

80/20 *Sales Performance*

SPECIAL REPORT:

How to Develop an Effective Sales Compensation Plan

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This special report is an excerpt from the book, ***How to Beat the 80/20 Rule in Sales Team Performance: A Step-By-Step Guide to Building and Managing Top-Performing Sales Teams***, by Alan Rigg. For more information, visit:

<http://www.8020sales.com/products.html#books>

Alan also offers sales compensation products and consulting services at:

<http://www.SalesCompensationStore.com>

Introduction

I invite my company's website visitors to send me questions via e-mail. The number one question topic (by a wide margin) is sales compensation!

I have concluded that sales compensation is a challenging topic for many people because they think in terms of **absolutes**. Most of the questions I receive begin with, "What is the **standard** (salary, draw, commission percentage) for (an industry, product or service, geography)?"

Unfortunately there are very few "standards" that apply to sales compensation. The variations in sales compensation plans are infinite and the published research that provides compensation **details** (salary or draw + commissions + bonuses + other incentives) by industry or geography is quite expensive. This makes sense when you think about it - if a company has managed to develop an effective sales compensation plan, what incentive do they have to share it with others?

The best advice I can give you to help you develop an effective sales compensation plan for your company is pay **less** attention to what other companies are paying and **more** attention to developing a sales compensation plan that:

1. Takes into account the **profitability** of your company's various products and services, and
2. Motivates **desired** sales behaviors

These are the twin cores of any truly effective sales compensation plan!

There **are** some basic concepts that will help you develop an effective sales compensation plan. Let's begin by reviewing these concepts.

Why 100% Commission Plans Don't Work

Many companies make the mistake of using 100% commission sales compensation plans. Why do they do it? They feel a 100% commission plan will **minimize their financial risk**, as no sales made means no commissions paid.

Besides, any salesperson that is any good should have **enough faith** in their own ability to work on 100% commission, right?

Wrong! Any salesperson that **is** any good knows it takes time to build an opportunity pipeline, regardless of how much experience they have or how robust their personal network is. Plus, they must invest considerable time and effort to learn about their new employer and its products and services. **They still need to pay their bills** while this learning and pipeline building takes place. Not surprisingly, these talented salespeople usually choose to work for employers that are willing to **invest** in them.

If you run an ad for a 100% commission sales job, what kinds of people will respond? Usually they will fall into the following three categories:

- 1. Manufacturers' Representatives:** These salespeople work as independent contractors, not employees. Usually they sell a portfolio of products and services on behalf of multiple clients.

Make no mistake – these are **mercenary** salespeople. The amount of time and effort they will invest in selling your company's products and services will correlate directly with the amount of return they feel they can earn on their investment. If other companies offer more lucrative compensation plans, a monthly retainer, or do a better job of providing sales leads, don't expect to see much activity for **your** company's offerings.

- 2. "Newbies":** These job candidates are exploring sales as a career for the first time. Because of their lack of experience they may have difficulty finding jobs that aren't 100% commission. Or, they just may not know any better.

Newbies may or may not have the talents required for success in your company's sales job (80 percent of them won't), and they probably don't have the first clue about how to build a sales opportunity pipeline. Still, they may be willing to come on board and grind away for a few weeks. But, if they don't luck into some early sales, chances are excellent they will drift away and look for an employer that is willing to **teach** them how to sell and **pay** them something while they are learning.

- 3. The "Other 80 Percent":** It is rare for a salesperson with **both** talent and experience to be willing to accept a 100% commission sales job. If an "experienced" salesperson is willing to take your 100% commission sales job, they usually belong to the 80 percent of salespeople that produce 20 percent of sales!

Perhaps this salesperson is making a last-ditch effort before giving up on sales. Perhaps they need to be able to say they are employed while they search for another job. At any rate, the odds are very poor that the salesperson will deliver more than mediocre performance.

Lack of Accountability

Another challenge unique to 100% commission sales compensation plans is you lose the ability to **hold your salespeople accountable** for performing necessary administrative activities. These activities include attending training sessions and sales meetings, working from the office on specific days, and updating records in your company's contact management system. If a salesperson doesn't do what you ask, **so what?** What have they got to lose?

One 100% Commission Concept That Can Be Successful

There is just one 100% commission concept that I have seen produce good results with some consistency. It is where:

- The **company supplies** most or all of the salesperson's **leads**
- The leads are of **reasonably good quality**
- The **sales cycle is relatively short** (ranging from a one-call close to no more than several weeks in length)

This combination of circumstances can enable salespeople to begin earning commissions **quickly**. Plus, they don't have to prospect, which is an attractive proposition to many salespeople. This increases the chances that quality salespeople will be willing to **accept** the position and be able to earn enough money to motivate them to **stay** in the position.

Providing an Income Floor

Sales compensation plans that attract and motivate quality salespeople usually include some type of **Income Floor**. This is a guaranteed minimum amount of compensation the salesperson will earn during a specified time period.

An Income Floor is usually provided in one of three ways: via a **Salary**, a **Recoverable Draw**, or a **Non-Recoverable Draw**. Here are definitions for these three terms:

Salary

This is a fixed amount of money that is paid within a specified time period. Any commissions earned (if applicable) are paid **in addition** to the salary.

Recoverable Draw

This is also a fixed amount of money that is paid within a specified time period. Think of it as **commissions paid in advance**.

If the actual commissions earned during the time period exceed the draw amount, the salesperson is paid the difference at some later date. However, if the actual commissions earned during the time period do not equal or exceed the draw amount, **the salesperson owes the company the difference**. Any commissions in excess of draw that are earned in future time periods will first be applied to eliminate any negative balance in the salesperson's draw account before commission payments are made to the salesperson.

Non-Recoverable Draw

This is also a fixed amount of money that is paid within a specified time period. Just like with a Recoverable Draw, if the actual commissions earned during a time period exceed the draw amount, the salesperson is paid the difference. However, if the actual commissions earned during the time period do not equal or exceed the draw amount, **the salesperson does NOT owe the company the difference**. The slate is "wiped clean" at the beginning of the next time period.

Tables 1 and 2 demonstrate the difference between a Recoverable Draw and a Non-Recoverable Draw:

Table 1: Recoverable Draw Example

Time Period	Draw Paid	Actual Commissions	Owed to Company	Commission Paid	Total Earnings
Month 1	\$3,000	\$4,000	-	\$1,000	\$4,000
Month 2	\$3,000	\$2,000	(\$1,000)	-	\$3,000
Month 3	\$3,000	\$5,000	\$1,000	\$1,000	\$4,000
TOTALS	\$9,000	\$11,000	-	\$2,000	\$11,000

Table 2: Non-Recoverable Draw Example

Time Period	Draw Paid	Actual Commissions	Owed to Company	Commission Paid	Total Earnings
Month 1	\$3,000	\$4,000	-	\$1,000	\$4,000
Month 2	\$3,000	\$2,000	-	-	\$3,000
Month 3	\$3,000	\$5,000	-	\$2,000	\$5,000
TOTALS	\$9,000	\$11,000	-	\$3,000	\$12,000

What is the difference between a Non-Recoverable Draw and a Salary? The primary difference is a Non-Recoverable Draw can eliminate a potential fairness concern that can arise when a company uses a Salary + Commission compensation plan. The best way to explain this fairness concern is by using an example:

Sample Company has an annual revenue target for each salesperson of \$1,000,000. Management is willing to pay 10% of this revenue (\$100,000) as total annual salesperson compensation. Annual base salaries range from \$40,000 to \$60,000 based upon salesperson experience and need. The balance of each salesperson's compensation is commission.

If a salesperson receives a base salary of \$60,000, their target annual commission compensation is \$40,000. Assume that commissions are calculated by applying a **multiplier** against each dollar of revenue the salesperson produces. To calculate the multiplier, divide the target commission compensation (\$40,000) by the revenue target (\$1,000,000). This produces a multiplier of .04.

If a salesperson receives a base salary of \$40,000, their target annual commission compensation is \$60,000. Dividing the target commission compensation (\$60,000) by the revenue target (\$1,000,000) produces a multiplier of .06.

Table 3 compares the earnings produced by these two compensation plans at three different levels of sales production:

Table 3: Compensation Comparison for Salary + Commission Plans

Annual Sales Volume	Multiplier	Annual Commission Earnings	Annual Salary	Total Earnings
\$800,000	.06	\$48,000	\$40,000	\$88,000
\$800,000	.04	\$32,000	\$60,000	\$92,000
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\$1,000,000	.06	\$60,000	\$40,000	\$100,000
\$1,000,000	.04	\$40,000	\$60,000	\$100,000
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\$1,200,000	.06	\$72,000	\$40,000	\$112,000
\$1,200,000	.04	\$48,000	\$60,000	\$108,000

As you can see, the salesperson with the higher base salary will have higher total earnings when the annual sales volume produced is **less than** the target of \$1,000,000. Both salespeople will earn exactly the same amount if they hit the annual sales target on the nose. When production **exceeds** the annual sales target, the salesperson with the lower base salary will have higher total earnings.

The fairness concern is that these two salespeople can earn different amounts of compensation for selling exactly the same amount! This fairness concern is eliminated when a Non-Recoverable draw is paid instead of a Salary.

In a non-recoverable draw compensation plan, the multiplier for both salespeople would be $\$100,000/\$1,000,000 = .10$. This multiplier would be applied to every dollar of revenue produced to calculate actual commissions for each period. The non-recoverable draw would be subtracted from each period's actual commissions, and any positive difference would be paid to the salesperson in the next period.

Under the non-recoverable draw model, at any level of annual production both salespeople earn exactly the same amount...**as long as their monthly production exceeds their non-recoverable draw amount.** If actual commissions are **lower** than the non-recoverable draw by large amounts or with any

regularity, the fairness concern will be resurrected, as the individual with the higher draw will show higher annual earnings.

The risk of this occurring can be dramatically reduced if you inspect your salespeople's **activities** on a regular.

Calculating Sales Commissions

Another common question is whether sales commissions should be calculated based upon **revenue** or **gross margin**. The answer depends upon your company's specific circumstances.

If your salespeople sell from a fixed price schedule and they **do not have much latitude to change prices** without management approval, then it makes sense to calculate commissions as a percentage of **revenue**. You could even consider offering different commission percentages for different price bands, with the commission percentages declining as the profitability of the price bands declines. This would give your salespeople some pricing latitude, yet still motivate them to secure the highest possible price. It would also protect the confidentiality of your company's profit margins.

If your salespeople **have considerable latitude when negotiating price**, it is desirable to base commission calculations on **gross margin**. A common approach is to offer a "**sliding scale**" that increases and decreases the commission percentage based upon the gross margin produced.

For the sake of discussion, let's say your company's target gross margin percentage is 30 percent and the target sales commission percentage is 10 percent of gross margin. In a sliding scale model, the commission percentage would be adjusted **upward** if the gross margin for a transaction is **higher** than 30 percent and **downward** if the gross margin is **lower** than 30 percent. An example is provided in Table 4.

Table 4: Sliding Scale Commission Example

Margin	Base Commission	Multiplier	Net Commission
40%	10%	1.50	15.0%
35%	10%	1.25	12.5%
30%	10%	1.00	10.0%
25%	10%	0.75	07.5%
20%	10%	0.50	05.0%

You can have as many or as few steps as you wish in a sliding scale. You also have complete flexibility when determining how much the commission percentage increases or decreases between steps. Usually it is wise to **cap the commission percentage** on both ends of the sliding sale. For example, in Table 4 the maximum commission percentage is 15 percent of gross margin and the minimum commission percentage is 5 percent of gross margin.

Additional Incentives

You may also want to consider adding additional incentives to your sales compensation plan. Common incentives include offering **fixed dollar bonuses** or **multiplier “kickers”** to promote the pursuit of new business, team selling, cross-selling, sales of specific products, or increases in customer satisfaction.

These incentives can motivate desirable behavior in some circumstances, but this motivation comes at the price of adding **complexity** to the sales compensation plan. When a sales compensation plan becomes so complex that salespeople cannot rapidly calculate how their performance will impact their compensation, the plan loses much of its motivational value.

Here are two real-life examples of highly effective incentives:

- 1. Quarterly and Annual Bonuses:** In one of my sales jobs the compensation plan included a \$500 bonus for achieving budget during a quarter and another \$500 bonus for achieving the annual budget. As a result, salespeople could earn a total of \$2,500 in bonuses (in addition to salary and commissions) if they achieved each of the four quarterly budgets and the annual budget.

I can vouch for the motivational value of this type of bonus program. One year I earned the first three quarterly bonuses and sold enough during those three

quarters to also earn the annual bonus. Yet, there was still one quarter to go. My pipeline was tapped out, yet I really wanted to go five-for-five and earn the final bonus.

I ramped up my prospecting activities and ended up selling more in the final quarter than I had sold during the previous three quarters combined! Needless to say I earned the final quarterly bonus and some very fat commission checks. I'm sure my employer had no problem writing those checks - they earned a lot more from my sales than I did!

- 2. Reward Trips:** Another sales incentive that consistently caught my attention was an all-expenses-paid trip to an exotic location. A very small percentage of the company's salespeople and sales managers could win the trip each year and the winners were joined at the exotic location by the company's top executives.

This promotion was motivating for several reasons that included:

- Wanting to earn recognition as one of the company's top salespeople
- Wanting to "rub shoulders" with the company's top executives (which could lead to future promotions)
- A spouse or significant other wanting to enjoy trips to exotic locations (never discount the power of this type of "indirect" motivation!)

Clearly it is possible to motivate salespeople by offering incentives that go beyond salary and commission. But, sales incentives can also **fail**.

Why Incentives Fail

Here are **three common reasons why sales incentives fail**:

- 1. Lack of Talents Required for Sales Success:** Many salespeople lack key talents required for sales success. When salespeople lack these talents, **no amount of incentives will cause them to suddenly sell more effectively**. A more likely outcome is they will start to press harder to close sales and suffer a **decline** in sales performance!
- 2. Performance Disincentives:** The concept of a performance disincentive is best illustrated by this true story:

Some years ago I had a lady friend whose husband worked for a large textile manufacturer. This textile manufacturer had a policy that capped salesperson earnings at 200 percent of their annual target.

My friend's husband was an exceptional salesperson, and **in the second month of the fiscal year he closed the largest order in the company's history**. One undesirable outcome of this achievement was that he had maximized his earning potential for the year with ten months remaining! He didn't know what to do. **Clearly he had little incentive to sell for those ten months.**

He went to his manager, and together they tried to convince the company to make an exception to the policy, but to no avail. This very successful salesperson ended up leaving the textile manufacturer for a sales job that did not cap his compensation potential!

When you think about it, capping a salesperson's income just doesn't make sense. If a salesperson sells more than the cap amount, are the sales in excess of the cap amount **less valuable** to your company than any other sales? Of course not! So why wouldn't you want to compensate the salesperson for those sales?

If anything, it would make more sense to pay some kind of **bonus in addition** to the salesperson's normal commissions to reward them for extraordinary performance!

3. Stacked Contests: Sometimes sales contests are perceived to be "stacked" in favor of certain salespeople. This destroys the motivational value of the contests for most of the company's salespeople.

To find out whether your company's sales contests may be perceived as being "stacked", consider the following questions:

- Do the **same** salespeople consistently win all of your company's contests and incentives?
- Do some salespeople in your company service **larger or more productive accounts**? Does this give these salespeople an **advantage** during contests? Or, are the contests structured to enable **all** of your company's salespeople to have a fair chance of winning?

- Is the contest designed to generate **incremental** sales, or is it simply **rewarding salespeople twice** for results they would have produced anyway?

Be careful about making excessive use of sales incentives and contests. Rather than constantly running new sales incentives and contests, save them for special situations such as **jump-starting sales of new products and services** or reinforcing desired **changes in how your salespeople sell**. Your company's sales compensation plan should be designed to motivate desired daily behaviors such as new business generation, maximum account penetration, team selling and cross-selling.

Top sales performers are usually internally motivated, success oriented and outcome focused. If you hire the right kind of salespeople and provide them with a compensation plan that rewards the right activities and results, you won't need to offer frequent sales incentives!

Putting It All Together

Now that you have an understanding of key sales compensation “basics”, you are ready to start developing a sales compensation plan. This section provides an outline of the process I use when working with clients to develop or revise their sales compensation plans. It is only an outline because the complete process would require getting into a level of detail that is beyond the scope of this special report.

1. What is the average profitability of your company's sales transactions?

If there are significant differences in profitability between product or service groups, or between **new** business and **repeat** business, calculate profitability by group and/or business type.

2. How much of this profit are you willing to contribute to sales compensation?

Look at all of your company's costs and the percentage of profit you want to re-invest in growing your business. If the best you can do is determine a **range** of profit that you are willing to contribute to sales compensation (example: 10% to 30%), that's OK! You will refine this percentage as you continue working through the remainder of the outline.

3. What is the desired mix of New business vs. Repeat business?

A key consideration is how deeply your salespeople have already **penetrated** their existing accounts. If they are doing a great job of selling your company's **entire portfolio** of products and services in every assigned account, it makes sense to focus them on finding more **new** accounts. You can accomplish this by paying a higher commission percentage on sales to new accounts.

However, if your salespeople are just scratching the surface in terms of selling your company's entire portfolio of products and services to existing customers, your focus should be on **increasing account penetration**. Why? Because it is **easier** and **faster** to sell more to existing customers than it is to sell to new customers. Plus, sales to existing customers tend to be **larger** and **more profitable**.

4. How much can a salesperson realistically sell in one year?

You will zero in on the answer to this question by answering other questions such as:

- How many (properly qualified) opportunities can a salesperson manage at once?
- What is the length of the average sales cycle?
- Do you think the average sales cycle length can be shortened?
- What is the average close ratio?
- Do you think the close ratio can be improved?

5. What is the Total Target Income you are willing to pay for this amount of annual production?

If you have determined the percentage of profits that you are willing to contribute to sales compensation, and you have determined how much a salesperson can sell in a year's time, you have the factors you need to calculate **total target income**. Once you have made this calculation, consider another question: Is this target income significant enough to motivate successful salespeople to **join** your company...and **stay** with your company?

6. How much and what kind of Income "Floor" are you willing to provide to your salespeople?

Now that you know the total target income for your sales position, you can split it into **fixed** and **variable** compensation. The fixed compensation will provide a "floor" to income and is usually paid as a salary or draw. The variable compensation will include commissions, bonuses, and any other incentives you choose to include in your sales compensation plan.

7. What Commission percentage(s) will you pay?

Once again you will find the answer by answering other questions such as:

- Does it make sense to pay a single commission percentage, or do you want to have different commission percentages for **new** business and **repeat** business?
- Should commissions be calculated based upon **revenue** or **gross margin**?
- Does it make sense to have one or more **sliding scales**, where the commission percentage increases as the gross margin percentage increases, and decreases as the gross margin percentage decreases?

8. Do you want to include any Bonuses for achieving specific performance targets?

In addition to paying commissions, you may want to consider paying bonuses to salespeople who achieve specific performance targets. For example, you may want to pay a **quarterly bonus** for achieving each quarter's sales target, and an **annual bonus** for achieving the annual sales target.

9. What other sales behaviors are critical enough to be addressed by the sales compensation plan?

You may decide it would be desirable to tie bonuses or other incentives to specific behaviors such as team selling, cross selling, etc. However, it is important to recognize that the **motivational value** of your sales compensation plan will **decrease** as its **complexity increases**. If your salespeople cannot easily determine how much they will earn from their efforts, they will not perform as well as they would if they could easily relate sales performance to earnings.

About the Author

Sales performance expert Alan Rigg is the author of **How to Beat the 80/20 Rule in Sales Team Performance** and the companion book, **How to Beat the 80/20 Rule in Selling**. His **80/20 Selling System™** helps business owners, executives, and managers end the frustration of 80/20 sales team performance, where 20% of salespeople produce 80% of sales.

For information about Alan's products and services to help organizations **build and manage top-performing sales teams** plus more FREE sales and sales management tips, visit <http://www.8020sales.com>.

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