What commissions should I pay my new sales person?

This is a key question for any sales manager or business owner contemplating hiring a new sales person. The answer is complex and will vary depending on the unique circumstances of the company involved and the general practices in the industry for that company.

This article presents the considerations that typically go into the determination of the commission structure and payment plan. Each sales manager can design a compensation plan based on these considerations but invariably the sales manager is competing for the services of the sales person with other companies in the same industry. So understanding what other companies' commission plans are, would help in ultimately deciding the proper commission structure and payment. Calling other companies in the same industry and doing the research is an important step in deciding the final design.

Should it be Salary or Commissions?

One of the major decisions to make, regarding a compensation plan, is to decide the basic structure of the compensation plan and whether it will be a salary or a commission plan. Sales reps can be hired with a straight salary plan, salary plus commissions or a straight commissions plan. There are pros and cons to each approach.

Straight salaries tend to result in fixed and predictable selling costs, but tend to discourage individual initiative and result in poorer sales performance. A straight commission plan on the other hand will connect their sales performance directly to their compensation, but will tend to focus them on short term sales opportunities and ignore company strategic goals such as good customer satisfaction. Salary plus commissions will allow greater alignment of the sales person with company goals as well as motivate the sales person towards higher sales performance.

The majority of sales people will tend to want some security in the form of salary, but too much of a security requirement may indicate a poor sales performer. Sales people will also expect to have similar plans to other companies in the same industry.

Attributes of different types of plans

	Straight Salary	**Salary plus Commissions**	**Commissions only**
Sales Performance	Lowest	Moderate	Highest
Alignment with Corporate Goals	Highest	Moderate	Lowest
Reassign territories and accounts	Easy to reassign.	Difficult to reassign.	Difficult to reassign.
Cost of Sales predictability	Predictable	Moderately unpredictable	Can vary significantly

Administration	Easy to administer.	Difficult to administer.	Difficult to administer.
Sales Person Income Upside	No Upside.	Moderate Upside	Highest Upside
Sales Person Security	Highest Security	Moderate Security	Lowest Security
Retention	High	Moderate	Low

Straight salary compensation plans are straightforward and this document does not add value to that process.

How much should I pay?

This is possibly the most difficult question to answer in designing the compensation plan. The marketplace, in other words the companies that make up your competitors, are the best determinants of the appropriate compensation to be paid to the sales person. If it is possible to get that information, that should be the comparison for the compensation plan you design. Industries tend to have similar plans but the individual firm can design their very own compensation plans.

A simple formula to determine the commission can take the following steps:
One of the first questions to ask in deciding the compensation level, is to determine how much additional revenue a reasonably performing sales person is expected to bring in. This expected amount can be called Performance (P). This can be an expectation of the sales manager or from what similar sales people achieve.

The next answer that we need to know is how much a reasonably performing sales person should be expected to be paid in a year. This can be based on average compensation in the region and/or from typical industry practice. This can be called Targeted Compensation (T).

The proportion of the targeted compensation that will be treated as Base Salary can be expressed as a percentage (S%). This can be zero if there is no salary component.

The Commission Rate (C%) to be used in the compensation plan can be calculated as follows:

$$\text{Targeted Commission Amount} = T \times (1 - S\%)$$

$$\text{Commission Rate (C\%)} = \frac{\text{Targeted Commission Amount}}{\text{Performance (P)}} \times 100$$

Example:

Let us assume that the expected Performance (P) is $1,000,000 for a sales person. Let us also assume that the Targeted Compensation for the sales person is $100,000. If we assume that 30% of targeted compensation is expected to be paid out as Base Salary (S%), then the Commission Rate to be used would be as follows:

$$\text{Targeted Commission Amount} = \$100{,}000 \times (1 - 30\%) = \$70{,}000$$

$$\text{Commission Rate (C\%)} = \frac{\$70{,}000}{\$1{,}000{,}000} \times 100 = 7\%$$

The commission rate derived here is a simple flat rate.

To Quota or not to Quota

Quotas (or Goals) can be specified for the expected performance of a sales person. These can be merely stated as expectations or encouraged through means of modifying the compensation based on attainment against Quota.

In the second case the simplest way of encouraging achievement of Quota is to pay a different commission rate for any attainment above Quota. The recommendation would be to pay a significantly increased commission rate for performance above Quota, to make exceeding the quota meaningful.

Example:
Let us assume that the expected performance is $1,000,000. This can set as the Quota for the sales person. Then the commission rate tiers can be set as follows:

Quota: $1,000,000

Sales attainment against Quota	Commission Rate
0% to 100%	6%
101% and above	12%

Underachieving sales people can be incented towards higher performance by disincenting lower level performances, such as in this example.
Example:
Let us assume that the expected performance is $1,000,000. This can set as the Quota for the sales person. Then the commission rate tiers can be set as follows:

Quota: $1,000,000

Sales attainment against Quota	Commission Rate
0% to 50%	2%
51% to 100%	10%
101% and above	15%

In this situation, the first 50% of performance is clearly under incented to drive people towards more optimal performance which is above the 50% threshold.

When to Commission?

The frequency of how often commissions should be paid is typical of industries. Frequency of commission payments follow one of these standard intervals: weekly, bi-weekly, twice-monthly, monthly and even quarterly.
In addition to industry practices the guidelines for determining the frequency of payment are these:

- the closer the commission payments are to the actual sales, the better the connection between the performance and reward
- the longer the sales cycle involved the longer the frequency interval can be

Additional criteria for triggering commission payments would be the revenue event. The typical revenue events are bookings, billing and collections. Other events can be used to trigger payments as well.

Bookings based commissions focuses the sales rep on bringing in the business, but possibly at the expense of long term customer relationships. Collections based commissions have the benefit of making sure the sales person manages the customer relationship to some extent but on the other hand sales people may spend valuable time doing collections responsibilities. Billings tend to be a balance between these two approaches.

What to Commission?

Some general commission considerations were presented in the earlier sections. But very often companies are interested in emphasizing sales performance in certain parts of the business. Different Companies want to make sure the emphasis is on new business, profitability, certain product lines or certain customer segments. This is possible in a well-crafted commission plan.

New Business vs. Recurring business

Companies want to make sure their sales people are focused on bringing in new business rather than working the same set of customers for additional business. There are multiple ways of doing this. Here are some ways:

- Revenue from new customers may be commissioned at a higher rate for the first order or for a period of time.
- Long term customer contracts may be commissioned at a higher rate in the first year and then trail off in the subsequent years.
- There maybe a separate bonus for new customer signups.
- Year to year sales performance may be compared to determine net new business and that may be commissioned separately or at a much higher rate.

- Have sales reps focus on new business and turn over established customers to account executives for follow up business.

Revenue vs. Profitability

Some companies where costs are a significant concern, or where the sales people have a lot of leeway to change the price, maybe more concerned about the profitability of the deal rather than on straight revenue. Here are some ways to address that concern:

- Commission directly on profitability rather than on revenue.
- Commission revenue only when certain profitability thresholds are met.
- For different tiers of profitability for a deal, use varying commission rates.
- Commission on revenue but provide a bonus on overall profitability.
- Commission sales reps on revenue but sales managers on profitability.

A couple of things to consider in using profitability are:- determining profitability in certain businesses will be difficult; profitability is not transparent to the sales reps and consequently could lead to some frustration for the sales reps.

Customers

Because of differing business conditions, specific focus on customers or customer segments maybe necessary to get optimal sales performance. Here are some of the ways commission plans can be designed for that:

- Name customer accounts and assign them to sales people as their territory of business.
- Name certain customer accounts and associate with them specific sales people so they always get an override on business to those accounts.
- Identify preferred customer segments and provide higher commission rates in those segments.
- Provide customer satisfaction based bonuses.

Products

It is fairly common for companies to commission products or product groups differently. This differing rates maybe due to difficulty of selling products, the age of product lines or the profitability of certain product lines. Here are some ways:

- Pay higher commission rates for highly profitable product lines
- Pay higher commission rates for products that have to be cleared from inventory
- Pay higher commission rates when products are sold in a bundle

<u>Draw!</u>

A draw is fully defined as ‘a draw against future earnings’. This is when the sales person is advanced an amount against expected future earnings. This is typically used to support a new sales person while they are learning the ropes of your business. It is typically set at an amount enough to cover the basic expenses of that person but not at full expected commission. It is typically short in duration, maybe three or six months and rarely longer. During that period, if the sales person earns less in commissions than the draw amount, then the difference is given as an advance and a balance is maintained. When the sales person starts performing well enough where they start exceeding the draw, then the balance maybe settled by using the excess earnings above the draw. This is also called a 'Recoverable Draw'.

A typical draw could be: Draw of $2000 per month for the firs 3 months of employment.

Draw is typically used for employee sales people who do not have a base salary.

The variation on this is where the sales person is guaranteed a minimum amount of compensation for a set period of time. This is appropriately called a 'Guarantee'. Sometimes it is referred to as 'Non-recoverable Draw'.

Cap that well!

Some commission caps will cap the total amount of compensation that a sales person can make. This does not follow the philosophy in commissioning sales performance. The more sales a sales person brings in the better the company prospects, so the company should incent additional sales rather than penalize them.

But there maybe situations where sales people may get windfalls due to no particular effort on their own. In these cases it maybe reasonable to cap commissions related to an individual deal at a fairly high limit such that true effort is still rewarded.

Now what!

After designing an effective commission plan after due consideration, the next step is to administer the plans and communicate the commission results accurately and in timely fashion. This is not trivial. Many customers start off by using spreadsheets and soon land in a nightmare of calculation errors and upset sales people. So it is highly recommended that they search for a flexible and well-support vendor software to calculate sales commissions.

Author:

Gopi Mattel, an executive at CellarStone, Inc., a provider of sales commission solutions and services.
gopi_mattel@cellarstone.com

www.qcommission.com, www.easy-commission.com, www.qxchange.com, www.cellarstone.com.

