

Sales Compensation: A New Technology-Enabled Strategy

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A profit-center approach to compensation, enabled by new technology, aligns the goals of the sales representative and the corporation.

The best sales compensation strategy allows employees to earn unlimited amounts but guarantees profitability. But too many times, sales compensation is determined by the concepts reflected in the following statements:

“His quota was \$1 million last year and he made that, so let’s make it \$1.2 million this year.”

“She has the biggest territory, so let’s make her quota higher.”

“Last year we had several sales reps who made more than the president of the company did, so we’re going to have to change our incentive plan.”

If you have been involved in determining sales force compensation plans for any length of time, you’ve heard comments like these—and you know why quotas have a bad reputation. Quotas are perceived as arbitrary—at best based on unrealistic perceptions of market size and poten-

tial, at worst a manipulative tool that makes the sales representative a pawn in office politics. In fact, many salespeople see their incentive plan as designed to keep them from making money rather than the other way around.

Wouldn’t it be better to have a compensation structure based on solid numbers that was fair to everyone and offered sales associates the potential to earn an unlimited amount of money? And even better if it guaranteed that the company would reach a predefined level of profitability? That is the promise of a new profit-center approach to sales force compensation. The basic approach is that sales representatives need to contribute their share of corporate expenses and profit. After their contribution is paid, they are able to keep most of the money they bring into the company.

Although this is an unusual approach, it benefits the company. The opportunity to make an unlimited amount of money provides a significant incentive to sales representatives. As a result, they typically become more productive. Their income increases, as does corporate rev-

enue. It also becomes easier to recruit new sales associates, particularly top producers. Improved recruitment translates into faster growth and increased market share. In addition, ensuring that the company will reach a predetermined level of profitability adds value to the business and enhances the firm's financial stability.

The foundation of this strategy is the belief that the best way to set up compensation plans is to tie them directly to the costs of running the company. Most companies use the same basic compensation structure as the other businesses in their industry. But it makes more sense to base plans on what is financially necessary for the specific company. Sales force compensation plans should

- make sure the costs of running the business are covered,
- ensure a predefined level of profit, and
- allow salespeople to keep the rest of the money they bring in.

The first goal of any company should be to make sure it can pay its bills.

This approach eliminates many of the problems with quotas. Instead of arbitrary quotas, commissions are based on solid numbers—corporate expenses and profitability—making these plans easier to explain and justify. This system also removes the barriers many top producers face. Their commission does not decline as sales increase, and there is no ceiling on what they can earn. The ability to move to a higher commission once the representative's contribution to corporate expenses and profit has been paid and, potentially, to make an unlimited amount of money is a very effective way to motivate the sales force. Sales typically increase substantially when this plan is implemented.

This profit-center approach also typically results in an increase in profitability for the firm. This increase is due, in part, to fixing an incorrect business model. But the main cause is improved productivity. To put it simply, once the sales force sees how much more money they can earn by selling more, they do sell more. So both the sales

associates and the company make more money. So, how does this approach work?

Cover Corporate Expenses

The first goal of any company should be to make sure it can pay its bills. An accounting concept that is valuable here is the distinction between fixed and variable expenses. To simplify, fixed costs are expenses that do not increase as business increases. Examples include office space, utilities and salaries for support staff and management. Variable costs are expenses that vary with the amount of business you do. Commissions, telephone charges and manufacturing costs are variable expenses.

Variable costs are tied to revenue—if you do not have any sales, for the most part, you do not have those expenses. But whether you bring in any money, you still have to cover your fixed expenses. The best way to make sure fixed costs are covered is to allocate them equally among sales associates and make each associate responsible for bringing enough revenue into the company to cover his or her share.

Variable costs also need to be paid out of the revenue a sales representative brings in. However, because those costs are tied to sales, instead of allocating them equally, it makes more sense for each representative to be responsible for the variable costs associated with his or her sales.

So at the beginning of the year, the representative's commission level starts out low. The company is keeping enough money to pay both fixed and variable expenses. Once the company has taken out enough money to pay fixed expenses, that contribution stops. The money that was going to the company to pay fixed expenses now goes directly to the sales representative. The sales representative will now typically receive a substantially higher commission.

Allocate Expenses among Sales Associates

One of the difficulties in dealing with sales representatives is that they don't all produce the same amount. Some are top producers, whereas others, particularly those who are new to the company, sell little. So what is the best way to fairly allocate expenses among the members of the sales force?

The most equitable approach is to make everyone responsible for contributing the same amount. Anything else penalizes top producers and is a

disincentive to selling more. But, realistically, some people won't be able to bring in that much. One alternative is to simply hope top producers bring in enough money to cover the amount low producers are short.

A better approach incorporates a concept called the "fully productive equivalent." With the fully productive equivalent, newer sales associates or low producers are counted as partial representatives rather than whole ones. So, for example, at an office with 16 sales representatives, the fully productive equivalent may be 13 1/4 representatives. This method of accounting for the reduced contribution of low producers brings a higher level of accuracy to the expense allocation.

Ensure Profitability

The second goal of any company should be to make a profit. The best way to ensure profitability is to add the desired amount of profit into the expense allocation as the first expense. This is an unusual approach—most businesses define profit as what is left over after expenses—but treating profit as an expense, and planning for it, is the most effective way to make sure the company is profitable.

Derive Commission Levels

Now that the total expense figure (including profit) and fully productive equivalent number of sales representatives have been determined, the next step is to identify the correct placement of commission levels. First, divide fixed expenses by the fully productive equivalent number of sales associates. Then, determine what percentage of each sale needs to be held back to cover variable expenses and profit. This is the break-even point, or the amount of money each sales associate needs to bring in, as well as the maximum a company can afford to pay out once fixed expenses are covered.

To sum up, the competitive advantages of such an approach are clear:

1. There is no upper limit to how much a sales representative can earn—no barriers to high performance. This motivates the sales force and makes recruiting easier.

2. These compensation plans are aggressive, yet tied to the company's actual costs of doing business. The risk associated with being so aggressive is virtually eliminated.

3. Finally, profitability is built in. Not only does the company get the benefits of a motivated and expanded sales force, but it does this while putting the company on a sounder financial footing and building long-term value into the firm.

In addition to these benefits, this strategy offers another significant advantage in that it aligns the goals of the sales representative and the corporation. Both want each sales representative to reach the higher commission level as quickly as possible. The sales representatives want to get there so they can start receiving a higher percentage of each sale. Management wants the sales representatives to get there because at that point, corporate expenses are covered and profit is ensured. This gets everyone pulling in the same direction. Now, let's take this to the next level.

The second goal of any company should be to make a profit.

Offer a Choice of Plans

The amount each representative must contribute for corporate expenses and profit has been calculated, along with the highest commission level the company can afford to pay. The simplest strategy is to pay at a lower commission level until the representative's contribution is made and then move to the higher commission level. However, it is possible to motivate these sales force even more by giving them a choice of how they get paid. With these numbers, a company can offer its sales force a variety of compensation structures to suit different needs and personalities.

For example, an experienced representative who knows the market and the products may want a package that is almost 100% incentive based. Representatives right out of school, new to the industry, or with college-aged children may want less risk, preferring a higher percentage of straight salary. But it is possible to go beyond simple blends of salary plus incentive. Consider the following possibilities:

- No commission (or a very low commission) on the first few sales each year. Some representatives may prefer to pay their contribution quickly and move up to the higher commission level as fast as possible. This benefits the company as well because the firm gets its money up front.

- Flat monthly payments. The contribution can be divided into 12 equal parts, with the representative paying that amount to the company each month or having it deducted from his or her pay. That way, the representative can receive the higher commission year-round.

The bottom line is that when the level of risk in a plan is matched to the desired level of risk in the sales associate, the result is a happier and more productive member of your sales force.

Technology Is the Key

Sophisticated software is the key to making this profit-center approach work. In the past, it would have been difficult to implement because of the amount and type of data required, as well as the complexity of the calculations. However, with the rapid advances in technology that have taken place over the past decade, the necessary calculations can be made for even the most complex corporate structures. There are three areas in which technology is essential:

- *Defining commission levels.* Deriving the correct placement of commission levels and amount each representative must contribute to the company requires very complex calculations. In fact, it is almost impossible to calculate the correct levels without the appropriate software.

- *Designing compensation plans.* It is important to analyze the results of a plan before it is put into effect. Optimally, plans should be designed to maximize the amount paid out without risking profitability. This also requires complex calculations. The software must provide a warning when a plan is unprofitable. In addition, most companies find it useful to be able to structure compensation so that all plans pay similar amounts at any given volume of sales.

- *Managing compensation.* Giving salespeople a choice of compensation plans requires software to assist in managing compensation. Otherwise, the logistics can be a nightmare. It is important to make sure that commissions are calculated accurately and tracked appropriately.

All of these calculations require accurate and current financial information, as well as historical data. It is particularly important to have current data in industries that are subject to rapid change, such as high technology. All businesses should also complete an analysis of current industry and market conditions to assist in devel-

oping an appropriate compensation strategy for the particular corporation.

Proof Positive

This profit-center approach has been developed through many years of experience in the real-estate industry. Real estate is a business that is heavily commission driven and that uses more complex commission structures than almost any other industry. Both in and out of real estate, the results have been impressive.

One company was suffering from a number of problems: high turnover, a disgruntled sales staff and lack of profitability. In fact, they were borrowing money to stay in business. We analyzed their compensation plans and identified a number of de-motivators that had been built into their plans. For example, after a certain point, the commission rate would decrease. Needless to say, people did not often go past that point. They also had built-in incentives for longevity—each extra year you were there was worth an additional percentage commission. This was very frustrating to sales associates who had high production levels but had not been there long. There was a lot of discontent.

We implemented our profit-center approach to sales force compensation, restructuring their plans so everyone was treated fairly and rewarded proportionally to their effort. All of the plans were directly related to production. We offered multiple plans, so each sales associate could choose the style that best met his or her needs and motivation level.

The results were compelling. In the first year, with the same sales force, production increased 32%. Over the next couple years, their recruiting became so much more effective that their sales force is now four times what it was. Revenue has increased comparably, and profitability has improved dramatically.

One question we are often asked is how the sales force felt about making these changes. To be honest, there was resistance. There almost always is. That is natural whenever an important change is made. In this particular case, the company lost about 8% of its sales force. But these were mostly people who were being overcompensated under the old system. For example, there was one top producer who was receiving so many extra perks that the company had actually been losing money on every sale she made, despite her high production levels. For the most part, however, the people at the top stayed.

Another company we worked with was much smaller. In fact, it was a dental practice that was having trouble attracting dentists. It had not even been able to recruit dentists from overseas. We convinced them to change their offer from 60% of receivables to a plan that started at 50% and went up to 80% after breakeven. Within 2 months, they were able to quadruple their recruitment and substantially improve profitability. Today, the practice has grown to 22 chairs and is so successful that the owner has cut his work schedule back to just 2 ½ days a week.

Corporate Applicability

This approach to sales force compensation offers substantial advantages, yet it is not appropriate for every firm. Here are some indicators that a company should consider an approach like this:

► *Is the product a commodity?* The more similar its product is to the competition's, the more aggressive a company must be in its compensation plans. You can identify how commoditized a product or service is by asking whether representatives can take their customers with them when they leave. For example, in industries like insurance, stock brokerage or real estate, the quality of service is more closely tied to the ability of the sales associate than to the strengths of the corporation. In this case, the company that can attract the best sales representatives will dominate the market.

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Dennis Gould is the managing partner of CompensationMaster Corporation, where he is responsible for operations in Canada and overseas. Before joining CompensationMaster, he was a senior officer on the strategic operating team at Royal LePage, a firm with more than 200 offices and 10,000 sales agents. He played the lead role in implementing CompensationMaster's approach there, which helped the company go from a \$34 million loss to a \$5 million profit in just over a year. CompensationMaster Corporation is headquartered in Toronto, Canada.

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► *How easy is it to make sales?* If salespeople are primarily order takers, there is less need to motivate them. The harder they have to work to close a sale and the more skill is involved, the more important it is to attract quality sales representatives.

► *How big is the territory that needs to be penetrated?* If a company is launching a new product and needs to reach a lot of prospects quickly, a strong recruiting advantage and the ability to motivate the representatives so they become as productive as possible is highly desirable.

► *How fast does the company need to grow?* The stronger the pressure for rapid growth, the more representatives are necessary and the more aggressive a company must be in their compensation structures.

Conclusions

The biggest mistake a company can make is to assume that because things have always been done one way, they must continue to be done that way. All it takes is for one company with a new idea to enter the market. Even if the newcomer does not lure away the best sales representatives, if it has more successfully motivated its sales force, it will rapidly gain market share.

Compensation is an area that is ripe for change. Low unemployment rates and competition from dot.coms have already raised the bar in many industries. A company that does not explore new approaches to compensating employees is placing itself at considerable risk.