QUANTUM SALES COMPENSATION
Plan Mechanics

Good morning, everyone. My name is Randy MacLean. I'm the president of WayPoint Analytics. This is the second in our series "Master Classes on Sales Compensation Design." In today's session, we're going to look at plan mechanics, the mathematics and the rules and regulations that we could put in place in designing a good sales compensation plan.

Now as you remember from last week or from the last session, a good plan design is going to pay for persuasion, it's going to protect the best reps, it's going to protect the company against runaway earnings, it's going to make sure that the people that make the best contributions are going to be rewarded, and it will provide performance insurance for the company.

Today we're going to look at the mechanics that we can employ for that and why those things are necessary. That will lead into next week's session where we'll look at the actual spreadsheets and look at the actual mathematics and how to choose the numbers that you're going to use in the plan mechanics so that you can design your own plan.

Tale of Two Sales Reps

The first thing I wanted to look at is I wanted to talk about two reps in the business as it is now. The first rep we're going to look at is Minn Fuller and we're going to look at the metrics of his particular performance. Minn's a younger guy; he's been around for a little while and is pretty much of a go-getter. He's nowhere near our superstar, who we'll also look at, but he's a mid- to upper-range rep that we'd like to look at.

Minn generates $190,000 in gross profit. We don't really care about revenue, of course. Revenue is not all that relevant to what we do in terms of producing profit for the company, but gross profit dollars are. His production is $190,000 of gross profit dollars. After we pay for all of our operating expenses for his business, we have $125,000 left. So, about $65,000 is how much it costs the company to service Minn's accounts. We pay Minn $73,000 for having done this and that works out to about 58.8% or 59% of the NBC gets paid out to Minn Fuller.

Now the NBC number is very good because what it represents is the money that we have left after we paid for the product and we paid for all of our operations to deliver the product to Minn's customers' hands. It's the amount of money that the company splits with Minn. So out of the $125,000, we paid $73,000, the company gets to keep the rest. Now Minn is getting just about 60% of the NBC that he's generating, but that's actually fairly typical in wholesale distribution. The number usually tends to be between 40% and 60% of the NBC that's generated gets paid out to the sales force on average where we have profitable territories, so he's right in the range. It's not that we're paying Minn on this. We're just taking a look at what the numbers are in terms of what's really happening. Minn is actually paid a base plus commission, and the commission is based on the gross profit, and this is how it works out.

Let's take a look at our second, one of our best guys, Joe Posey, who's at the top of the list. Joe generated about $900,000 in revenue, $177,000 in gross profit. When we look at his NBC, we're actually $6,500 underwater. The cost to serve his accounts was only $65,000 for Minn; it looks like it's something on the order of about $180,000-185,000 for Joe Posey to service his accounts. When we pay him $65,000 for having done this, he has lower margins so he gets a smaller commission but he still has a base, and essentially we're paying our $65,000 on a territory that loses $6,500 compounding the losses in the territory. But for years, Joel's been a big guy, he's got the revenue, he's got some big commission checks. Right now in this particular quarter that we're looking at, he's down a bit but typically he has higher margins than Minn and does more sales than Minn, so we pick him as the top guy. But if we look back through his territory, he's been losing money for a long time. We don't pay a lot of attention to it if we don't have the numbers, so it's really important to look at the NBC numbers.

Gross Profit Commission Plan

Now we've taken a look at what goes on in the market. This particular chart, we've taken a subset of sales transactions from a lot of different sectors across a very short period of time; in fact we just looked at one day in the year across the number of industries, number of geographies, and we tracked all of the sales and what commissions were paid on the sales.

The actual commission amounts for the NBC that's generated on the invoice are on pink line here but we'll smooth it out so we can really see what's going on with this red trend line. It shows that as the NBC is being reduced, and this blue line is the NBC that we're seeing on the invoices, so we rank them all from the highest NBC to the lowest NBC, and up here we have an invoice where we had about $600 of NBC and there was about $300 of commission paid out on that particular invoice. As this blue line is actually the NBC or the profit line on this invoice, this is where we rank them all from the most positive NBC to the most negative. When we look down at the bottom, we have an invoice that lost $200, and unfortunately that $200 paid about $40 of commission.

So the blue line here shows the ever-decreasing amounts of NBC, we get down to break-even invoices, and then go below break-even here, and yet the mechanisms of our commission payment plan tends to flatten out, the lowest certain gross profit. We stopped paying commissions and you can see there's a few of them that hit zero line here, but in other cases, we're still paying commissions because the gross profit is high enough but there's no profit or there's a loss on the actual sale. So what we've essentially done is that we have for the top end of the program, the profitability and the commissions track reasonably well, but when we get down to the low end, we have an anomaly generally in our compensation programs where we're still paying commission while the profit on the invoice goes to zero and then goes below zero.

This is problematic because we're not only increasing the losses by paying commissions on invoices that are underwater, we're also encouraging the sales force, we're incentivizing the sales force to bring us more business but the profit is underwater because they will be rewarded for doing so. This is one of the things that we'd like to curtail. What's really happening is there's a certain segment of the business here where the plan is malfunctioning and not doing what we intended it to do.

Now there are a lot of devices that people put in to try and prevent this. There are a lot of people that have load factors that take some of the gross profit off the invoice and don't pay them the full amount of gross profit. There are some programs where they have thresholds where if you drop below a certain amount of gross profit in a territory or on a sale, you won't get paid commissions, but the problem is that things just above threshold will still pay. Those mechanisms don't really solve the problem because we're not looking at the actual profitability; we're just looking at the gross profit or gross margin. Gross margin is really not related to profitability at all.

NBC Commission Plan

So what we'd like to do is switch to an NBC commission program, where we see the blue tracking of the profitability on the invoice, the green shows where the commission on the invoice would be. When we take one of these NBC driven plans, we're actually able to pay on profitability. But a very important distinction on these plans is that they allow negative commissions. If there's a sale where the company is losing money, it winds up being a deduction from the paycheck or from the commission that goes to the salesperson. That means the salespeople not only share in the profits that are generated in the territory, they also share in the losses that are generated.

This can help a great deal because you wind up reducing commissions on sales that are underwater, and the mechanism works the same for the salesperson as it does for the company where a money-losing sale deducts from profits that have been made elsewhere, and the money-losing sale will also deduct from commissions that are made elsewhere. That helps synchronize the objectives and incentives that the company has with the objectives and incentives that the sales rep has.

Sales Compensation Rates

So let's take a brief look at sales compensation rates. There are a few things that you can do as a thought exercise if you're not using WayPoint. If you don't have NBC numbers directly, there is a way of calculating rough NBC so you can see what's going on. I have a couple of interesting facts: The first thing is most companies pay between 40% and 60% of the NBC to the salesperson. That's not the commission rate. Of course, there are commission plans where people are on straight commission, full commission, all they get is commission, and there are other plans where there's a mix of a base salary and a commission rate. In some cases, companies don't have commissions at all; they just pay a salary for their sales folks and the salary is not tied to performance in any way at all. But when we look at all those numbers, regardless of what they are, industry averages and history tradition usually bring companies to an endpoint where about 50-60% of the NBC that they're producing is being paid out to sales force.

Now you can do a self-check on what you've got right now. If you don't have the NBC number through WayPoint, then what you can do is take your sales compensation total. This is the total amount of money that you have paid out to your customer-facing salespeople—the people that are responsible for bringing in new business, the people that meet with customers in one way or another, and the people that are supposed to be expanding the company sales. You take their total pay: base plus commission plus bonuses or incentives, or if there's anything else that you give them, but do not include things like benefits and state deductions and those kinds of things. Just keep it clean. The same amount of money that represents their gross pay, you total that up here. Then what you do is take your operating profit and add back in that total pay, so you wind up taking the sales compensation total and dividing it by the operating profit plus the sales compensation total.

If you do that, you will find out what percentage of NBC you are paying out to your sales force and you can do a self-check and see where you fit. If you're paying out 20% of your NBC to the sales force, congratulations, well done, you got an efficient and low-cost sales force. If you're paying out 80% of the NBC to the sales force, then you're behind the curve and you're paying more than you probably ought to be. It really means that the company is very much a junior partner in the profit generation exercise that the company has.

NBC Commission Plan

We recommend an NBC commission plan because they meet all of the objectives on the five elements of a good sales compensation plan. So when we start looking at the mechanics of the plan, they may have a monthly base salary or some kind of base salary component. A lot of companies, even though they have straight commission, will wind up with a component because they'll have new reps or new territories, they sometimes will have somebody coming in, they have to develop a territory, somebody has to get their feet wet and get ramped up. So what they'll do is they'll guarantee a certain amount of pay or they'll advance a certain amount of pay through a draw system in order to make sure that people can get some traction before they are left to swim on their own, as it were. So they will wind up having a base component even on a straight commission.

One of the great things about having a base pay is that it provides a smoothing to the amount of pay that goes out to the sales rep. What we mean by that is if we have a plan with a mix of the base salary or guarantee pay and the amount of commissions that's paid out, let's say 50-50 just for a round number, $60,000 a rep is having would have a $30,000 base and about $30,000 in commission in that kind of environment. What will happen is as the profit generation goes up or down from month to month through seasonality and other things, the fixed part of the income or the base salary helps smooth that out, so even if they have a sales cycle that gyrates wildly, they still are centered around that $30,000-60,000 range and they'll wind up with greater or lesser pay but it won't have a big impact.

Now if the economy goes south, sales go down, the rep is protected because they still get their base salary regardless, and the only part that drops is the incentive part of the program. So if you look at a territory that dropped off by 10% or 15% in terms of its profit production across the course of a couple of years, what would happen is that the sales pay would only go down by half of that, it will only go down by 7.5%, and so the company would wind up paying more dollars per unit profit generation across time like that.

The flip side is if the economy turns around and all of a sudden things are hopping along again, the company gets the benefit of the larger increase because the sales and the territory will go up by 15%. By the same token the amount of pay would only go up by half of that because only half of the pay package is variable. So, there's a smoothing function.

Now when you're designing a plan, one of the elements that you'll be looking at if you have a plan that has a mix is, how do you set the numbers? We'll get into that more specifically in the next session, but one of the interesting elements is this: Let's say that your company is broadly geographically based and you may have people working downtown Manhattan and you may have people working in Montana, and the cost of living is much, much different between those two places. You virtually need a million dollars to be able to buy a condo in New York of any sort, but you can buy a house in Montana for a tenth of that. So the amount of pay that needs to happen in those territories could be quite different.

Companies can use a mechanism that has a mix of base pay and commissions and you could say that we have the same commission in New York and in Montana, or the same commission rate is paid in both places, but the base pay in Montana is substantially lower than the base pay in New York. So the base pay component can give you a mechanism that helps keep the profit production part of the pay package; that's where they tied in to how much profit they bring in to the company. You can keep that fairly simple and then have geographic differentials or sales role differentials in terms of the base pay. Having differentials in the mix is fairly common, and that's one of the good ways of doing it.

Now programs may have, instead of a base salary, they may have a guarantee. There's a difference when we're talking about professional design between a draw and a guarantee. A draw against commission is where somebody might not be making the commission or making the pay that they need to make or that you'd like them to make in a particular period but you'll pay them more than they've actually earned in that time frame with the idea that you'll deduct it out of future earnings. That's called a draw. So, a draw is recoverable.

A guarantee is where you say, "No matter what you sell, we're going to pay you at least this." The idea is that you're not going to recover it; you get a clean slate at the end of each session. The rep would be looking at a particular month where they're underwater while you'll just sort of top them up and then you forget about it and move on to the next month; hopefully they'll have a really good month and make good pay in that way.

Most companies don't set out to have guarantees unless they have a specific circumstance, usually the startup of a new rep or a new territory, opening up some new business and you're trying to keep your people focused in that area. However, most draws in my experience turn into de facto guarantees if you have somebody that has got a draw this month and then gets a draw next month and then gets a draw the third month. They wind up taking a look into the future and winds up becoming a huge demotivator because they start to recognize that they're never going to make good money. They're just in their mind going deeper into debt in the company or with the company.

It usually leads to somebody finding other employment and leaving, and then it's very difficult. Most companies won't go through a legal action to try and recover draw from somebody, so it effectively becomes a guarantee. If the management of the company can see that this demotivating factor is happening where the usual draw is backfiring and removing incentives to sell, they may decide to forgive the draw just out of good management decision making, in which case the draw becomes a guarantee as well.

So I would be very hesitant about using draws. I can't think of a circumstance across the course of my career where draws have been used where they were particularly effective or, at the very least, didn't have larger negative consequences than positive ones. And so I'd be very hesitant about putting draw into place.

At any rate, the most common uses of a guarantee is new reps, new territories, or new business segment where you're trying to get something done and you need to put somebody out there and it's going to take them a while to get established. That's where the company's making an investment to accomplish a goal.

The last point in here is the beauty of an NBC program is that it's very, very simple. In a previous life, I was at an organization that would encourage its clients to, after they paid somewhere between $100,000-500,000 and have a plan design, they would be encouraged to buy a million-dollar software system that would help calculate commissions in these complex programs that we've put together.

The real issue that we have back in the olden days, certainly before WayPoint, is we didn't really have a way of figuring out what the profitability on a territory was, and so we would have to bring together a lot of complex mechanics that would simulate profitability or what we thought were indicators of profitability, like the gross margin rate versus the size of the sale, having different thresholds where if the territory made this much of quota, then it would be this rate, and if it was that much of quota, it will be a higher rate. We would use mechanisms where they get multipliers and other things, or we'd look at KPIs where we thought if somebody does such and such in a territory, it's likely going to be more profitable and therefore we should pay more to get that to happen. These plans could wind up being enormously complex, both to design which is part of like the costly expertise that we brought to the gain and the cost of the complicated or complex system that needed to draw out different elements of the selling activities and needed to track for elements of selling activities so we could make an educated guess as to where profit is being generated.

Today in the age of WayPoint, that number is directly known, the NBC on every invoice and certainly on every territory and we know exactly what costs are involved and we know exactly how much money we made, and so we have a very simple program.

Now one of the things I should mention is that a good compensation program, especially in the WayPoint environment, there's going to be a certain fluctuation in the numbers. In the accounting department of any company, the actual costs of a particular month are usually not known within the time frame of the month. We have trailing invoices that come in later and expenses get close past the end of the closing on the billing for the period and may take us a while to get journal entries and other things through the system, so we don’t know what the profitability is.

Now this has an impact on WayPoint and the most common regime in WayPoint is where the financial information is close to the end on a quarterly basis. So if we look at January, we’re looking at a cost structure that’s finalized from the previous year on a calendar-year company, and it’s a pretty good estimate of what’s going on. But at the end of the first quarter, the books will be closed, the journal entries will be made, and we will know what the real costs are. There may be some adjustment to the amount of profitability that we thought that we have through the projections.

In those kinds of environment, it’s very simple to resolve the variations that will inevitably come out of that. All large companies understand this and have a mechanism in place for this. Certainly as you look at profitability, people have been paying their management teams bonuses on profit for eons, and these kinds of things are usually dealt with by either delaying the bonuses until well after the end of the period or keeping them till the end of the year. But it’s a lot more effective having an incentive program that pays out at least quarterly or, in case of sales, on a monthly or periodic basis.

So the mechanism that professionals use to deal with this is called a true-up. The way that it works is at the end of January, you’ll have an idea what the profit is, more or less, and you’ll pay the person based on that and you’ll remember how much was paid. At the end of February, you will be able to calculate how much the person should have earned for the first two periods of the year and you will know how much has been paid out already. You’ll true it up by paying out the balance. You’ll essentially do that throughout the year. When you get into the commissions for the fourth period, you’ll already have closed out the first quarter.

There may be some variation in how much money should have been paid. It could be that you made more money than you estimated from the projections and the rep is owed more, and you’d true up and make sure that they get the rest of what was due. It may be that you’ve overpaid them; you didn’t make as much money as you thought you did through the projections and that will wind up being deducted out, that variation will come out of the next amount of pay. You’ll wind up doing that for 12 periods or 13 periods through the year, depending on how many periods you have on your calendar.

At year end, of course, there’ll be a final true-up. By the end of the year, the rep will always have made exactly what he was supposed to have made, the company will always have paid out exactly what was supposed to be paid out, and the rep will be well served and so will the company. This shouldn't cost a lot of dissension or problems as long as everybody understands what the rules of the game are.

You can use good management discretion if for some reason your projections were wildly out. I can't remember a circumstance where this has happened, but if it does happen, then you can take more than one period to do the true-up. You can take part on the differential out of one period and part of it the next period, and you have a mechanism for situations where you have wild variations or gyrations in the amount of pay that was calculated. But in seven or eight years of WayPoint, I can't recall any instance of that ever happening and I wouldn't expect that to be an issue.

So let's go on with the bullets here. A good program should also have a transition plan. That means that the program should be designed in such a way that the people don't have to switch from one plan to the next cold turkey on a single day. It's much better to build a plan that gives you an adequate transition period. In a lot of cases, transition periods can be six months; they could even be a year.

One of the best mechanisms that we've seen, as suggested by a very sharp incentive design person we met working up in New York. She helped design a program for one of our clients, where they had a program where they were going to start paying NBC at a rate that they had selected. They could see that several of the sales reps that they have would immediately be making a lot less money because they were like Joe Posey where they were underwater or they were generating very low amounts of NBC.

So, what the company came up with her design was, in the first quarter that they ran the plan, they were going to pay them the higher amount of either the NBC program that they were on, or 100% of what they had made in the same period of the year before. In the second quarter, the plan changed to where they made whatever the NBC program was or 90% of what they had made in the same period of the year before. Through the course of the year, it went from 100% down to 70%of what had happened the year before. That gave the sales management team lots of time to bring the reps along, help them change the nature and the mix in their territories so they had more money-making and fewer money-losing accounts by transitioning some of the accounts from money-losing to money-making and kept the pay in line so they could get what they needed.

You should always be flexible post-launch to allow for unforeseens. If you run into a situation where the plan is clearly not working, you should be flexible enough to make adjustments or course corrections on the plan. In a well-designed plan, it's uncommon for that to happen. But who knows? We don't always know everything that's going to happen in the future. Just recognizing and letting the people know that we are not out to hurt them and if the plan is not working, we can make adjustments to it, can be very helpful in reducing the heat and smoke that comes with it.

Finally, the last point I want to make is that the plan should incorporate territory realignment. The first principle is you'd like to have your A accounts in the hands of your A reps. There's nothing worse than having a really top premier hugely profitable account disappear because it's bungled by a C rep. So, one of the things that Merrifield recommends is that you review your sales force and put them into two or three piles. You look at each person and you say, "Wow, this is a great person we wouldn't want to lose them. If we could find more like them, we'd hire them in an instant." That's your A pile. In the C pile, you look and say, "If we had a choice, we would never hire this person again." All the rest go into the middle, into the B pile.

If you have the luxury of geographic reach or proper coverage in all the places where you need sales, you'd like to carefully consider having your best accounts in the hands of your best reps. You can rebalance the territories so they have a good mix of money-making and money-losing accounts, where the people have the ability to convert the money-losing accounts into moneymakers to make money for themselves and for the company.

The A reps are spending an increased amount of time on numerically smaller territory made up of larger accounts where they can really shine and they can add more large accounts like that to the territory. The people that are better at the mid-range accounts are specializing in the mid-range accounts. So having territory realignment can be a very powerful tool. As you work through the territory alignment, you may find that some of the C reps you have don't need to be there anymore and you can look at reducing the sales force with those people so that you don't have people that are creating a drag on sales and the sales performance of the company.

So that's the general look at the plan mechanics and the methodologies that we'll use. Our objective is to marry the pay to the proper production. In our session next week, we're going to get right down into the details. We're going to look at some of the spreadsheets that we're going to share with you that you can use to start working out what the numbers might be and give you the things that you would need to have, the tools you'd need to have to start working on an actual plan for your company.

So thank you very much for spending time with us this morning. I'm really looking forward to next week's session. We'll see you then.