TopLine

Sales Compensation Solutions

Everyday Diagnostics for Improving Incentive Compensation

Introduction

Regular diagnostics will increase the effectiveness of your company's incentive compensation program. Being intimately acquainted with the program's strengths and weaknesses will provide the insight to decide whether, when and how to implement the changes needed to keep salespeople focused and productive.

Considering the acute sensitivity of incentive compensation and its impact on sales effectiveness, it is critical that the management of incentive compensation programs be based on sound judgement and decision-making. A structured, fact-based evaluation makes sense because it avoids the risks associated with subjective sources of information such as anecdotal feedback and "gut feel". It is also vastly superior to the common practice of using sales results as a general proxy for incentive compensation effectiveness. Finishing the year above target may be cause for celebration, but it may also hide serious structural faults in incentive compensation that have been overcome by general economic trends or good fortune. Failure to identify and address these issues will undermine future success.

This paper reviews the following diagnostic exercises:

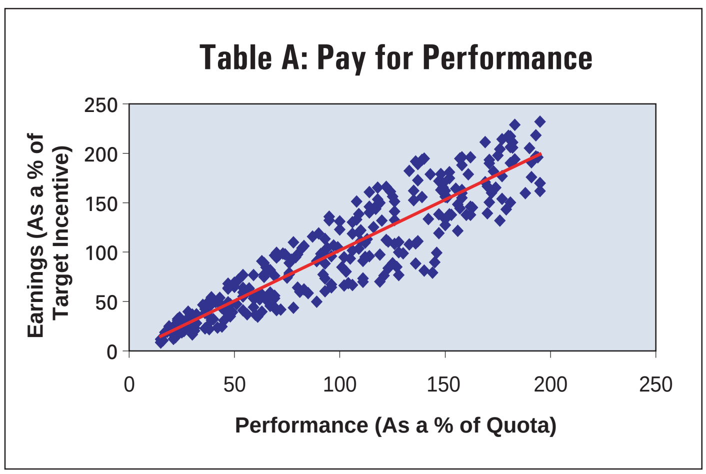
1. Pay-for-Performance
2. Earning Demographics
3. Market Competitiveness
4. Turnover
5. Operating Expense
6. Payment Errors

Each is designed to help you develop deeper insight into your incentive program's design elements and their effectiveness.

Pay-for-Performance

The correlation between performance and earnings, i.e., Pay-for-Performance, is the foundation of incentive compensation. However, as companies move away from traditional flat-rate commission programs towards quota-based structures and other non-traditional measures, this relationship can be easily undermined.

An effective way to evaluate the strength of this correlation is to plot incentive earnings against performance. An example is presented in **Table A**. Upward-sloping data points confirm the required correlation between earnings and performance. The correlation strengthens as the slope of the trend line increases.



Particular attention should be paid to outliers or incongruent data points. While some can be easily explained as new hires on guarantee programs or as individuals who have recently left the organization, be prepared to investigate further. This analysis can be especially effective in uncovering flaws in quota-setting methodologies.

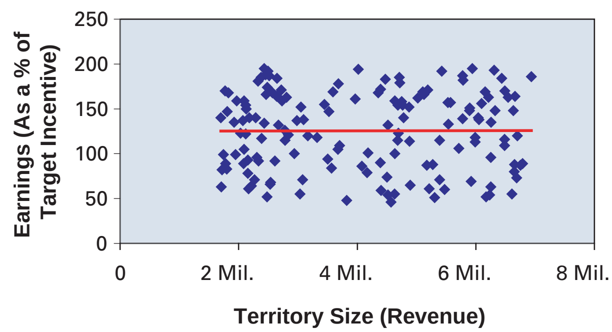
For additional insight, also consider plotting sub-sets of the overall population to assess the pay-for-performance correlation based on different sales regions, positions and product lines.

Earning Demographics

Once implemented, even the best designs can produce unexpected results. For instance, does your incentive compensation program inadvertently favour sales representatives with small territories over those with large territories? This section introduces a test designed to uncover any systemic faults that may undermine the integrity of an incentive compensation program.

To test whether territory size impacts earning potential, plot incentive compensation earnings in terms of gross dollars or % of target incentive pay against territory size. As displayed in **Table B**, a horizontal dispersion of data points would indicate a level playing field. Skewed dispersions would suggest a systemic earnings advantage.

TABLE B: Earning Demographics



A similar approach could be used to explore the impact of geography on earnings. Consistently higher earnings in specific geographic regions may indicate that flaws exist in the quota-setting process, or that the number of Sales Representatives deployed is inconsistent with the market potential in a particular region.

Exploring the relationship between earnings and tenure, training or product lines may also provide valuable insights.

Market Competitiveness

Understanding market pay levels in terms of total cash compensation is critical to successfully recruiting, retaining and motivating top sales people.

Regardless of how your company is positioned, for instance the 25th, 50th or 75th percentile, market information should be re-visited annually to maintain that competitive positioning. Market benchmark information helps to identify potential turnover risks and the cost of retaining top performers. It also provides guidance on recruitment tactics and merit pay increases.

Despite its value, it is important to recognize that market data is historic or backward looking. Therefore, be sure to keep track of the compensation packages offered to new hires, and the feedback received during exit interviews. This ensures that you can react quickly to emerging or localized trends that may represent a departure from market data.

Turnover

The loss of key sales people, whether to your competitors or other industries, can quickly undermine your ability to meet and exceed sales targets. While some degree of turnover is perhaps unavoidable, it is important to understand this particular threat to your success.

Analysis of turnover statistics starts with comparing the results in the Sales organization to the rest of the company, as well as to industry benchmarks. This will indicate your relative performance and the urgency with which you may need to act.

The second level is to delve deeper into Sales organization results by differentiating between voluntary and involuntary turnover. Of particular interest will be the performance of the individuals who voluntarily left the company. If a significant percentage were at or above quota, then further investigation and remedial action will be warranted.

In the process of analyzing turnover, be sure to gain access to the transcripts of exit interviews. These can be an excellent source of information where individuals have referenced incentive compensation or compensation in general as one of the reasons for leaving.

Additional benefit can be gained by tracking the number of weeks required to fill a vacant position (i.e., the average duration of an empty, unproductive territory), as well as two statistics relating to newly hired Sales Representatives: (1) time to first sale, and (2) time to reach quota. These statistics, along with gross turnover, should be shared with Sales management and Finance to quantify the cost of turnover, and improve the accuracy of revenue forecasts.

Operating Expense

Outside of the Sales organization, the biggest concern associated with incentive compensation is usually its cost. After all, it is a bona fide variable cost program with a reputation of inexplicably exceeding whatever budget was set for it.

To eliminate expense budget anxiety, time should be invested prior to the implementation of the incentive compensation program to develop an in-depth understanding of the dynamics of the plan – including concepts such as accelerators, qualifiers and minimum performance thresholds – at an individual and aggregate level. While most costing models are developed using spreadsheets, many of the incentive compensation software applications now available feature built-in modelling functionality that makes this exercise relatively quick and easy. Once refined and properly calibrated, the costing models should be used in the planning process to set a realistic budget.

The evaluation cycle starts when actual sales and payment results become available. The costing models should then be used to validate results and explain variances. This insight, when combined with accurate sales forecasts, will provide the information needed to ensure unexpected budget overruns become a thing of the past. Forecast accuracy in the plus or minus 2% range of your incentive compensation expense budget is a reasonable goal.

Payment Errors

Payment errors are one of the most contentious and destructive aspects of an incentive compensation program. Payment errors occur when an expected sales transaction is omitted, assigned to the wrong person or is otherwise perceived as having been processed incorrectly. While efforts should be made to minimize their occurrence and to resolve them quickly, care should also be taken to extract as much information as possible from them when they do occur.

To harness this information, payment errors need to be tracked and categorized. The first level of categorization should reflect the design of the incentive compensation program by attributing each payment error to the associated design item: measure (e.g., new customer revenue, margin), feature (e.g., accelerator, minimum performance threshold) or policy (e.g., order cancellation, new hire draw). The second level of categorization should capture the apparent cause of the error. Possible categories include items such as software/programming, data entry, manual miscalculations and the misinterpretation of policies or practices. For instance, if the in-house software you are using is the cause of a disproportionate number of payment errors, then time needs to be invested with IT to identify and correct them. Conversely, if most errors are attributable to the misinterpretation of policies by Sales Representatives, then additional workshops or FAQ (Frequently Asked Questions) documents should be considered. By categorizing at two levels, you'll be better able to identify and prioritize the remedial action that is required to prevent future occurrences.

Special attention should be paid to escalations. These are situations where the resolution of a payment error is beyond the discretion of front-line staff and their managers, and usually involve disputes over policy interpretation or events not directly addressed in program documentation. Ultimately they are resolved by escalating to a dispute resolution committee or a senior executive tasked with hearing these types of occurrences. Escalations are serious time-wasters for all involved, especially Sales Representatives, and tend to generate more contention than they are worth. Examine each carefully and assess whether the incentive compensation plan can be modified either immediately or for the next fiscal year to pre-empt future disputes.

Conclusion

When dealing with a program as sensitive as incentive compensation, it is imperative that its management be based on facts. Anything less, such as relying on subjective perceptions or personal preferences, brings with it the risk of needlessly alienating your sales people.

A thorough, structured evaluation of your incentive compensation program delivers the insight needed to improve its effectiveness. Knowing whether, when and how to implement a change will minimize contention and keep sales people focused on delivering the results you need.

About the Author

Greg Blysniuk, founder of TopLine Sales Compensation Solutions, offers deep insights into the operational and strategic issues that are integral to effective sales compensation. With experience dating back to 1991, he has used his hands-on, practical approach to solve sales compensation challenges in a broad range of industries including telecommunications, software, retail insurance, e-commerce, manufacturing, distribution, retail, professional services and broadcasting.

About TopLine

TopLine Sales Compensation Solutions is a consulting firm dedicated to helping clients improve sales results by harnessing the full potential of their sales compensation plans.

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