales transformation process.

It's clear that the challenge is complex: compensation plans need to not only reflect their industry sector (with associated compensation benchmarks) and offerings (with varying sales cycles), they also need to take into account the company situation (start-up to mature) and be effective for a range of different performance levels. Best practice sales compensation plans should also support effective onboarding and have the flexibility to cope with special/temporary assignments.

Furthermore, sales compensation plans also need to be aligned with functions beyond sales, particularly where functions like pre-sales and tele-marketing are managed separately.

But despite all the complexity, certain principles seem to have stood the test of time. Let's take a look at some of the well-known problem areas and the way that good compensation plan design can help to avoid/overcome these issues.

THE DEFAULT STATE

We have a good idea of what a bad year looks like:

- ✓ Q1 starts with a number of capable salespeople leaving the business, disappointed that they have been unable to earn the OTE they were promised and that they felt they deserved. This immediately throws the territory planning and target allocation process into a contentious cycle of revisions.
- ✓ In parallel, several of the remaining salespeople contest their Q4 and full-year pay-outs, on the basis of ambiguities in the prior year sales compensation plan. Sales management effort is focused on resolving these with Finance and Sales Operations.
- ✓ The glamorous sales kick-off event announces new organization structure, resourcing, strategy, product lines, sales incentive trip … but not the year's sales plan or quotas, which are not yet ready to be launched. The draft plan turns out not to be fit for purpose, and Finance/HR strongly disagree with Sales leadership about the best way to motivate the sales team cost-effectively.
- ✓ The salespeople react with cautious cynicism, reluctant to push hard for deals left over from the prior year without knowing what they will earn on them.
- ✓ Four months into the year the sales compensation plan and targets are issued with a brute force demand that they are signed within five working days. The plan will apply retroactively to the first quarter. This creates a firestorm of protest since many of the plan features are new and the targets don't reflect all the temporary account assignments made to cover the salespeople who have left.
- ✓ The first line sales managers are horrified, not only by the way the plan has been communicated but also by the fact that their incentives are no longer aligned with those of their teams: in fact, they won't hit OTE even if all their salespeople do.
- ✓ After a major internal row, HR back down and the plan is revised such that the prior year plan is extended to Q1 and the new plan is reworked to cover the last three quarters. The issues with alignment are not resolved.
- ✓ The salespeople now raise issues about the Q1 pay-outs. And in parallel they start modelling the impact that the new scheme will have on their earnings.
- ✓ As the first compensation plan cycle is processed by Sales Ops and Finance it becomes clear that the plan requires some metrics that are not in fact collected by the business. A revision to the plan has to be issued to work around this, creating further confusion.
- ✓ As the half year approaches, sales performance is well behind plan. In an attempt to accelerate sales, a half year Sales Performance Incentive (SPIF) is issued that pays extra commission on deals that involve the company's newest and most strategic offering. Since the sales cycle for these deals is more than 6 months the effect is to pay more for deals that were due to close anyway; no additional business is won.
- ✓ With sales performance lagging, HR insist that salespeople at 90% or less of target at the half year point are put on Performance Improvement Plans. A number of new recruits – struggling to cope with multiple plan and territory changes – are caught in the net and immediately start applying for roles outside the company.
- ✓ The Performance Improvement Plans – which coincide with customers' vacation period – prove to be largely unachievable and the sales team therefore enters Q4 under headcount due to a combination of voluntary and involuntary attrition. Sales management now face the double task of trying to achieve target with the remaining salespeople and finding/onboarding new recruits.
- ✓ As Q4 starts, it becomes clear that one of the unintended consequences of the complex sales comp plan is that many of the most experienced and successful

salespeople will not make OTE, creating further flight risks. In desperation, a further Q4 SPIF is announced to try and compensate, despite opposition from Finance. This is not rolled-up into sales management, further eroding sales management morale.

- ✓ The full year results are poor: disappointing sales/bookings, low employee engagement scores, high churn and unsatisfied customers. Finance are furious about the high cost of the pay-outs. HR insist that further PIPs should be implemented immediately.
- ✓ The cycle re-starts in Q1; work on the new year's sales comp plan has not yet started. And sales management have the added challenge that the sales incentive trip is cancelled due to poor full year performance, further eroding the morale and engagement of the sales team and discrediting sales management.

This tragedy of errors – where poor compensation plan design and management reinforce weak sales performance to create a vicious cycle – is quite capable of driving a firm out of business if leadership do not take decisive corrective action.

THE SIX KEY PRINCIPLES

Although there is no universal panacea, six key principles underpin most successful plans.

1. SIMPLICITY

Many functional groups are keen to be involved in the development of sales compensation plans. Executive leadership, Finance, Sales, Sales Operations and HR are all key stakeholders, and often Marketing and Operations may want to play a role. The danger is that the plan design tries to satisfy all these groups and ends up with a dozen different elements, including time-based and product-based accelerators, caps, multiple thresholds etc.

This is the path to disaster. The cardinal principle of successful plan design is that it must be simple, with a maximum of three elements. Those elements must be focused on the highest priority desired outcomes for the people covered by the plan. And no element should be worth less than 15% of the total On Target Earnings (OTE) for the year.

This is not to say that there cannot be multiple plans – for hunters and farmers, for big deal specialists, for pre-sales, for new salespeople onboarding – but each individual plan must be as simple as possible.

2. TRANSPARENCY

Achieving simplicity automatically helps with plan transparency. Salespeople must be able to quickly and accurately calculate the pay-out they will achieve by winning a particular deal.

This substantially reduces the time wasted on resolving commission plan queries, and (combined with good cadence) increases the motivational impact of the plan.

The plan should also be transparent in the sense that the sales management plans are fully aligned with the plans of individual performers: the targets must "roll up". Misalignment creates unproductive tensions as salespeople get conflicting messages from the compensation plan and their line managers.

3. AFFORDABILITY

Self-evidently, the company must be able to afford the pay-outs that the salespeople earn. But this becomes more complex to manage when:

- ✓ Different parts of the company portfolio carry very different margins.
- ✓ Some elements of a total solution sale are sourced from third parties and billed as pass-through revenue
- ✓ The company's business model is in transition e.g. from one-off box sales to annuity service revenues

The key here is to shield this complexity from the salespeople: maintaining margins must be managed by good pricing discipline/approval processes not by creating a separate compensation plan for every product line (or worse still, adjusting the compensation plan for every deal).

4. FEASIBILITY

A successful plan must be based only on metrics that can be reliably, unambiguously and efficiently collected. These metrics must be captured rapidly enough to match the cadence of the plan's pay-out cycle.

Furthermore, the plan must be feasible in the sense that the metrics being used are ones that salespeople can actually influence. The cardinal principle of simplicity should help here. Make sure that additional metrics are not being added to the plan which salespeople cannot significantly impact: bad debt, usage levels, delivered margins are all examples of unhelpful metrics that dilute plan impact.

5. CONSISTENCY

It's normal that compensation plans change year-on-year as the challenges faced by the business change. And of course targets are new each year, to match the year's budgets.

But beware of radically changing the plan structure and format every year. This erodes the salespeople's trust in the leadership vision. It also wastes a lot of sales time as salespeople try to figure out how they can earn their OTE, particularly if the plan introduces new complexity.

And try to avoid muddying the waters by introducing too many SPIFs through the year – they add complexity and may well have unintended consequences.

6. CADENCE

At the top level, the plan and associated targets must be agreed and ready to communicate within 10 working days of period start. This is not a trivial challenge, and the danger is that neither Sales (focused on Year End performance) or Finance (focused on budgets) make the necessary time available in Q4.

Simplicity and consistency will both help, but ultimately there must be a clear project plan with owners to ensure that the sales compensation scheme is formulated and approved on time. It won't happen by accident.

In execution, the objective is to make the gap as short as possible between goal achievement and pay-out. If the cycle time is so long that the salespeople no longer remember which deal has contributed to the pay-out the motivation impact is substantially reduced. A simple plan, feasible metrics and good process automation will all help to deliver this.

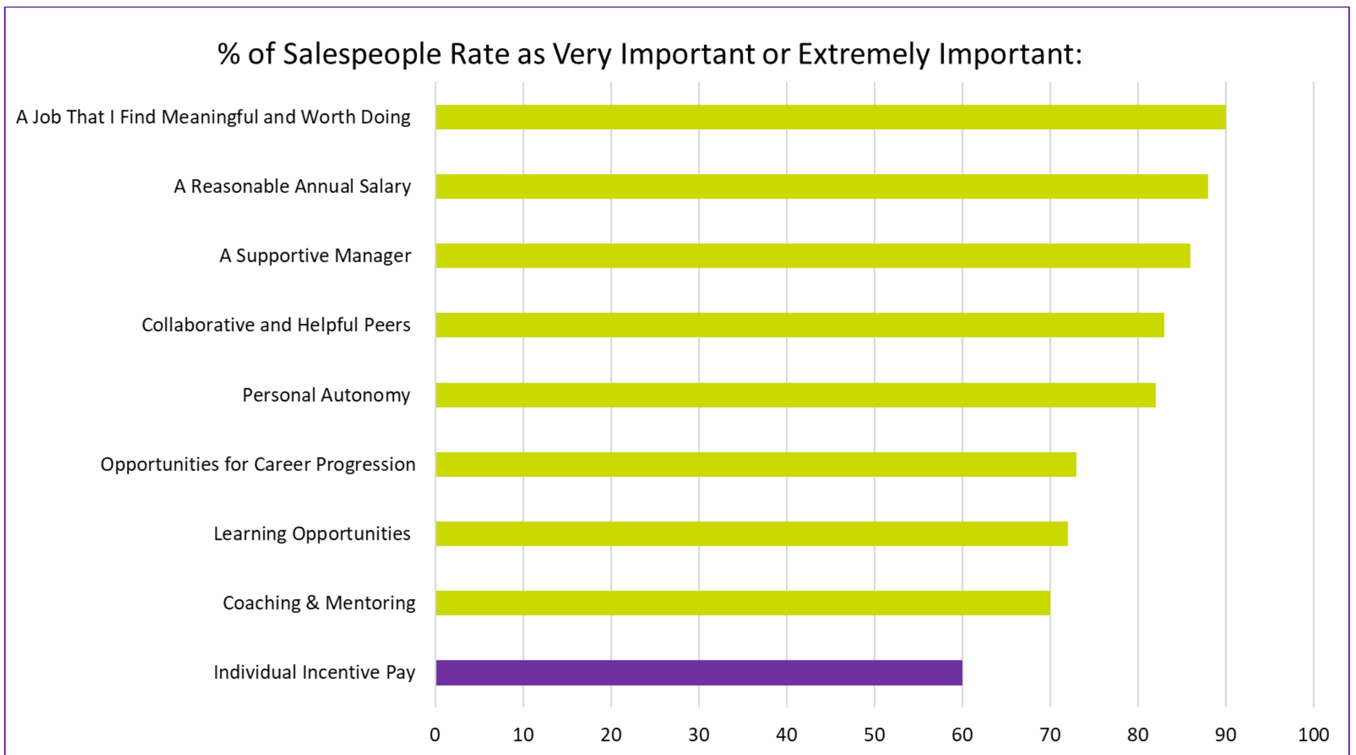
As you consider potential changes, a simple RAG matrix may be helpful to explain the planned changes to different stakeholders:

	Current Year Plan	Next Year's Plan
Simplicity	5 metrics plus SPIFs and clawbacks.	3 metrics plus one planned Q4 SPIF
Transparency	Calculation only possible retrospectively.	Commission calculator tool to be issued with plan
Affordability	Successfully held sales comp costs at 8% of revenue.	Uncapped: may hit >10% of revenue if big deals in pipeline are won.
Feasibility	Usage data proved difficult to collect. 28 commission queries over the year.	Only 3 metrics to be collected. Process automation and CRM integration tested.
Consistency	Same structure as prior year.	Substantially different structure and metrics.
Cadence	Plan launched finally Q2. Quarterly bonus payment plus true-ups.	Will be launched at Sales Kick-Off. Monthly payment cadence.

THE PAY-OFF

This paper focuses on the sales compensation plan as a component of sales motivation. But it's far from being the only one.

Research by Cranfield School of Management[6] looked at a range of motivational factors and asked salespeople to rate them in terms of importance. Individual incentive pay (commissions/bonus payments) was rated as Very Important or Extremely Important by about 60% of respondents, well below many other factors.



And that's not all: other research[7] shows that aggressive focus on performance-based sales compensation alone can actively demotivate salespeople, as extrinsic incentives drive away intrinsic motivation.

Fixing your sales compensation plan should therefore not just be an isolated goal: it should form part of your overall transformation agenda.

But the good news is that a simpler, more effective sales compensation plan will free up sales management time and resources to focus on the other motivational levers that make salespeople effective. Instead of endless e-mails and meetings to resolve outstanding commission queries.

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Sources

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