12 | 09
workspan
The Magazine of WorldatWork®

SALES COMPENSATION

Pay for Profit … and Get What You Pay For

By Elliot Scott, Towers Perrin

QUICK LOOK

- Companies that find effective ways to reward salespeople who impact the bottom line get what they pay for.
- Companies reward salespeople for product-mix decisions not just to increase profit, but also to ensure that new products are effectively launched and that all products get appropriate focus.
- To increase the percentage of lower-cost sales, it is usually best to reward the customer first (through lower prices) rather than the salesperson, but that may not be feasible or it may conflict with marketing strategy.

President's Club was going very well. As senior vice president of sales I had insisted on a first-class resort, and it really felt good to be recognizing our top producers. Our revenue numbers for the year were outstanding, and the salesforce was the envy of the company. OK, profits were down, which might be why we just got a new COO, but sales bonuses were rich. And over cocktails in Cabo my regional managers had committed to pulling in a few more deals to hit our first-quarter numbers.

Just as I was ordering up a second round of drinks, an e-mail from the new COO came through: "This year, there will be a profitability measure in all incentive plans." At first we assumed this did not apply to sales. After all, if it ain't broke, why fix it? But further down in the e-mail I saw the words "including sales incentive plans."

Often, companies that put aside that reluctance and find ways to reward salespeople for their impact on the bottom line can benefit enormously.

My managers immediately identified all the reasons this was clearly a bad idea:

- *"This is the salesforce. We need to be focused on top-line revenue!"*
- *"We have no control over profit. That's finance's problem."*
- *"Nobody can figure out how to measure gross margin! Isn't that what all those consultants are trying to do? I hear we don't even know which sales are profitable."*
- *"All our discounts are approved by senior management."*
- *"Salespeople who sell more should earn more. It's that simple. And I don't want anyone losing deals for a few points of margin."*
- *"Our top revenue producers are going to quit!"*
- *"We've tried that. It doesn't work."*

When the drinks arrived I assured my managers that I would straighten things out with the new COO … but I also knew that the sales compensation plan would have to change. I had to find a way to make it work.

While the story above is tongue-in-cheek, it is true that many sales organizations have a knee-jerk reluctance to use their sales incentive plans to reward anything other than top-line revenue. Often, companies that put aside that reluctance and find ways to reward salespeople for their impact on the bottom line can benefit enormously.

Why Pay for Profit With the Sales Incentive Plan?

You don't need an MBA to know that a slight increase in margin rate can have an enormous impact on the bottom line. And while the salesforce does not determine the cost, list price or market price of its products, it is naïve to say salespeople cannot have a significant positive influence on the profitability of the business. Let's face it: Some salespeople have that rare ability to generate more profitable sales than others. And companies that find effective ways to reward salespeople who impact the bottom line get what they pay for.

The following example from a high-tech company shows how various levels of price discount can impact a sale's profitability. With a product gross margin of 40 percent, a 10-percent reduction in sales price results in an 87-percent decrease in net income. And a 15-percent reduction in sales price results in a loss. (See Figure 1.)

In this company, as in many others, if a salesperson can positively influence his or her average discount, even only incrementally, it is clearly worth paying for. A company with $300 million in sales can reduce the average discount by 2 percent, which might not seem like a big swing to a salesperson, but that's $6 million of profit.

When Paying For Profit In The Incentive Plan Doesn't Work

Alas, profit measures in many sales compensation plans are a flop — and at their worst, they have actually

FIGURE 1: NET INCOME REDUCTION DUE TO DISCOUNTING

Product list price	$100
Gross margin of product	40%
SG&A[1]	24%
R&D[2]	5%

Discount	0%	5%	10%	15%
Discounted price	$100	$95	$90	$85
COGS[3]	$60	$60	$60	$60
Gross margin	$40	$35	$30	$25
SG&A	$24	$24	$24	$24
R&D	$4.5	$4.5	$4.5	$4.5
OPEX[4]	$28.5	$28.5	$28.5	$28.5
Operating income	$11.5	$6.5	$1.5	-$3.5
Tax	$2.3	$1.3	$0.3	$0
Net income	$9.2	$5.2	$1.2	-$3.5
Reduction in net income	0%	43%	87%	138%

1 Sales, general and administrative expense. 2 Research and development expense.
3 Cost of goods sold. 4 Total operating expense.

You have a problem if your salespeople don't know how much they will be paid for a sale until a Ph.D. performs a black-box calculation.

lowered gross profit. The most common dysfunction is the intrusion of a hefty corporate profit measure that a salesperson has absolutely no control over. The justifications tend to go like this:

- "The rest of the organization is measured on corporate profit. Why should salespeople be given a pass?"
- "This will bring the sales organization into the fold and increase cooperation with other departments."

That all sounds nice, but a sales compensation measure like total corporate earnings, with no line of sight to individual actions, has no motivational impact and decreases the effectiveness of the entire plan.

Another problem is complexity. You have a problem if your salespeople don't know how much they will be paid for a sale until a Ph.D. performs a black-box calculation. It may be because the linkages between plan measures have become dizzyingly difficult to comprehend. ("It's simple: You get additional commission on product X if you hit your quota for Y and the company exceeds its EBIT target by Z2.")

Other common dysfunctions include the following:

- If profit *percent* is a stand-alone measure with significant upside, it might be possible for someone with lower profit *dollar volume* and a high profit percentage to earn more than someone with higher profit dollar volume and a slightly lower profit percentage.
- Carelessly designed sales expense measures can drive salespeople to reduce customer face time.
- If the company decides to pursue an unprofitable deal for strategic reasons and the sales compensation plan punishes the account manager for it, the company may lose the deal ... or the account manager. At a minimum the seller becomes less motivated to go the extra mile.

Nevertheless, while there are pitfalls to paying for profit, they can be overcome. And companies that do it carefully and well have been very pleased with the bottom-line results.

How To Pay For Profit With The Sales Incentive Plan

Companies that successfully use their sales compensation plans to increase corporate profits take a few steps to increase their chances of success:

1. They align the sales incentive plan with the corporate strategy for increasing profit.
2. They understand what profit levers the salesperson and sales manager have the most control over.
3. They design incentive measures around results that are clearly linked to actions.
4. They carefully consider possible unintended consequences and try to guard against them.
5. They start small and keep it simple.

Keep these principles in mind as you address the problem.

Note that at the highest level, a company's efforts to grow profits tend to be centered on one of the following goals:

1. Raising the average *price* paid for its products
2. Selling a different *product mix*, which is either more profitable now or will be in the future
3. Lowering *cost of sale* and/or the *cost of production*.

There are many actions salespeople can take to support these goals and many ways companies can support those actions with their sales incentive plans. Following are a few ideas.

Instead of paying the same commission rate for all sales, pay a higher rate for emphasis products. In a quota-based plan, salespeople might get double quota credit for certain products.

Price

To raise average price, salespeople can:

- Reduce the average discount through more skilled and precise negotiation.
- "Value sell" with greater use of business cases.
- Reduce the influence of purchasing by cultivating relationships with key decision makers.
- Focus efforts on customer segments or individual customers who are known to be less price sensitive.

To reward higher prices, the following incentive plan tools can be used:

- *Price realization measure*. Measure the percentage discount from list price, either for each sale or in aggregate, and pay more for a sale when discounting is lower. A common form is a commission multiplier. The base commission rate might be multiplied by as low as 0.5 x or as high as 1.5 x depending on the discount given. If all discounts are approved by management, the company may choose to apply this incentive to managers only. But some companies still take this measure down to the individual seller level to discourage requests for aggressive discounts. As one CFO said, "I don't want the salespeople automatically requesting a 10-percent discount. I want them to try an 8-percent discount first."
- *Gross margin dollar volume measure*. Instead of measuring net revenue (revenue minus discount), measure gross margin (revenue minus discount minus product cost).

Companies sometimes get hung up on this one because they know they cannot accurately measure the product cost of each sale, but absolute precision is not necessary to make it work. Using a standard, estimated product cost may be better than rejecting the measure entirely.

Product Mix

To sell a different mix of products, salespeople can:

- Gain improved product knowledge and knowledge of customer business processes to increase their ability to sell new or more profitable products.
- Improve solution-selling skills.
- Target a different customer segment.

Companies reward salespeople for product-mix decisions not just to increase profit, but also to ensure that new products are effectively launched and that all products get appropriate focus. In fact, newer products may be less profitable to the company in the short term, but critical to the company's long-term profitability.

To reward product mix, the following incentive plan tools can be used:

- *Differentiated rates*. Instead of paying the same commission rate for all sales, pay a higher rate for emphasis products. In a quota-based plan, salespeople might get double quota credit for certain products. But avoid having too many rates and be sure that quotas are scaled to reflect the expectation that a percentage of sales will be double credited.
- *Separate quotas*. At the sales director or VP level, consider making above-target earnings contingent not only on achieving the overall sales goal but also on achieving a reasonable level of performance on two or more product groups that make up the sales quota. This type of scheme is more appropriate for managers than individual sellers, for whom product-level opportunity is less predictable. When using product-mix measures, be sure to model the likelihood of achievement so that the measure does not become punitive. For example, if achieving 100% of five separate individual product quotas is statistically unlikely, you don't want to make all upside contingent on that event.

Cost of Sale

To lower the cost of sale, salespeople can:

- Encourage customers to purchase through lower-cost channels, such as online, telephone or direct (vs. reseller) channels.
- Reduce sales expenses (travel, entertainment, marketing materials, rebates, samples, demos, use of specialists).
- Lower the working capital tied up from order to collection by negotiating better terms and following up on receivables.

Rewarding lower cost of sale can take the following forms:

- *Temporary credit for sales made through new channels*. Getting customers to buy through lower-cost channels can be seen as a threat to the salesperson's relationship or to sales credit. To enlist salespeople's help in moving customers to Web-based or telephone ordering, it can be helpful to temporarily credit salespeople for sales that do not directly flow through them. And if your salesforce knows that in the future it will not get full credit for certain customers or products that are best sold through lower-cost channels, it may work harder to make sure customers can effectively use those channels today.

- *Sales expense measure*. Sales expenses can have a significant impact on profit, particularly when you include not just travel and entertainment expenses but also rebates and other payments to an indirect channel. Since these expenses may be impossible to associate with a single sale and may be hard to regulate on a case-by-case basis, some companies offer incentives based on expenses as a percent of revenue, rather than based on expenses as a percent of an expense goal. Rather than being employed as a stand-alone measure, this is frequently used to modify the incentive on the primary revenue measure to avoid over-rewarding low sales expenses where sales are also low.
- *Working-capital measures*. In low-margin, high-volume businesses such as distribution, the cost of capital can mean the difference between profit and loss on a sale. Capital equipment companies also make good use of working-capital measures in their sales compensation plans. These measures may take the form of higher commission rates for better terms, measures to improve average days' sales outstanding or receivables aging, or even, where there is line of sight and accuracy, a measure for gross profit.

Cost of Production

In some environments, salespeople can significantly influence the cost of production. To lower the cost, salespeople can:

- Influence the customer to buy at a time of year that minimizes production cost.
- Focus on products that are in inventory.
- Reduce customization.

To increase the percentage of lower-cost sales, it is usually best to reward the customer first (through lower prices) rather than the salesperson, but that may not be feasible or it may conflict with marketing strategy.

Rewarding lower cost of production can take the following forms:

- *Delayed sales credit*. To discourage salespeople from getting orders in at times of the year when a higher cost per order will be incurred (such as the last two weeks of the quarter), some companies will delay sales credit for sales that come in during that time. The amount of incentive will be the same, but it will come later.
- *Credit on shipping*. If an item is not in stock or requires customization, the delay between ordering and shipping may erode margins. Crediting the sale (or part of it) when the product ships, rather than at the time of order, can motivate the salesperson to focus more on products that are readily available. A variation on this is to credit part of the sale upon successful implementation or customer acceptance. Salespeople will soon learn that sales with less customization or back order will put money in their pocket sooner.
- *Short-term incentives*. Perhaps the most common and flexible way to encourage salespeople to focus on sales with a lower production cost is through short-term incentives. For example, special incentives to move excess inventory are well-established in transactional environments like automobiles and retail. In long sales-cycle environments they are more problematic, but they can be useful when short-term add-ons to existing sales are possible.

The Bottom Line

The primary goal of most sales incentive plans should be to drive short-term revenue growth. But salespeople have many ways to influence profitability, and a profitable sale is worth infinitely more than an unprofitable one ... literally. There's money on the table for companies that find ways large and small to reward salespeople for incrementally increasing profit. At next year's President's Club, you should be celebrating not just the top-line winners but the bottom-line ones as well. WS

ABOUT THE AUTHOR

Elliot Scott is a senior consultant in the salesforce rewards practice in Towers Perrin's New York office. He can be reached at elliot.scott@towersperrin.com.

RESOURCES PLUS

For more information related to this article:

www.worldatwork.org

Type in any or all of the following keywords or phrases on the search line:

- Sales compensation
- Salesforce + incentive
- Incentive plan design.

www.worldatwork.org/bookstore

- *Sales Compensation Essentials: A Field Guide for the HR Professional*
- *Sales Compensation Math*
- *Designing Sales Compensation Plans: How-to Series for the HR Professional*
- *Sales Compensation: A Collection of Articles from WorldatWork.*

www.worldatwork.org/education

- Elements of Sales Compensation, Certification Course: C5
- Sales Compensation Design — Developing Next Year's Plan, Seminar
- Sales Compensation for Complex Selling Models, Seminar.