

Five Common Flaws in Sales Compensation Formula Design and How to Address Them

By: Jerry Colletti & Mary S. Fiss

We are now in midst of that great American business past time, affectionately referred to as “tweaking” the sales compensation plan. If you are not familiar with this phenomenon, perhaps you are among the lucky few who have avoided it. However, for many others it’s roughly the period of time from the Monday after Labor Day to a day or two before Christmas Eve when HR/compensation, finance, and sales managers are rushing to “tweak” the current plan in time for next year!

The purpose of this Short is to identify five common sales compensation formula design flaws that too often occur as a result of tweaking and provide suggestions about how to avoid each.

#1 – Incentive rates based on “optics”.

“Optics” refers to adopting the practices of competitors or other internal divisions because it looks good, for example, adopting a 10% commission rate because that’s what others do. One potential problem this approach causes is commission costs that are too high or not aligned with the desired target total cash compensation. It’s best to avoid this practice. The way to do so is to: 1) set an incentive comp target by job; and, 2) link rates to the incentive comp for performance in the job and business plan – particularly if it’s a commission rate.

#2 – Too many payout “modifiers”. This practice is rooted in the belief that “...*if you don’t pay them, they won’t do it...*” The consequence, of course, is too many measures or modifiers on measures in the plan. This flaw can be avoided by limiting the number of measures to three including modifiers. Also, other performance management tools – merit pay, performance appraisal, contests, and recognition, wisely used, can serve as more effective alternatives.

#3 – Performance range “too-high; too low”. When the performance range is set too high – meaning the range from threshold to excellence -- too few sales people gain entry into the plan; and, even fewer benefit from the over-achievement (OA) or leverage opportunity. A

performance range that is set too low means just the opposite, that is, too many sales people not only gain entry into plan payout but also those who do exceed quota benefit from over-achievement pay without true overachievement performance. To avoid either case, the best approach to take is to complete thorough historic performance and cost modeling exercises to validate the right performance range anchors (threshold; excellence) associated with plan cost.

#4 – Rate change(s) disconnected from where selling makes a difference.

This flaw is often the result of management’s desire to use multiple points of acceleration in the incentive payout line. Of course, those points of acceleration result in incrementally higher incentive costs; thus, it is critical to confirm that accelerated rates are a factor in moving sales performance to the next level. One way to address this design challenge is to: a) identify the highest performing sales people; b) identify the point of sales performance between (a) and the next highest performers (i.e., cluster) and, finally, (c) “test” or model the cost consequence of putting an acceleration point in between.

#5 – Misuse of advance design techniques.

This flaw is the result of using formula design techniques – linkages, matrices, multipliers – that may be either inappropriate or unneeded relative to the desired selling behavior and performance. Too often we see formula designs used – complex ones in particular – that do not solve the sales performance problem. The most common is to use multipliers or accelerated rates to mask overly aggressive sales quotas. Because complex formulas often add to sales force confusion about incentive pay, it is wise to first validate that a performance problem is solvable through the comp plan irrespective of formula type.