

Running on Empty?

MANAGING SALES COMPENSATION COSTS IN A SLOW MARKET

WHEN THE ECONOMY IS SPUTTERING, companies need to drive down their sales compensation costs without driving away their sales force.

By Bill Weeks, Weeks Consulting Group

Last year your company cut out the cappuccino machine, the Ping-Pong table and unnecessary travel. This year, it raised the employee's share of benefits plan costs, froze executive salaries and downsized its work force. Despite some painful reductions, business costs still are too high and management is getting pushed to make further cuts. Until now, it's shied away from looking at its sales force. After all, without sales, how will the business survive?

But is it a black-and-white case? Can the company manage down its sales compensation costs without driving away its sales force or cutting sales even further?

Managing the Sales Plan

Managing the costs of a sales compensation plan starts with managing sales compensation plans. Like the broader business they support, compensation plans have a life cycle. All too often, they move quickly from youth to old age because they are not being nurtured. As business conditions change, poorly managed plans become stale and lose their fit to the business needs. Soon, exceptions

become common, the plan becomes more complicated, and its costs are higher than they need to be.

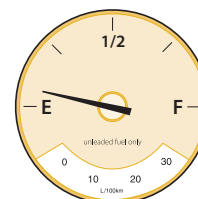
As those changes occur, poorly managed plans lose their ability to motivate superior performance or they become too costly for the performance they motivate. At that point, a plan's sponsors become disenchanted and the plan has to go. Unfortunately, many companies have such fear about replacing their plans that they continue using them long after they should have been buried.

For plans still in their teenage years, it is critical to observe and nurture them. Well-designed plans include design objectives and model performance that can be managed. These usually include:

- An intended mix of salary and incentives at various performance levels
- Total compensation that has ties to some level in the marketplace
- Design elements that are intended to produce specified income at particular performance levels
- Minimum requirements and/or maximum payouts that need periodic adjustment based on business

conditions

- Some relationship between total compensation and quotas or goals. Beyond managing the plan to those objectives, there are several conditions that suggest other adjustments:
- Temporary plan changes or exceptions
- Particular circumstances or types of sales that caused the company to pay out above what the plan design called for
- Complaints, inquiries or lawsuits related to plan administration in specific situations
- Administrative provisions that proved necessary that were not



QUICK LOOK

- ⇒ All sales compensation plans have a life cycle.
- ⇒ Poorly managed sales compensation plans lose their ability to motivate superior performance.
- ⇒ Annual plan reviews provide an opportunity to revisit objectives and incorporate new design features.
- ⇒ Companies in the same industry tend to follow the same approach on how they pay their sales force.
- ⇒ Most companies use traditional forms of sales compensation, such as commissions, volume-based bonuses, product incentives and goal or quota elements.

included in the original plan documents

- High proportion of the sales force operating well above or below expected performance (and payout) levels.

Each area presents an opportunity, if not a requirement, to adjust the plan or its administration while staying in tune with its plan design. Annual plan

Understanding what makes a profitable sale is essential to setting and marketing to a target market.

reviews also provide an opportunity to revisit objectives and incorporate design features that seemed too aggressive when the plan was installed. As small compensation elements tend to be ignored, it is important to resist adding bells and whistles.

If the company has small elements (e.g., less than 10 percent of total compensation), consider shifting its funding to other elements. That same caution about adding elements should not prevent the company from adding an occasional contingency, escalator or cap to prevent unwanted outcomes or encourage desirable results. For instance,

does the company want to pay out its highest commission rate to someone with poor quality business or destructive behavior?

There are other opportunities that relate to changes in the sales environment. Your plans may no longer have enough leverage on the upside and/or the downside. If the design was focused on a particular market, a company often finds that sales not fitting the norm get paid extraordinarily well. If several of its services or products are more profitable if delivered together, this is the chance to align the sales plan with that dynamic. Careful responses can mean the company will avoid expensive unintended consequences and pay less over time than it would have had without such management. Particularly with the beginning of a new plan year and open communication, most salespeople will be nonplussed at such plan adjustments.

Reinforcing Profitability

Most sales executives will proclaim that their sales force can only sell what their company gives them to sell. Consequently, if a product happens to be unprofitable, it is clearly not the fault of the sales force. Based on that logic, few sales plans include any tie to product profitability. Unfortunately, that logic is incomplete for most companies. Shifting money to emphasize profitable behavior typically will reward your better performers while maintaining or cutting overall costs. There are several methods to influence behavior to assure that sales are profitable without making your sales force responsible for product

profitability.

Most firms can tell you everything about how sales are made, except whether an individual sale is profitable. Creating a tie between sales compensation and profitability requires that you understand where you make a profit and adjust your plan design to incorporate that focus. Hewlett-Packard made business headlines a couple of years ago when it stopped paying commissions for sales generating less than \$200,000 in revenues. It concluded that its margins were too thin on those sales to involve a face-to-face salesperson and they were better off either not making those sales, or making them through alternative channels (on the Internet or through telemarketers).

Other firms would be wise to follow Hewlett-Packard's lead. If the compensation plan pays less (or nothing) on sales with poor profit margins, the sales force will make fewer of those sales and more sales with higher margins.

It quickly will become more discriminating about how it uses its time. This does not mean that the company should abandon smaller or more remote customers (who may become your biggest customers in the future). Instead, it requires that the company approach them via a sales channel, whose costs are more in line with the projected profit margins. This is particularly true when the sales opportunity relates to repeat business rather than an initial sale.

Understanding what makes a profitable sale is essential to setting and marketing to a target market. Product pricing involves tradeoffs between being competitive and being profitable. Every product whose pricing varies has its sweet spots where it is either very competitive and/or very profitable. Creating synergy between

the sales force and the manufacturer around those sweet spots is one key to improving profitability without cutting overall sales compensation.

Consider a product that is priced to be profitable when sold in very high volumes to a single buyer. By definition, it is not as profitable when sold in more modest quantities. Without understanding the pricing and the related profit margins, those setting product compensation typically will reward each sale made equally but pay bonuses to those hitting higher total volumes. In direct contrast to the manufacturer's intention, those compensation plans send a message to sell big volumes (to big companies), thereby producing total sales with low-profit margins.

If the product pricing and sales compensation were set together, the sales compensation could echo and reinforce the manufacturer's pricing. The compensation plan could, for instance, pay a higher rate on sales made that fall between x and y sizes. The sales compensation plan then would support what is profitable as it aligns with where the company makes a profit. While the sales force still will not have responsibility for selling profitable products, its compensation will help the salespeople focus on where the company can best make a profit.

Adding a Quality Element

In a similar vein, companies can compensate based on the quality of sales made to improve product profitability. Tailored to the business' economics, it can be tied to size of sale, market penetration, individuals or groups sold within a larger entity, repeat business, affiliated products sold, follow-up sales made, etc. As the most costly part of making a sale is acquiring the customer, rewarding repeat sales

gives a clear signal that the initial sale created a positive, ongoing relationship.

Adding a quality component is a great place to improve the plan's effectiveness and perhaps even manage down the compensation costs. Moving compensation dollars from quantity-based elements to reward quality helps put pay dollars where they can best reward present and future profitability. What better way is there to manage costs than by improving profitability?

If structured to pay more to those selling top-quality business, about the same to those generating sales of target quality, and less for sales of poor quality, better performers quickly will see that they can make as much or

more than before the change. And, those who produce large volumes without commensurate quality will have a hard time arguing that they deserve top-level pay. Depending on how disparate the performance is, this can save significant sums in the short term, and assure more profitable operations in the long term.

Other Compensation Tradeoffs

In difficult economic times, sales of many products are more difficult to make and many salespeople need to cope with income reductions. They usually understand the risk and are prepared to deal with some volatility. Nevertheless, it is important to understand what the income swings are and be prepared to assist in extreme

An Effective Compensation Plan Keeps on Truckin'

A good sales incentive plan is like a good pickup truck. Both have a 10-year life span, but the shine begins to fade after two or three years. Trucks aren't designed to run on autopilot; they all require ongoing care and feeding. Some newer ones are dented or rusted, while many older ones still look brand new.

Those that last a long time not only are well maintained, but also have had some protection installed for where they carry the load. That protection helps the truck carry its cargo without destroying the basic underlying design. Those trucks that get a new owner every couple of years have a much slimmer chance of enjoying a long life. If the basic maintenance plan is continued, they may still be driveable. But once the initial owner is gone, it takes a special team to keep them running at their design specifications.

Many trucks are asked to carry too heavy a load and they fail much too soon. Eventually, there comes a time when the maintenance cost is higher than the replacement cost. Even the best-kept trucks eventually reach a point where they don't work well anymore and need to be replaced.

A sales plan can live a long life if the company treats it like it intends to keep it by following these rules of the road:

- Build it on a good frame of design objectives that both the drivers and the riders approve.
- Rigorously test its performance and load capacity before driving.
- Break it in slowly to give the owner and the truck time to get used to each other.
- Don't load it up with too many bells and whistles.
- Don't expect it to carry the full load of managing your sales force.
- Make sure that any new owners and passengers appreciate how and why it works.
- Give it at least annual maintenance.
- Finally, when it starts to creak and groan, don't try to eke out the last mile because it may break down by the side of the road.

cases. While this may increase short-term costs, it avoids the substantial cost of replacing a good performer with a new hire.

This assistance can take a variety of forms. It can be as simple as inserting a draw against future pay or modifying the terms of a current draw program. It can be a restructuring of territories to spread the opportunities among fewer players. It also can include revising the mix of pay to add more salary while reducing the rates paid on sales.

The right answer may be a combination of several approaches. For instance, a company may want to reduce its rates, but increase its territories. It also may want to insert a transition plan that emphasizes a critical compensation element to help carry participants until sales recover. Another option is to reduce some plan elements, but add or inflate another plan element in which the sales force can recover their "lost income" with good performance.

During difficult periods, it is essential to communicate frequently. As Xerox can attest, changing the sales plan and the organization of the sales force can have substantial repercussions. (Xerox's credit rating and stock price still have not recovered from the drop in sales following the changes it made roughly two years ago.) In particular, it is critical to keep any goals included in your compensation plan tied to realistic expectations. If a company is taking obvious steps to open new markets, then particularly aggressive goals may be acceptable. Barring that, a sales force with unattainable goals will be discouraged, rather than motivated, by that potential compensation. If its value within their total package is high, it's a virtual certainty that salespeople will shift their focus from planning their next sales call to plan-


ning retirement (or relocation).

Exploring Nontraditional Options

Companies in the same industry tend to follow the same approach to paying their sales force. For instance, financial services companies pay product-based commissions and bonuses but ignore quotas or goals, while pharmaceutical firms typically use a quota or forced distribution system with occasional product kickers. Each industry can improve its performance and its cost structure by borrowing from approaches used in other industries. In the previous example, the financial services industry would do well to install a sales goal element, while the pharmaceutical firms could generate greater sales with a more open upside for its sales force.

Most companies still operate with the traditional forms of sales compensation, such as commissions, volume-based bonuses, product incentives and goal or quota elements. Other approaches have received some press but not much implementation. Beyond the target market pay referred to earlier, there are team-based pay, relationship management and cross-selling incentives, bonuses for customer satisfaction levels and performance scoreboard plans. Each requires performance metrics that companies are just beginning to collect. As compensation administrative systems become more sophisticated, those options become much more feasible.

Regardless of design features, it seems unlikely that any sales compensation plan will ever operate on autopilot. As always, the key requirements are to get agreement on design, keep it simple, incorporate realistic expectations and market-level compensation, understand potential outcomes, communicate it carefully and manage it over time. These require-

ments take on even more importance in tough economic times. 

ABOUT THE AUTHOR

Bill Weeks has returned to consulting after nearly four years as vice president, sales compensation, for Prudential Financial in Newark, N.J. He can be contacted at weeksconsulting@aol.com

Contents © 2001 WorldatWork. The content is licensed for use by purchasers solely for their own use and not for resale or redistribution. No part of this article may be reproduced, excerpted or redistributed in any form without express written permission of WorldatWork and appropriate attribution. Reach WorldatWork at 480/922-2020; customerrelations@worldatwork.org

Reprinted from *workspan*, January 2002, with permission from WorldatWork (formerly American Compensation Association); 14040 N. Northsight Blvd., Scottsdale, AZ 85260; phone (877) 951-9191; fax (480) 483-8352; www.worldatwork.org. © 2002 WorldatWork. Unauthorized reproduction or distribution is strictly prohibited.

FOOTNOTES

Visit our Web site at www.worldatwork.org and go to Information Central. There you will find ResourcePRO, a powerful database that holds almost 7,000 full-text documents on total rewards topics.

For more information related to this article:

- ⇒ Log in to ResourcePRO Search and select Simple Search
- ⇒ Select the Rewards Category: Compensation
- ⇒ Type in this key word string on the search line: "sales compensation" OR "sales and economy or economic" OR "sales and program or plan" OR "sales and design"