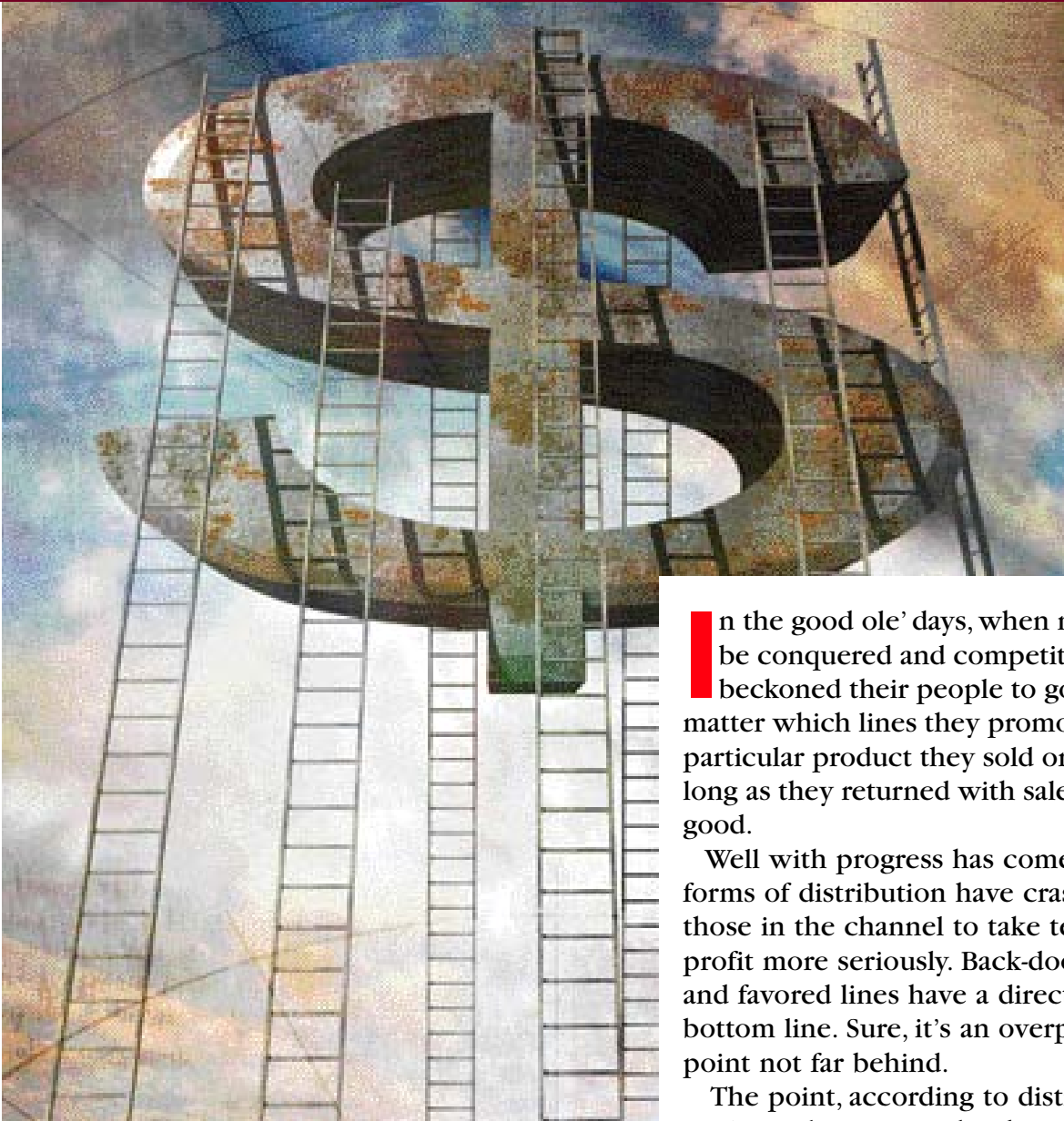


# Building

## A Better Sales Compensation Plan

**How do you know when it's time to change yours?**

By Stacy Ward,  
Managing Editor  
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**I**n the good ole' days, when markets were waiting to be conquered and competition sparse, sales managers beckoned their people to go forth and sell. It didn't matter which lines they promoted, how much of a particular product they sold or who they called on. As long as they returned with sales in tow, business was good.

Well with progress has come change. Alternative forms of distribution have crashed the party, forcing those in the channel to take terms like gross margin profit more seriously. Back-door deals are a way of life and favored lines have a direct impact on a company's bottom line. Sure, it's an overplayed song but there's a point not far behind.

The point, according to distribution experts, is that if you're truly interested in being profitable, no longer is it feasible to do business based on models handed down from generation to generation. In other words, intense times call for strategic measures. For example, writes pricing and margin management experts Advanous in the NAW publication *Price for Success*,

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distributors must go to market with a keen understanding of the “cost to serve;” sales reps must have a working knowledge of how sales, gross margin dollars and gross margin percent co-exist; and tools such as compensation must be leveraged to carry out company goals and objectives.

Sales Consultant Dave Kahle agrees. But the problem, he says, is that most distributors are not strategic when it comes to variables like sales compensation. “The reason they have their current plan is because they had it. It’s a vestige of decisions that were made in the past and when I ask why they have it, they pause and say because my father did it.”

Dave Stafford’s response is a bit different. “Economics,” he says without hesitation when asked why his company Stafford-Smith, Inc., decided to change its compensation plan three years ago. “We couldn’t afford the other one anymore.”

Before the economy took a nosedive in 2001, sales reps at the dealership had an opportunity to make anywhere from 35 percent to 50 percent commission on equipment sales. Like the current plan, the former one included incentives such as a 401 K Plan, dental benefits and respectable healthcare (cafeteria plan and AFLAC). For instance, via the provider IBA, an employee with three children and a spouse could receive family coverage for \$37.50 a week with the company paying 77 percent of the cost of healthcare and 100 percent of dental.

“Our salespeople get all of the same

advantages that our other employees get, plus we provide them with a computer, cell phone and car allowance,” says Stafford, the executive vice president of the Kalamazoo, Mich.-based, company.

“With the continuous increase in health-care costs, it was like we were feeding a monster. It had gotten to the point that we felt that providing our employees  
*continued on page 14*

### Is It Time to Revise Your Sales Compensation Plan?

By Dave Kahle, the DACO Corp.

Here’s a self-evaluation tool to help you analyze whether or not you should be revising your sales compensation plan. Simply answer yes or no, and then compare your answers to the list below.

1. Has it been three years or more since you last made significant changes in your plan?
2. Does your sales force cost you more than 25% of gross profit?
3. If 25% or less, are you growing at a rate with which you’re satisfied?
4. Has the percentage of sales force cost compared to gross profit (the number from question two, above) been declining over the last few years?
5. Are you facing more competition today than a few years ago?
6. Assuming you have a strategic plan, do you specifically and significantly reward salespeople in a way that directly supports your strategic goals?
7. Have you been frustrated in the inability of your sales force to support commitments you’ve made to some of your vendors?
8. Are you concerned that you may not be utilizing your sales management to its best use?
9. Do you believe you may not have the right kind of salespeople to see your company successfully into the 21st century?
10. Are you having a difficult time hiring salespeople who become profitable to the company as quickly as you’d like?

If your answers are those in column one below, you have no reason to investigate revising your sales compensation plan. If you have answers in column two, any one may be reason enough to consider a revision. Several answers in column two would indicate a need to consider a revision.

Your sales force compensation has huge upside and downside potential. On one hand, your plan can be one of your strongest strategic tools. On the other, it is also your biggest ongoing cost. Now is the time to carefully review your plan to take advantage of its upside potential and minimize its downside cost.

Column One	Column Two
1. NO (it has been three years or less)	1. YES ( it has been more than three years)
2. NO	2. YES
3. YES	3. NO
4. YES	4. NO
5. NO	5. YES
6. YES	6. NO
7. NO	7. YES
8. NO	8. YES
9. NO (I’m satisfied with the quality of my salesforce)	9. YES (I’m concerned)
10. NO	10. YES

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with reasonable healthcare was more important than them getting a couple of additional points.”

So a couple of months before the new calendar year began, the Vice President of Finance, Stafford and his father, who is the president of the company, poured over the numbers for every salesperson, weighed overhead costs and made tough decisions about

what they could and could not afford. Then they took a risk.

### When You Should Consider Change

Taking a risk is exactly what distributors feel they're doing when they tamper with their sales compensation plans, according to Tony Pericle, the founder and principal of Advanous, a company that specializes in helping distributors generate higher profits through margin management. “Usually our clients stay away from compensation because it affects the lifeblood of the company. And if you get the sales reps upset with you, you can have serious issues.”

That aside, he argues, there are some instances in which it's worth the risk. A

**Usually our clients stay away from compensation because it affects the lifeblood of the company. And if you get the sales reps upset with you, you can have serious issues.**

**Tony Pericle,  
Founder of Advanous**

steady decline in sales dollars per order or low gross profit percentages are at least two indicators that a company's sales compensation plan should be a

candidate for review, he says. Others are high turnover in your sales department or management's inability to get salespeople to carry out objectives such as to sell more of a particular line and less of another.

Another pause for concern is a noticeable sense of complacency among seasoned professionals or a leveling off of performance over an extended period of time. “That's an indication that you're

probably paying too much,” Kahle says. “They're too content.”

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the company an appropriate percentage of the gross profit," Kahle explains. "For example, you would like your salespeople to get new accounts but you're paying them on straight commission. That's ineffective because you're rewarding them for getting the easiest business (staying with their current customers) but you're asking them to get the hardest business. It doesn't line up."

On the other hand, it's possible to have a plan that's effective but not efficient, meaning that you're paying too much or too little of the gross profit to your salespeople.

### Why Distributors Rely on Sales and Gross Profit Percent

Once you decide your plan is lacking,

If any of the aforementioned applies, your policy falls in one of three categories—ineffective, inefficient or ineffective and inefficient. "Effective means your compensation plan rewards the behavior that your company wants, while efficient means the plan costs

### FEDA Member Compensation Practices Typical

"If there's one thing we've seen time and time again there are lots of ways to compensate your salespeople," says Dr. Al Bates, pretty much summarizing the results of a recent FEDA member compensation survey designed to give participants an idea of how they compare to others in the industry.

Distributed to the entire membership, the survey included a select number of questions about E&S dealers' outside sales pay plans. For example, 41 percent of respondents reported paying their people a salary and commission, while 37 percent said their plan included a draw against commission and commission. There was even one respondent who pays based on an hourly rate.

Keeping in line with most compensation plans, a little over half of respondents paid commission based on gross margin (flat percentage of gross margin). Other factors influencing payout were also similar, although the most common was based on how long it took salespeople to collect. This applied to 63 percent of participants.

Finally, FEDA members appear to be pretty flexible when it comes to allowances. Over half of the survey respondents provide a travel allowance, cell phone allowance, mileage reimbursement and full compensation for equipment such as laptops.

### Participate in FEDA's Cross-Industry Compensation Survey

Want to know how your compensation program compares to others in the industry, along with those in other industry? Then make plans to participate in FEDA's Cross-Industry Compensation Survey. FEDA members will receive the survey in early January and participating members will get the results back in the middle of April. More details to come. Until then, call FEDA's Executive Vice President Ray Herrick at 312-427-9605 with any questions.

Stafford has one bit of advice: Proceed with caution. "Don't just do it because you want to fatten your bottom line," he says. "Really look at your program, evaluate it, and be sure that you're doing it based on the facts; not emotion."

The fact of the matter is that most compensation plans are built on sales and gross profit because they're easy to measure. But there's a downside, says Pericle. Compensation models that rely solely on the two often come up short because of their inability to show a complete picture, when it comes to profitability.

"While gross profit dollars measures profitability, it's only one aspect of profitability," Pericle says. "For example, if I've generated a gross profit of \$10,000 at the end of the month and Jane generates \$8,000, it appears that I made the company more money. But once you take into account other factors, the scenario changes. Jane only called on five customers. Those customers placed a total of 20 orders and the total lines processed were 100. I,

on the other hand, have 75 active customers. Each customer purchased 10 orders and the total lines processed were 1,000. There's an order of magnitude difference between what I'm doing and the costs I'm causing the company to bear vs. Jane."

Throw in other variables such as order size, order frequency and time spent, and the question of what truly constitutes a profitable sale—not to mention how to compensate for it—becomes more difficult to answer. But not impossible, says Pericle, if a distributor has the proper technology and a true understanding of the cost of doing business, which he often refers to as "cost to serve."

"Successful companies are now taking steps to incorporate "cost to serve" in their compensation plans," he says. "They don't compensate their salespeople for orders that generate a gross profit less than \$50 because a company's break-even cost to serve is more like \$75 in gross profit, depending on the industry or the product."

Twenty years from now, he predicts that the majority of distributors will have a greater understanding of the cost to serve and will be able to precisely measure what it costs to service any given customer. That is when the technology to correctly assign every cost within the selling process to each unit sold is available to the masses. Then, companies will be able to incorporate such precision into their compensation plans. "They'll be able to say for this particular sale and this particular customer on these particular transactions you're going to be paid this amount because you cost the company this particular amount," Pericle adds. "Unfortunately it's going to take a decade or two to get there."

#### **Compensation By The Matrix**

Until that time, he says, the next best step for most companies is to use a matrix to structure their compensation plan. Like traditional compensation plans, it factors in data such as sales dollars, gross

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It opens wide.

Now you say,

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profit percent and gross profit dollars but includes an important competitive advantage—a predetermined compensation for every individual order.

“Think of it as a big box like an Excell Spreadsheet,” says Pericle, who has seen similar models used by six of his company’s 50 clients. The y-axis shows an order’s sales dollars [\$0 to \$50, \$50 to \$150, etc.], and the x-axis shows an order’s gross profit percent [0 to 5 percent to 10 percent, 10 - 15 percent, etc. up to greater than 50 percent]. In each of the cells will be a percent and that percent is used in conjunction with that order’s gross profit dollars to measure the compensation for each specific order.” (see figure 1)

But how are the initial percentages determined? Distributors must first establish how much they pay out in total compensation and then work backwards. In the end, rows and columns must add up to that dollar amount.

“If you tried to do this 10 years ago you’d never get it to work because you’d have to leverage a \$10,000,000 main frame,” Pericle says. “This could be done now with a \$300 desktop computer and access to a standard spreadsheet program like Microsoft Access.”

### “Keep it Simple...”

Of course, the matrix is just one of many options. With all of the software on the market today, companies have the freedom to make their compensation plans as simplistic or as sophisticated as they’d like. But Stafford cautions against making it too complicated. “If you make it too complicated, even you as an owner will not know what you have in front of you,” he says. “You have to make it simple enough so that everyone will understand it. Our salespeople can pull up their numbers in the system at any time and figure out their pay. They know their compensation plan upside down and backwards.”

More importantly, he makes sure his salespeople are aware of everyone else’s numbers as well. Every week each salesperson receives a report that includes year-to-date, quarter-to-date, month-to-date, and week-to-date sales figures for everyone in the company. There are also percentages that show how close an individual is to his or her target and how that percentage compares to the prior year.

“I call it pressure from your peers,” says Stafford, who hands out



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**Figure 1 Sales Compensation Order Multiplier\***

Sales \$'s	GP%					
	5-10%	10-15%	15-20%	20-25%	25-30%	>30%
\$0-\$50	21%	23%	25%	27%	29%	31%
\$50-\$100	20%	22%	24%	26%	28%	30%
\$100-\$200	19%	21%	23%	25%	27%	29%
\$200-\$500	18%	20%	22%	24%	26%	28%
\$500-\$100	17%	19%	21%	23%	25%	27%
\$1000-\$5000	16%	18%	20%	22%	24%	26%
>\$5000	15%	17%	19%	21%	23%	25%

\*Information is for visual demonstration only

**“If you make it too complicated, even you as an owner will not know what you have in front of you,” says Dave Stafford about compensation plans.**

the stats during Monday morning sales meetings. “Our salespeople actually call one another to talk about their performance in an attempt to elevate their own. We think it’s what makes them better.”

Such openness also makes for a good compensation plan, he adds. “There are no mysteries here. “Everyone’s plan is the same,” says Stafford, who believes side deals can ravage camaraderie, not to mention trust. “If you don’t have consistency, you’re in trouble. Every year we have our salespeople re-sign their sales agreement, which contains their commission policy, a non-compete agreement, collection procedures, installation procedures, ordering procedures and a code of conduct.

“And it’s not something that we just hand out to them. We sit down and walk through it with them.”

**A Win-Win Equals Success**

When he and his father introduced their new plan at a companywide sales meeting on January 2, 2001, they carefully outlined the reasons for the change, gave everyone a copy of the plan and then used the overhead to work through various scenarios using the new formulas. (Regional managers were told about the plan in advance to prepare them for the change.)

Initially there were a few gripes, but on the whole the transition was a success, Stafford says. “Even with the change, our salespeople still have an

opportunity to make quite a bit of money based on their performance.”

And that’s the key, according to Pericle. “You have to make it a fair and equitable transition,” he says.

For those considering change (specifi-

cally from a plan based on gross profit to one focused more on cost-to-serve), he suggests creating a compensation plan that’s similar to your existing one to make it more palpable. “What will happen is that you’ll have some reps who are going to be compensated significantly more, and these will be the reps that should be compensated more because they’re bringing the highest value to the customer. Then, you’re going to have some reps that aren’t going to be compensated as much as they should. You have to create a bridge for them and simultaneously give them the tools to not only get up to where they were before but to make more money.

“Initially you may be paying more in compensation but what will inevitably happen is operational costs will come way down and you’ll have a much greater benefit with gross profit because now the reps will understand that they get incrementally more compensation as they try to achieve higher gross profit.”

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