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Selecting From the Menu of Plan Design Alternatives

Up to this point, we have examined the role of the salesperson in the marketing mix, seen how to determine compensation levels relative to the competitive market, and studied the concept of risk as it affects sales behavior and compensation. Now we are ready to turn to the main point of this book: the choices for paying salespeople.

Fortunately (or unfortunately, depending on your perspective), the sales manager has a tremendous variety of choices. The three basic components of compensation—salary, commission, and bonus—can be mixed and matched in numerous ways to create a compensation approach that supports corporate and sales strategy, and motivates and rewards desired sales performance. (As a reminder, we are covering only *cash* compensation in this chapter. Benefits are not generally considered effective in driving salesperson behavior, while noncash incentives are. These and other parts of a total reward program are covered in Chapter 21.)

11.1 Salary-Only Plans

Sometimes straight salary might be the best option, as it is in the following examples:

- *Highly technical sales.* A highly technical sales process often requires the vendor to create a customized product tailored to the needs of the customer. Here the sales rep becomes a coordinator of a team of sales, marketing, technical product design, and engineering resources required to execute the sale. In such cases, the salesperson may have very little direct influence over the sale. One example is the sale of steel to automobile manufacturers, where a complex design and testing process is required before orders are placed. The sales rep in this example functions as both project coordinator and relationship manager, while the sales team consists of engineers,

chemists, and manufacturing managers. In this situation straight salary may be appropriate because the sales representative has little direct influence (or prominence) on the sale.

- *Extremely large, infrequent sales.* Some products are purchased only after a multiyear sales process due to cost or the strategic implications of the purchase. The commercial aircraft industry provides an excellent example of sales that can range into the hundreds of millions of dollars and take years to complete. The salesperson in such an environment spends much of his time maintaining relationships with both existing and prospective customers so that he will be positioned properly when the next sales opportunity arises. A straight salary approach effectively compensates these salespeople in the long periods between sales and ensures they are not overpaid when major sales occur.

- *Pull-through (demand generation) sales.* Some sales reps concentrate their efforts on creating demand rather than on selling directly to the end user. One example is the agricultural-chemical salesperson, who spends much of her time educating farmers about agricultural chemicals in general, and her company's products in particular. Her role is to increase awareness and influence the resulting demand, but not to close sales. The actual fulfillment of the sale occurs through the distribution channel—in this case, the local farmers' cooperative or agricultural products retailer. Because it is difficult, or perhaps impossible, to link the salesperson's efforts directly to sales of the product in such cases, a straight salary approach may be appropriate.

- *Volatile or unpredictable marketplace.* Sometimes demand does not fit known patterns or is driven by unpredictable, external factors. The steel industry is an example. The volatility or unpredictability of the marketplace makes it difficult to set and allocate goals, or determine the degree of the salesperson's influence on a particular sale. Straight salary helps ensure fair and predictable sales rep earnings in these markets.

- *New or transitioning salespeople.* Salespeople who are new to a company, a job, or a territory may need some time to ramp up their selling performance. Inexperienced, salespeople may need time for training and to acquire a base level of product or service knowledge. A salary-only plan can be used to allow sellers in these circumstances to get up to speed and develop a sales pipeline. To help the transition to an incentive plan after the initial period, the salary may be expressed for a defined time period as a draw against future incentive earnings or in the form of a guaranteed incentive.

Advantages of Straight Salary Plans

- They are simple to understand and administer.
- They encourage customer service, because getting the next sale (and its incentive payment) is not uppermost in the rep's mind.
- They provide salespeople with predictable income.
- They eliminate sales crediting issues, especially in complex team-selling environments.
- Management has maximum flexibility to rearrange territories, reassign accounts, and change salesperson priorities without affecting pay.

Disadvantages of Straight Salary Plans

- They limit management's ability to use compensation as a tool for driving sales force behavior and communicating sales priorities.
- Fixed compensation costs increase, thereby raising the cost of sales when revenue production is down.
- They lower salespeople's incentive to increase sales results dramatically.
- They may attract security-minded (risk-averse) salespeople who may not strive for maximum results.
- They do not differentiate top performers from underperformers; indeed, top performers subsidize the pay of poor performers.

11.2 Cost-of-Sales vs. Cost-of-Labor Philosophies

Before proceeding to the discussion of commission and bonus plans, we must introduce an important concept in determining whether to use commission-based incentives, bonus-based incentives, or a combination of the two. The issue is whether the company adopts a *cost-of-sales* or a *cost-of-labor* philosophy for managing sales force pay.

The cost-of-sales philosophy is predicated on the notion that salespeople should receive a piece of the action or a portion of every dollar they sell, *regardless* of how much they may earn in total relative to other company employees or their peers in the competitive labor market. Simply stated, the sky is the limit when it comes to paying salespeople; management is indifferent about how much they earn as long as sales are significant. Under this arrangement, compensation cost as a percentage of revenue is essentially constant.

By contrast, a cost-of-labor philosophy states that salespeople have a defined dollar value in the labor market regarding a competitive range of pay. The company should not need to vary from this market pay rate in order to attract and retain the desired level of sales talent. Accordingly, for a specified level of performance (often expressed as a target, goal, or quota), the company will provide a specified amount of pay that is competitive with the defined labor market. In other words, the cost-of-labor approach delivers a planned amount of pay to salespeople who deliver a targeted level of performance.

Organizations in markets where the salesperson, not the company, "owns the customer" usually adopt a cost-of-sales philosophy. A good way to determine who owns the customer is to see whether customers follow their sales rep to a different vendor when the sales rep changes employers. Industries where the sales rep is likely to own the customer include insurance (particularly individual, as opposed to corporate, lines of insurance), real estate, and the equity markets (such as stock brokerages). Also, a cost-of-sales approach is often adopted by start-up companies when the key sales and service delivery functions, such as sales, marketing, and customer service, normally present in a more mature company are, in fact, imbedded in the salesperson. As such, the prominence of the salesperson—his ability to influence personally the customer's buying decision—in the overall marketing mix is relatively high. If not for the efforts of the salesperson, little, if anything, would happen.

Companies that believe the organization, not the salesperson, owns the customer most often employ a cost-of-labor philosophy. Most organizations that sell their products and services in a business-to-business environment fall in this category. Correspondingly, a cost-of-labor approach is more prevalent in mature, stable organizations or industries with established marketing, sales support, and customer service functions to reinforce the sales process. As such, the prominence of the salesperson in the overall marketing mix is somewhat diminished, not because she is less effective in her selling role but because there are more resources contributing to the sales process.

The implications of a cost-of-sales versus cost-of-labor philosophy are straightforward. Cost-of-sales firms often pay an incentive ("a piece of the action") in the form of commission-only plans or salary plus commission plans. Conversely, cost-of-labor organizations often use goals or quotas to calibrate their compensation plans, equalize unequal territory sizes, and define performance targets for salespeople. Salary plus bonus plans are best suited to this ap-

proach. Combination salary plus commission and bonus plans blend elements of both philosophies by paying both a piece of the action and a bonus for achieving a specific goal. However, combination plans are generally better suited to a cost-of-sales philosophy than to a cost-of-labor philosophy.

11.3 Commissions

A commission is an absolute form of measurement that pays the salesperson a percentage or portion of all the business she generates. The cost-of-sales philosophy provides a rationale for paying salespeople a piece of the action or commission. Commission-based plans come in two forms: commission-only plans (straight commission with no base salary) and salary plus commission plans that pay commission in addition to a fixed salary. The former is relatively uncommon today.

Commission-Only Plans

From the sales rep's point of view, the straight commission plan represents the best opportunity to build a franchise. In its most common form, the straight commission plan is simple in concept: the salesperson receives a percentage of the revenue dollars generated. In a straight commission environment, selling expenses may or may not be reimbursed by the company. If they are not, the commission rate (the percentage of the unit of volume earned) is generally somewhat higher to offset costs incurred by the salesperson. Commission-only plans generally pay incentives from the first unit of sales volume generated.

Two basic variables define the form of a commission plan:

1. *Basis of performance measurement.* The unit of volume against which a commission rate is applied can take numerous forms and should be driven by company objectives, sales and marketing strategy, defined selling roles, and the factors most controllable by the salesperson. Some of the most common bases of measurement for a commission plan include the following:

- x percent of revenue dollars generated
- x percent of gross or net profit dollars generated
- x percent of list price
- \$ x per unit sold

2. *Shape of the commission payout curve.* The shape of the commission payout curve is most easily illustrated by plotting the intersection of two variables: performance along a continuum from low to high and the resultant commission payout. There are two basic approaches that lead to variations in the shape of the resulting payout curve. A *flat commission rate* implies a single commission rate (e.g., 3 percent of all revenue sold) regardless of the corresponding performance level. In other words, the slope of the payout curve is a constant line that does not change shape or slope as performance increases or decreases. With a *variable commission rate* approach, commission rates are adjusted upward or downward at various levels of performance to help calibrate earnings and motivate the desired behavior. The slope of the payout curve will vary at key points in the performance continuum (e.g., at a break-even level of sales volume, when quota is achieved, or when a defined level of excellence is attained). A variable commission rate plan may incorporate accelerators (increasing the slope of the payout curve), or decelerators (decreasing the slope of the payout curve), or both. A detailed discussion of this type of commission rate adjuster is provided in Chapter 13.

Very few companies pay only straight commission. Although commission-only plans are consistent with a cost-of-sales philosophy, other conditions should be present. A straight commission approach may be appropriate in the following situations:

1. The sales rep's success can be measured completely and accurately on a short-term basis.
2. The sales cycle is relatively short, allowing frequent performance measurement and incentive payout.
3. Few factors other than the salesperson's personal selling skill and effort determine the success of the sale.
4. No significant nonsales activities (customer training and education, installation support, customer service, receivables management) need be performed by the rep.
5. Cyclicity or seasonality is minimal, so revenues are relatively smooth from month to month.
6. The company makes little investment in its salespeople in the form of training, and salespeople are easily replaced. In short, turnover is not costly.
7. There is no compelling need to control or otherwise manage sales rep earnings to a specified level.

Advantages of Commission-Only Plans

- Management can attract high-performing salespeople who are willing to share the risks of the business.
- Nonperformers are encouraged to leave the organization.
- Compensation costs are completely variable.
- They are easy to understand and administer.
- They encourage maximum sales effort, making them very useful in penetrating new markets.
- They minimize the need for supervision by treating sales reps much like independent contractors.

Disadvantages of Commission-Only Plans

- They severely limit management's ability to direct selling efforts, require nonselling activities, modify or realign territories, communicate and reward desired levels of performance, or promote salespeople into nonselling positions.
- They encourage a short-term orientation, possibly at the expense of longer-term, business-building activities or customer service.
- They allow sales reps to earn a high level of income from mature territories without making new sales or acquiring new accounts.
- All territories are assumed equal in size in order to yield equal commission payouts for equal selling skill and effort (in reality, few territories have equal potential).
- They reward salespeople who pursue the greatest payoff for the least effort (straight commission plans allow reps to set their own performance goals based on their desired level of income).
- They may create conflict between the salesperson's dependence on any and all volume, and the company's need to focus on the most profitable or strategically important products and markets.
- They generate little employee loyalty.

Salary Plus Commission Plans

The salary plus commission approach can be thought of as a joint venture between the salesperson and the company. Through commissions, sales reps share in the business that they help to generate. At the same time, the company pays salespeople a salary that com-

pensates them for personal experience and skills, and also for the nonsales activities management requires them to perform.

The salary plus commission approach is consistent with the cost-of-sales philosophy. A salary plus commission plan is most appropriate in these situations:

1. Barriers to entry require a level of guaranteed income to compete in the labor market.
2. Sales results are directly related to the activities of sales reps but are not fully controlled by them, making it appropriate for the company and salespeople to share the risk. In a cyclical or seasonal market, for example, a salary helps companies retain sales talent through the inevitable downturns.
3. The company enjoys high levels of market and customer awareness of its products and services, decreasing the reps' overall prominence in the sales process.
4. Sales results are important, but management wants to retain some control over the reps' nonselling activities. A salary enables the sales manager to encourage, for example, postsale service, customer education, market or customer research, and other nonselling activities.

The relative weight of salary and the target incentive pay or commission (the pay mix) is primarily driven by the prominence of the sales job and the company's philosophy on risk in the pay plan. However, prevailing market pay practices should also be considered. Generally the more prominent the sales job is, the larger the proportion of the incentive or commission element relative to the level of target total cash compensation. However, in some circumstances, the market may require a high base salary to attract and retain sales personnel.

Advantages of Salary Plus Commission Plans

- They attract sales reps who have skills beyond just pure selling.
- They help retain employees during tough times while maintaining a variable compensation element in the pay plan.
- They help sales management direct salespeople to perform nonsales activities.
- They provide a tight link between pay and performance.
- Companies can begin to construct career paths based on both selling and nonselling skills.

Disadvantages of Salary Plus Commission Plans

- They can become overly complex and therefore difficult to understand and administer.
- The emphasis on the most important results can be diluted when management designs plans that try to micromanage the sales force.
- They increase the level of fixed compensation cost relative to commission-only plans.
- All territories are assumed to be equal in size in order to yield equal commission payouts for equal selling skill and effort.
- They share some of the disadvantages of commission-only plans, including limiting management's ability to realign territories or reassign accounts while rewarding salespeople merely for having large territories.

The salary plus commission plan is popular among both companies and salespeople. The commission element provides companies with a means to motivate and reward desired selling behavior, and the salary element provides management with a lever to help direct nonselling activities. From the salesperson's perspective, the commission element provides significant earnings opportunity while the salary provides a sense of security.

11.4 Salary Plus Bonus Plans

A bonus is a relative form of measurement that pays the salesperson all or a portion of a fixed dollar amount (e.g., 20 percent of base salary or \$10,000) for the achievement of a predefined objective or quota. The higher the achievement relative to the assigned objective, the larger the incentive award. The salary plus bonus approach resembles the salary plus commission plan but is more appropriate in the following situations.

1. The company has a cost-of-labor philosophy (as opposed to a cost-of-sales philosophy) and desires to manage pay more closely around predetermined cost objectives.
2. The sales rep has a lower degree of prominence or influence on the sale than commissionable reps.
3. The salesperson has important objectives that cannot be measured or motivated by a volume-only commission plan.

Because of these factors, a bonus is almost never used without a base salary.

A bonus plan can be constructed to resemble a commission by delivering an uncapped, linear payout curve that yields additional earnings for each incremental unit of goal attainment. The key difference is that the slope of the payout curve is driven not just by sales volume alone, but by the percentage of quota or goal achieved. In addition, rather than pay a percentage of the volume generated, the bonus pays a percentage of a target bonus amount (or portion of base salary) for every percentage point of quota achieved.

Although salary plus bonus plans are best suited to companies that meet one or more of the conditions described, it is useful to examine some specific circumstances that may drive the need for salary plus bonus plans:

1. *Results cannot be measured purely in volume terms.* Sometimes a company wants salespeople to help achieve the company's product mix, channel mix, or other strategic objectives in addition to its overall sales goals; in other words, the *quality* of the volume generated is an important consideration. Examples include selling a balanced mix of products or increasing revenue through defined channels of distribution or specific customer segments.

2. *Sales dollar volume is not a direct reflection of the quality of performance.* Some businesses require a specific level of selling effort to close the sale; however, the revenue generated by the rep varies widely from sale to sale. For example, process control systems for paper plants vary tremendously in price, depending on the size of the installation, but the steps and effort required to make the sale are, for the most part, the same for all sales.

3. *New account sales generate relatively low initial revenue but yield significant annuity dollars.* In some cases, acquiring a new account does not yield significant short-term revenue but instead creates a stream of recurring sales with considerable long-term potential. In these cases the primary role of the sales rep may be to identify and acquire new accounts, leaving the account development and primary revenue generation activities to others. The services industry, data processing in particular, does business in this manner.

Advantages of Salary Plus Bonus Plans

- Management can equalize unequal territory sizes by predefining a target level of performance (or quota) specific to each terri-

tory, which when achieved yields the same predefined target bonus amount among all salespeople.

- Management can reward both the amount (volume) and the quality of the business the salesperson generates.
- Management can direct and reward the performance of important nonselling activities.
- The plan provides the flexibility to balance short- and long-term objectives for the sales force.
- The company can manage variable pay more closely around the achievement of defined objectives.
- Management has flexibility to realign territories or reassign accounts without affecting sales rep pay.

Disadvantages of Salary Plus Bonus Plans

- They rely on the development and administration of effective goal-setting and territory allocation systems, requiring well-defined processes and dedicated resources. Naturally, this increases the cost of plan administration.
- Depending on the performance measures selected, management may not be able to predict accurately the cost of sales compensation as a percentage of sales.
- They tempt management with many possible measurement and payment options. Management all too often succumbs to the temptation by creating plans that are complex, unfocused, and difficult to administer.
- They allow management to create poorly structured plans that reward sellers for performing activities rather than for achieving objective, measurable, and meaningful results.

11.5 Combination Plans

Combination plans, not surprisingly, provide reps with the opportunity to earn both commission and bonus incentives, in addition to a base salary. This approach has the distinct advantage of allowing the company to straddle the philosophical line between cost of sales and cost of labor. It allows management to provide salespeople with a commission on sales while also motivating other complementary behavior that is more suited to bonus plans. Companies most suited to this form of incentive arrangement generally operate in established markets that are either not fully mature or are underpenetrated by

the company. For example, a company selling into a mature market but with only a 20 percent market share may want to pay salespeople a commission on new sales and a bonus for managing existing business. Similarly a business with a 60 percent share in a growing market may want to continue to pay salespeople a commission for the business they help build, but may add a bonus to reward selling a broad mix of products. Like bonus plans, combination plans are almost never used without a base salary.

The combination approach provides companies with a flexible management tool but should be used with caution. Many organizations create combination plans by merely adding bonuses to existing commission plans. This rarely drives the desired behavior but almost always increases compensation costs. Companies designing combination plans should consider both the relative weight of incentive dollars paid in commission and bonus as well as the total dollars earned. Although there is no hard and fast rule, generally any bonus that comprises less than 10 to 15 percent of the target total cash compensation usually fails to drive behavior and instead only increases costs.

Combination plans share many of the same advantages and disadvantages as salary plus commission and salary plus bonus plans. Perhaps the biggest danger is creating a combination plan by adding a commission or bonus opportunity on to an existing incentive plan structure without a corresponding decrease in salary to fund the new incentive. This approach usually results in higher costs without motivating the desired behavior.