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Articulating a Sales Compensation Philosophy

The direction you need to take

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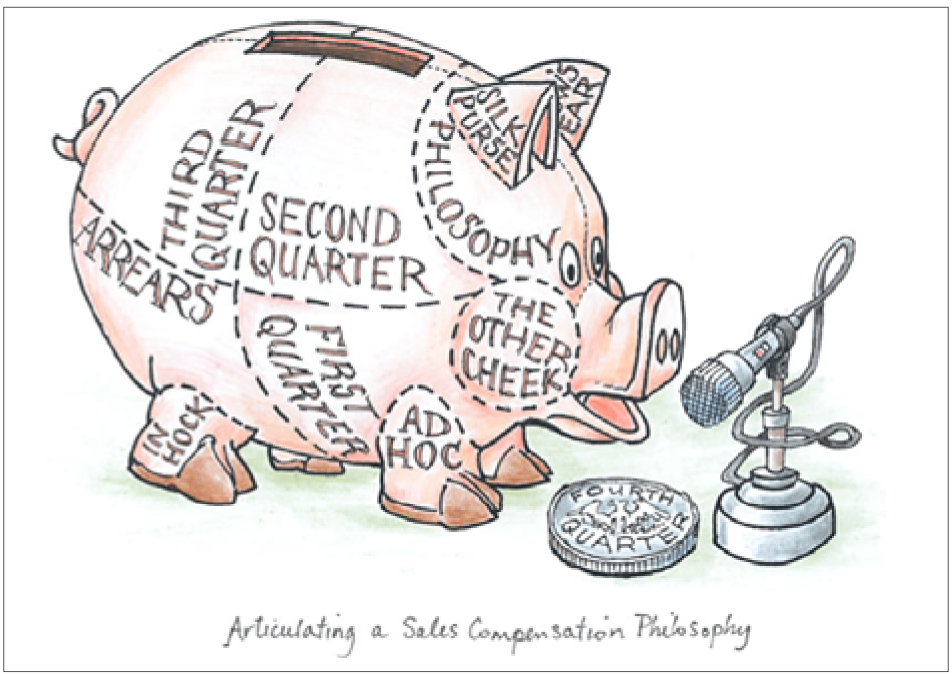


Articulating a Sales Compensation Philosophy

As the third quarter begins and most companies prepare for the fourth quarter sales compensation season, it is time to clarify and build consensus on the sales compensation philosophy.

The situation is all too common: the fourth quarter arrives, and individuals across the organization scramble to conduct this year's sales compensation design effort. This often results in less-than-ideal time for analysis, hurried decisions, and a rushed implementation. While some parts of a sales compensation program need to be discussed and determined each year, there are a number of more philosophical decisions that can be made in advance that can expedite the fourth quarter design process, and even serve as a foundation for a strategic design effort.

These critical decisions serve as a sales compensation philosophy, which clearly articulates the direction a business would like to take with its sales compensation plans. This article will highlight the nine key elements of a sales compensation philosophy, and provide some basic logic to get your organization started in articulating its own sales compensation philosophy.

The Case for a Sales Compensation Philosophy

Creating an explicit compensation philosophy has long been a tool employed by compensation practitioners outside of sales compensation. An executive compensation philosophy, in fact, plays a prominent role in every public company's proxy statement. Beyond just a document or paragraph in an SEC filing, however, leading companies use the compensation philosophy as an articulation of how the business intends to build and implement its rewards programs, which then focuses on compensation design decisions by establishing a set of boundary conditions. Moreover, the compensation philosophy is more static than plan designs, typically being revisited every three years or when one of the following occurs:

- Leadership transition
- Change in business strategy
- Significant in change in the nature of competition (new entrants, consolidations, etc.)

A sales compensation philosophy can serve the same purpose, being the foundation upon which specific compensation design decisions are based. As a statement of the sales compensation strategy for an organization, the compensation philosophy can provide the framework for a successful compensation design effort. The elements of a sales compensation philosophy define some key parameters of a sales compensation program:

Figure 1: Elements of a Sales Compensation Philosophy

Plan Governance	Defines ownership of plan strategy and design Identifies stakeholders and accountabilities
Design Consistency	Extent to which plan design can/should be customized by job role/business unit/geography
Non-Sales Alignment	Desired variance or alignment between sales roles and similar statue non-sales roles
Alignment to Business Goals	Extent to which individual compensation should be based on explicit links to business objectives
Pay Prominence	Extent to which pay should influence sales rep actions and decisions Degree of importance of pay in attacting and retaining talent
Compensation Level Positioning	Where base salary and target incentive levels are positioned relative to the competitive market (e.g., 50th percentile versus the 40th percentile)
Pay Mix	Proportion of total target compensation to be placed at risk or to be performance-based
Upside Opportunity	Extent to which sales reps can earn above target compensation Performance level at which superior levels of compensation are earned
Sales Rep Differentiation	Degree of difference between top performers/earners and average performers/earners Degree of difference between average performers/earners and bottom performers/earners
Performance Management	Timing, nature, and prominence of performance reporting and related information Frequency of formal performance interventions, and the related rewards/consequences

Defining a Sales Compensation Philosophy

The sales compensation philosophy will certainly be unique for every business. Differences in sales strategy and operating models dictate very different approaches to pay decisions, and the compensation philosophy will reflect those differences. That being said, the following sections highlight some guiding principles for each element of the sales compensation philosophy.

Plan Governance

There is no single right answer to the question of who owns sales compensation. Sales compensation strategy and design issues typically involve a number of corporate functions and business unit teams, but the ownership of such efforts typically falls into sales operations, the sales organization itself, human resources, or occasionally finance. As a link between sales and compensation, however, it is very common for sales compensation to have shared ownership between one or more of the listed functions.

Creating explicit ownership for sales compensation outside of a design effort is a strategic decision, rather than a "who has the manpower for sales comp this year" discussion. Creating a decision rights matrix like the one below can clearly articulate plan governance accountabilities:

Figure 2: Illustrative Decision Rights Matrix

	Sales	Sales Ops	Finance	HR	IT
1. Compensation Philosophy	Input	Input	Input	Input	
2. Target Pay Levels	Input		Input, Review	Suggest, Approve	
3. Pay Mix	Suggest	Input	Input, Review	Approve	
4. Upside and Pay-for-Performance Relationship	Suggest		Review		
5. Plan Communication	Review	Support		Draft, Administer	Support
6. Systems Implementation		Support	Support		Administer
7. Ongoing Payout Administration		Support	Support	Administer	Support
8. Periodic Reporting	Review, Support	Administer	Support	Support	Administer

Design Consistency

Sales compensation designs need to be customized to fit each individual selling role. That being said, some degree of alignment across sales roles may be desirable. Having similar measures, for example, clearly communicates that a few performance measures are important to the organization, regardless of job roles. The sales compensation philosophy should articulate the business' objectives for alignment across roles in terms of measurement and mechanics.

Similarly, different geographies and/or business units may face different talent markets or may have different selling strategies that warrant customized sales compensation programs. The need for customization needs to be balanced against the obvious efficiencies that come from a single, standard compensation program. Accordingly, the sales compensation philosophy should provide guidelines for when local and/or business unit customization is appropriate.

Non-Sales Alignment

The degree to which compensation strategy (and particularly total target compensation levels) should be aligned with similarly leveled non-sales jobs is an important one. The relationship between sales and non-sales compensation unambiguously communicates the relative importance of sales to the success of the business. If the organization is not driven by sales, but rather by new product development or operational excellence, then the sales compensation philosophy and approach needs to be adjusted accordingly.

Alignment to Business Goals

Certainly a sales compensation program needs to be aligned with key business objectives. What is less universally agreed upon, though, is the extent to which the attainment of individual and corporate goals explicitly impact representative earnings levels. In the most direct fashion, this will have an impact on plan mechanic decisions: true alignment between representative earnings and business goals is best achieved via a quota-based compensation plan.

However, organizations use this alignment philosophy beyond the commissions versus quota decision. Business leaders often only want sales reps earning the highest levels of compensation if the business can afford them. This commonly results in plan mechanics that "cap" representative earnings until certain business financial goals have been met. Alternatively, many believe that sales representative performance is the means that drives overall business performance, and as such prefer that a sales representative's earnings be determined based on their own individual goals only.

Pay Prominence

The stereotype of a sales person is the commission-based representative who really pushes for the sale. However, not all sales organizations want compensation to play a strong role in influencing representative behavior. Clearly stating the intended prominence of sales compensation defines upfront how much of a sales representative's day-to-day actions should be tied to the compensation plan. Furthermore, compensation is only one element of the overall relationship between the sales representative and the company. There may be other, more compelling or important elements (e.g. benefits, career progression, work content, or company affiliation) than can be more effective talent management tools, and as a result compensation need not be as prominent.

Compensation Level Positioning

Not all organizations can pay at the market midpoint. There are a number of business-based factors that can impact where target compensation levels should be positioned relative to some external benchmark. Applying this logic results in a target compensation level that accurately reflects the needs of the business, rather than simply the pay levels of your competitors.

Figure 3: Determining Target Compensation Levels

1. General Corporate Market Match Point	Below Median	Slightly Below Median	Slightly Above Median	Above Median
2. Degree of Company Stability	Rock Solid	High	Moderate	Low
3. Desired Business Results	Very Likely	Probable	Difficult	Unlikely
4. Expected Employee Performance (at Target)	Low	Average	Stretch	
5. Productivity Level	Low	Average	Above Average	Very High
6. Supply of Talent	Abundant	Adequate	Limited	Scarce
7. Mobility of Employees	Low	Modest	Some Hiring Away by	Frequent Hiring Away by
8. Staffing	Excessive	Adequate	Light	
Typical Relationship to Benchmark Pay Pay Mix	Significantly Below	Slightly Below	Slightly Above	Significantly Above

The proportion of compensation that is performance-based, whether it is via commissions bonus, or some other mechanic, can vary significantly across sales jobs and industries. Recently, a number of consumer products and packaged foods companies have significantly reduced the amount of compensation at risk, citing more power from retailers in the sales and distribution process as well as difficulties in setting accurate performance targets. The first concern, related to the role of the sales representative in the sales process, is the textbook driver of pay mix. The prominence of a sales representative, or the degree of control a representative exhibits over the sale, suggests an appropriate amount of compensation to be placed at risk.

Figure 4: Evaluating Pay Mix

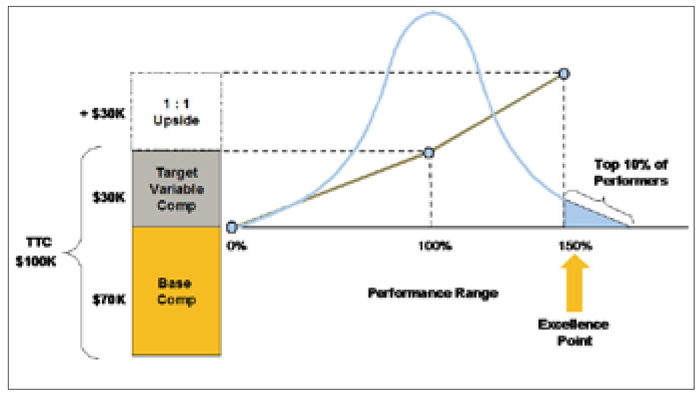
Low Prominence		High Prominence
High	Market Share	Low
Finite	Market Size	Infinite
High	Customer Acceptance of Product	Low
Repetitive and Predictable	Buying Pattern	Few/One-of-a-Kind
High	Sales Support	Low
High	Non-selling Activities	Low
Frequent	Team Selling	Never
Known	Customer Profile	Unknown
Farmers	Job Definition	Hunters
Low	Control Over the Sale	High
Low	Control Over the Sales Volume	High
High	Close Rate	Low
Low Incentive Mix (less pay at risk)		High Incentive Mix (more pay at risk)

Pay mix decisions are typically made for individual jobs. However, many of the criteria in the above framework can be applied to an organization as a whole. As such, an organization-level pay mix philosophy can be developed.

Upside Opportunity

The term upside is used to describe the opportunity to earn compensation in excess of targeted compensation. To place some terminology and mechanics behind this concept, upside is commonly quantified based on the expected earnings for performance at an "excellence point" which is typically achieved by the top 10% of performers.

Figure 5: Defining Upside Opportunity



Upside opportunity tends to correlate highly with pay at risk to create an appropriate risk/reward relationship; the more pay at risk, the more upside opportunity needs to be provided to offset the portion of compensation at risk. In addition to the factors identified previously to determine pay mix, a few other factors tend to impact upside opportunity:

Sales Cycle Length: Shorter sales cycles are more conducive to higher upside opportunity, since multiple transactions are included in each performance period. Longer sales cycles can result in a number of sales closing in the same period just due to timing, which can create an artificial performance high and thus payout disproportionately high levels of incentive.

Sales Culture: The more performance-oriented the sales culture, the more likely that high upside opportunity is available. The most driven sales cultures really want to reward the top performers, and as such need to provide high (often 3:1 or greater) upside.

Pay Differentiation

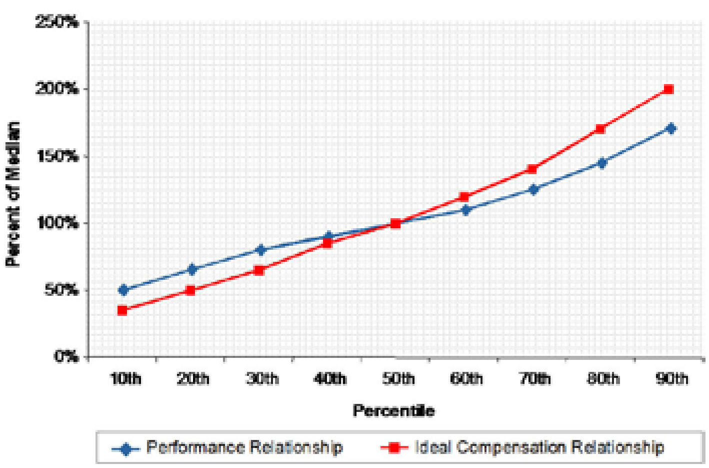
Closely tied to the concept of plan upside is that of pay differentiation. The difference between upside and differentiation is that upside is set in advance as a target earnings level for top performers, while differentiation is the desired actual relationship between representatives at all different earnings levels. While it is generally accepted that top performers should earn more than bottom performers, the obvious question is always how much more should they earn.

One way to begin to develop a pay differentiation philosophy is to look at the historical relationship between top and bottom earners and top and bottom performers. Start by calculating the earnings levels at each decile of earnings, and divide that value by the median earnings level.

By definition, deciles representing lower earners (below median) will have a value less than 100%, while the deciles above median will

be greater than 100%. Repeat this calculation for performance levels, and then plot the two on the same chart. An example is shown below:

Figure 6: Pay Differentiation Analysis



We typically expect to see the pay and performance curves to be similarly shaped, with a more aggressive slope on the compensation curve. The higher slope on the compensation curve indicates a reward for higher levels of achievement, and a penalty for underperformance. The 90th percentile point should roughly correlate to your target upside (differences in actual performance relative to expected performance can create some distortion). The 10th percentile point is also a critical element of the differentiation philosophy. If low earners are not adequately differentiated from average and high performers, sales representatives can settle into an earnings comfort zone that only requires mediocre levels of performance.

Performance Management

Sales organizations have very different philosophies on structured performance management. Some sales leaders believe that the compensation plan should be the primary performance indicator. As a result, very little management intervention and ongoing performance reporting is required other than a check stub. On the other hand, others feel that the frequent and directed performance management can have a tremendous impact on sales performance.

An organization's point of view on ongoing performance coaching, performance reporting, and formal feedback delivery should be tightly integrated with the compensation program, and as such must be included in the sales compensation philosophy.

Conclusion

The decisions comprising the sales compensation philosophy are generally more static than other more tactical design decisions. As such, the sales compensation philosophy needs to be refreshed less frequently than the details of the incentive plans. Many business leaders are happy to contribute to such efforts knowing that it will simplify the annual design process. By gathering all the key executive stakeholders up front to make these strategic and philosophical decisions, the organization creates the foundation upon which ongoing plan design and administration decisions can be based. SSE

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