How to Design a Credible Sales Incentive

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What is sales compensation?

Lucero (2019) alludes to sales compensation is the combination of base salary, commission, and incentives that are used to drive the performance of a sales organization. A sales compensation plan is the individual plan for a sales representative within your sales organization, and it should be designed with specific concepts and components in mind, based on their role within the sales cycle, types of sales engagements, seniority, and more.

Compensation is an important consideration for the sales team when recruiting and retaining talent. That's why having the right sales incentives for your organization is key to your success. You want to give the best talent a justification for taking a place on your sales team and sticking with your business for a long time. Different sales team roles will require plans that are unique to each rep. Sales compensation management is the method of overseeing plans and ensuring components drive performance aligned with organizational goals (Lucero,2019).

However, sales compensation can be tricky to get right. Not only are salespeople notoriously good at figuring out and exploiting loopholes in the pay structure, but there are also dozens of different variables you need to balance to ensure you are allocating your resources appropriately.

Examples of sales compensation plans

Your sales compensation strategy is the plan which drives the success of the sales team and helps them to increase revenue. A sales compensation package provides information on all aspects of a sales person's earnings such as their base pay, bonus, and any bonuses or benefits to which they can apply.

The following examples illustrated by Baker (2019) include the most common types of sales compensation plans. Each example has a different structure, so one will be able to tailor their plan to their specific sales team and business based on their needs, resources, and goals.

1. **Salary Only Compensation Plan**

With a salary-only structure, you decide ahead of time how much you will pay your salespeople. It does not matter how much (or how little) they sell, their take-home earnings are set. A salary-only structure is fairly uncommon for sales teams. That is because, without commission, reps are usually less motivated to go above and beyond. After they have hit quota, they may relax instead of pushing for the next deal because there is no incentive or reason to continue onward.

Plus, many salespeople love the thrill of scoring commission — the high stakes and competitive nature of earning a commission is often part of the reason reps go into sales in the first place. Not to mention, your top-performing reps may just leave your company so they can make commission elsewhere. So, are there any positives to a salary-only compensation plan? They make it simple to calculate sales expenses and predict hiring needs. Additionally, your reps may be less stressed because they don't have to worry about the financial consequences of missing their target or the weight of the competition.

2. **Commission Only Compensation Plan**

A commission-only structure means you pay reps purely based on their performance. If they do not sell anything during a month, their salary is zero. If they sell $50,000 worth of product in a month, their salary may be anywhere from $15,000 - $22,500 depending on the commission percentage you offer your employees.

Due to the simplicity of a commission-only compensation plan, you forgo a lot of risks because when your salespeople succeed, revenue increases; when they fail, you lose nothing. It also motivates reps by giving them the freedom to earn as much money as they can while saving you time trying to identify any poor performers on your team. However, commission-only plans can make it challenging to forecast your expenses and stick to a tight budget.

In terms of the commission percentage to pay reps, you may decide it to be anywhere between 5% to 45%, which is standard. Additionally, the more support you expect reps to give customers (such as implementation help or account management), the higher their commission should be. Remember to factor in their level of involvement in the sale as well, meaning if they are only producing leads (rather than closing them, too), you should allocate a smaller commission.

3. Base Salary Plus Commission Plan

The most common sales compensation pay structure is the base salary plus commission plan. This structure provides reps with a fixed yearly base salary as well as commission. They get the security of a steady income with the economic incentive to sell. This plan is ideal for most businesses because you benefit from greater clarity into your expenses (since there is less variability) and the opportunity to hire highly-motivated, competitive salespeople. Furthermore, since you are giving reps a base salary, they are obligated to fulfill some non-selling tasks such as training new team members.

In this plan, the commission percentage is lower because of the base salary. To determine your base-variable (or fixed) compensation split, think about the following factors:

- How difficult the sale is
- How much autonomy is needed (for example, are you providing your reps with leads, or are you asking them to generate their own? Are you giving them technical support or none?)
- How much experience is necessary

To determine the variable compensation think about the following factors:

- How complex your sales cycle is
- How much influence the rep has over the purchasing decision
- How many leads reps work with at a given time
- Your team's selling function (such as hunting or farming)

Essentially, the shorter and simpler a sale is and the less impact a rep has over the customer's behavior, the smaller the percentage of variable compensation should be.

For more guidance, you can think about the industry standard, which is 60:40 — meaning 60% fixed to 40% variable. A less aggressive ratio (think 70:30 or 75:25) is common when reps are required to teach the prospect because they're most likely selling a highly complex or technical product. Account managers may have a similar ratio of fixed to variable pay, driving them to spend more time helping their existing customers than finding new ones.

4. **Base Salary Plus Bonus Compensation Plan**

A base salary plus a bonus compensation plan is common when your reps tend to consistently hit their pre-set targets. This approach offers a high level of predictability and still motivates your reps to close sales. For example, you might pay $30,000 base and $15,000 for selling X amount per year. If you know about eight of your 10 employees will consistently hit quota, and total earnings are $55,000, you can set aside $440,000 in your annual budget for the bonuses. But again, this prevents reps from feeling any motivation to over-perform.

5. **Absolute Commission Plan**

An absolute commission plan requires you to pay your reps when they reach specific targets or milestones. For example, you might pay your salespeople $1,000 for every new customer they obtain or 15% of upsell and cross-sell revenue. These plans are easy for reps to grasp which typically drives good results. Also because the output is directly tied to salary, reps are usually highly motivated to perform. Additionally, you do not have to set a quota — instead, you can set benchmarks or recommendations, but ultimately, you are only compensating reps for what they sell.

However, this structure does not take into account market penetration or the number of opportunities. For example, one rep may be getting twice as many leads as their peer, but they would both be treated equally. Additionally, you will need to carefully consider what is best for the overall company when determining the commission. If you are trying to drive the sales of a certain product line, you will need to compensate reps accordingly (hint: reps will often do whatever is most lucrative for them, regardless of greater business objectives).

6**. Relative Commission Plan**

Unlike an absolute commission plan, a relative commission plan uses a quota or predetermined target. This target can be based on revenue (X dollars) or volume (X units). When a rep hits 100% of quota, they make their OTE which consists of either base plus commission or pure commission. For example, if a rep's yearly quota is $60,000, their at-plan commission is $50,000, and their base is $80,000, then their OTE would be $130,000.

7. **Territory Volume Commission Plan**

With a territory volume commission plan, sales teams work with prospects and clients in clearly defined regions. Your reps are paid on a territory-wide basis versus an individual-sale basis. Once the compensation period is complete, the total sales are split among the reps who worked that territory. This type of compensation plan is a good fit for team-based sales organizations where each rep works towards a common goal and focuses on a specific territory or region. To attract reps to this type of plan and grow your sales teams, you may offer them an attractive commission paired with a well-developed territory.

8. **Straight-Line Commission Plan**

A straight-line commission plan rewards reps based on how much or little they sell. For example, if a rep reaches 86% of their quota, they will receive 86% of their commission. If they reach 140% of the quota, they receive 140% of their commission. Although this approach is relatively easy to calculate, it is not perfect. The issue is you want to encourage over-performance as much as possible. If you are already paying base, getting a rep to hit 140% of their quota from 120% has a greater financial impact than getting an under-performer to hit 100% of quota from 80%.

Plus, a rep may be just fine making 80% of quota — you do not want to disincentivize any of your reps to sell because they are content with a lower salary (which is when you would incorporate an accelerator).

9. **Gross Margin Commission Plan**

Maybe your company will pay reps based on profit rather than sales. In other words, a rep would be compensated more for selling a product with a $2,500 gross margin than one with a $1,000 gross margin. This works well because it discourages discounting. Reps can become reliant on discounts to close deals which is not good for your business. Not only are your margins eroded, but the perceived value of your product goes down and future customers will come to expect a price slash. Tying commission to the product's final cost encourages reps to give fewer and smaller discounts.

Additionally, gross margin commission plans promote the sales of specific product lines. Not all of your products are created equal — whatever the case, paying on gross margin motivates your salespeople to sell more of your most profitable products. However, there are three main things to keep in mind when it comes to gross margin commission plans.

1. Revenue must be your priority if you use this plan. Perhaps you are trying to build market share or attract the top 20 logos in your industry. You want salespeople to focus on those goals by compensating them for profit may distract them and cause them to pursue the wrong customers.

2. Reps must have control over pricing. Reps have to be either selling multiple products at different price points or have discounting power.

3. You must be able to track your gross margins. Shifting product and/ or distribution costs, rebates, and territory changes can make calculating this extremely hard (Baker, 2019).

How to design a sale incentive

1. Determine Sales Compensation Plan Goals

The first part of developing a sales compensation plan strategy includes setting your goals. Laying out your business objectives is a critical part of any strategy. Clarifying your priorities will help you decide how to compensate your salespeople in a way that works for your business.

2. Choose Type of Sales Compensation Plan

Now that you have your goals, it is time to choose which compensation plan you will implement at your company. While determining which plan is best for your business, ask yourself the following questions:

What is my overall budget?

How many reps do I have?

What types of compensation plans do my competition use?

What will my salespeople expect out of the plan implemented?

You will also need to determine when you will provide compensation for employees. There are three standard options for paying commissions.

#1 When Customer Signs a Contract

Paying when the customer signs the contract is good motivation for the salesperson at hand because they immediately see the monetary impact of closing the deal. However, this payment plan can also lead to cash flow problems if there is a significant delay between the signed agreement and the first payment (especially if you are an early-stage business and/ or it is a large deal that is being closed).

#2 When You Receive the Customer's First Payment

Compensating reps when you are paid is the most common payment method. There is less lag between the time of the commission and revenue payments. You can also use clawbacks to incentivize salespeople to focus on good customer fit (rather than just anyone who will buy) which often boosts retention rates. Note: If you are a subscription-based business, this timeline can disrupt your cash flow. After all, if you give a rep commission on the entire contract when you get the first check, you are paying in advance of the customer's subsequent payments.

#3 Every Time a Customer Pays

Paying each time you get an invoice is ideal if you want to protect your cash flow. Nonetheless, it can be complex to plan if you are on a tight budget especially if you have a large sales team of reps closing and managing deals.

4. Choose a Payroll Software

Once you have determined your plan goals, type, and payment plan, you can choose a payroll software to assist in the action of compensating your salespeople. Depending on how long your company has been established and whether or not you have an HR team who handles pay and benefits, you may or may not already have a payroll software. If you do, it should be easy for you to incorporate your new sales compensation plan in the software.

If not, you might consider one of the following three popular payroll software options to help you carry out your plan.

Gusto: This software offers an all-in-one service which includes payroll, HR, and benefits so you can handle all payment-related work from a central location.

Intuit QuickBooks Payroll: With automatic payroll tax calculations, paycheck accuracy, and native payroll integration for your accounting software, this option will allow you to focus your time and attention on other important tasks you need to manage.

Patriot Software Payroll: Patriot is a great option for anyone with a low budget who needs the bare minimum payroll-related features and capabilities.

5. Set Quotas and Expectations for Compensation

Now it is time to set your quotas for your reps and/ or your team as a whole. This will allow you to establish expectations for compensation with your salespeople so everyone knows what is expected of them and how they are going to have the opportunity to make money. How do you decide what quota should be? There are two main approaches to setting quotas.

#1 Bottoms-Up Approach

The bottom-up approach requires you to consider your team's capabilities as well as the perceived market opportunity to determine what each territory's and/ or salesperson's quota should be. The more data you have here, the easier this will be. Your inputs will vary depending on your product and type of sale, but generally, you will want to consider the following when using the bottom-up approach to establish quota:

- Average contract value (ACV) or average deal size
- The average revenue per salesperson
- Number of salespeople
- Number of qualified leads (per month or quarter)

- Percentage of qualified leads that close

These considerations will tell you how many deals a rep should be working and thus what a reasonable quota should be.

Alternatively, you can simply multiply the typical number of closed deals by the average deal size. This will give you a baseline number to use for your quota. But beware that the more successful and experienced your salespeople become, the more deals they will be able to work and the bigger their contracts will be. This means their quota may quickly become inaccurate, so you will want to consistently evaluate it if you go with this approach.

#2 Top-Down Approach

With a top-down approach, you combine market data with your revenue targets to figure out what your team needs to bring in. So, if most companies in your space pay their salespeople in the X to Y range, and your reps need to close Y amount in total for your business to hit the established goal, you can determine a reasonable OTE as well as your optimal team size.

6. Maintain Your Sales Compensation Plan

As your business goals evolve, teams grow, product line changes, and competition adjusts over time, your compensation plan will need to be revisited. Like any business strategy, it is not going to stay relevant forever because what works now might not suit any of your needs a year from now. Remember to consistently review and analyze your compensation plan to keep your reps happy, motivated, and ensure you are implementing a plan that helps you positively impact your business' bottom line (Baker, 2019).

Remember, no sales compensation plan is perfect — your priorities are constantly shifting, your reps are always looking for new loopholes, and your prospects are periodically changing their preferences.

References

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