"Call it what you will, incentives are what get people to work harder. "

Nikita Khrushchev

(April 15, 1894-Sept 11, 1971)

INCENTIVE PLANS

If one of our most famous Communists (of all people), signed on to the power of incentives, then there must be something to it. The trick is developing incentives that actually work. If you've been in the world of work for much time at all, you've probably seen many plans that operated more like "dis-incentive plans."

A few years ago I was in that very position. Our commission plan was a simple one, every six months we set targets for the coming two quarters and then paid on performance to those targets with an accelerated payout to any team member who exceeded their target. The problem was that the fortunes of each major customer often changed quickly making it difficult to predict the short term. As a result, large payout on the upside or miss to the downside was a result of some large, un-forecasted change in a customer's business. The Sales team weren't motivated by the plan because if they beat plan significantly they felt it was deserved (that's human nature for you) but if a customer's business tanked they were being unfairly punished. In sum, rewards were not clearly tied to results from either the perspective of management or the Sales team.

Not happy with our plan, we sent our HR partner to do some research and get some training on compensation plans. Her most shocking finding was that while most companies had a plan similar to ours, less than a quarter of them were happy with it.

Why would so many companies stick with plans they weren't happy with? In our case the answer was that they are simple to devise and straightforward to budget, not because it motivated the Sales team to grow the business.

We took this to heart and set about redesigning our plan. It required a significant investment of our time, but in the end we learned that you can build effective Incentive Plans. This process has to start by finding objectives that are clear and then having the patience to sift through a lot of options until you find one that drives your team towards your objectives.

Key Point: *Sales Incentive Plans can have a positive impact on your business if the plan is consistent with corporate objectives and your culture; otherwise you likely have a "dis-incentive" plan. There isn't a middle ground.*

This newsletter will focus on Incentive Plans in the context of a Major Accounts selling program. Actual plan design is outside the scope of this newsletter. Our goal here is to provide a way for thinking through which elements to include in your plan and how to administer the plan as it rolls out.

A few definitions:

- **Total Compensation** - Base salary plus incentive payouts at 100% of plan.
- **Plan Target** - Performance required to earn 100% payout to the plan. A target is established for each plan element such as revenue, design wins, etc.
- **Plan Element** - Specific plan component. In addition to Revenue, your plan may have elements for other components such as Design Wins, Gross Margin, etc.
- **Bonus** - A payout related to a one-time achievement which is in addition to incentive payouts included in Total Compensation.

GUIDING PRINCIPLES

Development of an effective plan starts with the Executive team getting aligned on priorities. These priorities should be taken from (or at least consistent with) your corporate plan. Specifically, a point of view needs to be developed regarding:

- **Financial Priorities** - Understanding the relative priority of revenue, gross margin, and new business wins will guide decisions regarding those elements that should be included in the plan and how they should be weighted.
- **Strategic Products** – The decision needs to be made whether any specific products should be considered more important than others in terms of Design Wins and should therefore receive priority in the plan.
- **Executive Involvement** - Some CEO's participate in the plan through programs such as a President's Club. These programs can be an effective way of reinforcing the importance of hitting revenue targets, provided they are personally driven by the Executive.

After aligning with the Executive team on priorities, the list of guiding principles should be crosschecked against the plan as it is developed. A sample list of guiding principles is presented in Figure 1 below:

Incentive Priorities	• #1 - Revenue growth • #2 - Closing new business. • #3 - Gross Margin %
Executive Focus	The plan emphasizes that performance to these priorities is critical and receives regular CEO visibility.

Figure 1-Sample set of Guiding Principles for development of an Incentive Plan

Compensation is a topic where CEO's have very definite views on compensation and these views will vary widely and sometimes violently from CEO to CEO, so if you don't involve them early in the process, odds are good you'll be sent back to the drawing board when you present for approval.

I've worked with CEO's with very different views on Revenue and Gross Margin, ranging from the viewpoint that Sales should be incentivized only on Revenue, with Sales biased to book everything that moves, to the view that decisions should be made primarily on Gross Margin contribution (if it doesn't hit a target don't bring it in) and therefore must be a key part of the plan.

These two views will generate very different sets of guiding principles, which again highlights the need to get the Executive team, and particularly the CEO aligned before starting to choose of plan elements. Here, on the revenue vs. margin discussion is highlighted, but other conflicts exist and need to be worked through. For example, should Sales be responsible only for bookings/revenue or should they also be held responsible for customer payments?

Key Point: *Prior to developing the plan, taking the time to align priorities with the Executive team will allow you to build a list of Guiding Principles that can be used to validate the plan as it is developed.*

Obviously, an effective variable compensation plan directs behavior based on the size of the payout. Unless the plan is specifically designed with a lot of leverage to drive a high short term risk/reward (which would be an exception in a Major Account environment), it is best to avoid the potential of a demoralized salesperson who gets no payout at all.

PLAN COMPONENTS

Base vs. Incentive Split

A number of issues should be considered when deciding what percentage of a sales person's compensation should be put "at risk". The most important consideration is the amount of direct control the Salesperson has over the sale.

Take the example of selling door to door. The Salesperson either closes the deal on the spot or very likely doesn't get the sale. Given the Salesperson has substantial impact at the point of sale, all or at least most of their compensation should be in incentive payment i.e. "at risk". The harder they work, the better they get at closing business and the more they make.

Selling to a Major Account is very different, as it involves a broad list of activities some of which are related to supporting the existing revenues rather than generating new business. In addition, the Sales team should make decisions in a way that foster a long term relationship as opposed to the door-to-door Salesperson who will likely never see the customer again.

This breadth of responsibility raises these types of issues:

- **Revenue Carryover -** The longer the life cycle of your business, the more effort is spent managing existing run rate. This argues for a higher percentage to the base.

- **Selling Cycle** - Shorter selling cycles suggest that more compensation should be at risk as payment is closer to the start of the selling process where it can influence behavior.
- **Management Control** - The larger the percentage of compensation "at risk", the less control management will have over the day-to-day activities the sales person since the salesperson will have more incentive to maximize their short term payouts.
- **Cost of Sales Management -** Incentive payouts introduce variability into cost of sales. If operating to a fixed budget is important, variability is reduced with a higher percentage allocated to base salary.

Considering these factors, Major Account plans, which usually have longer selling cycles and need to foster longer term decision making are usually weighted more towards base than incentive, with base salary accounting for 60% to 80% of Total Compensation.

After deciding on the base vs. incentive split, plan development can turn toward the components themselves.

Key Point: *The decision regarding how total compensation should be split between base salary and incentive compensation should consider a number of factors including the amount of control the Salesperson exerts over the decision at the point of sale.*

Revenues, Bookings and Gross Margins

Driving revenue is the primary objective for any sales team, so performance to revenue targets will represent an important component of every plan. To ensure alignment between Sales and other functions in the company, the total revenue target for the Sales team (the VP Sales target) should be the same target the company has committed to stakeholders and that is used for any other corporate incentive programs.

Deciding whether or how to include Gross Margins requires contemplating several issues. As noted above in the discussion around Guiding Principles, the bias of your Executive team, particularly the CEO needs to be considered. The maturity of your team, specifically their ability to think bottom line, is a factor as well. Again, it is a question of direction. Putting the focus primarily on top line expansion leans toward directing payouts to revenue vs. a priority for "quality revenue" which indicates that Gross Margin should be included in the plan.

If Gross Margins are included in your plan, the Marketing team must be tightly aligned with Sales to make sure that changes in margin expectations, and cost structures, are quickly communicated to the Sales team so the team isn't turning away business that conditions would now warrant taking.

Having responsibility for Margins is another good reason to include finance in the professional skills training curriculum for your Sales team. Salespeople will respond if, in addition to being incentivized, they understand the Margin is literally the lifeblood of the company.

For most businesses, Bookings should not be a part of your incentive plan. Bookings are more fungible than Revenues, so there is more potential for “game playing” at the end of plan periods. Your plan will already have a substantial portion of the incentive allocated to revenue and given bookings is simply revenue that just hasn’t yet shipped, this base is covered. However, paying on Bookings may make sense in some capital equipment businesses, where the booking represents a significant milestone in a long cycle to recognize revenue.

Other issues to consider when developing the revenue component:

- **Acceleration -** As an incentive for salespeople to exceed their plans, it is common to have the payouts richer after 100% of the target has been achieved. Begin with a view of how much acceleration is required to get the attention and focus of the team. For example, you may want to provide an opportunity to double the incentive payout for achieving 150% of plan or some variation on that theme. After getting comfortable with a description of the overall messaging, careful modeling is needed to arrive at an acceleration curve with the right balance of incentive and a cost that meets the business model of the company.

  As mentioned in the introduction, I learned firsthand how an incentive plan can actually be a dis-incentive plan which sent us on a journey to match payouts to results in an environment with volatile revenues.

  The major change we made to our plan was to only provide accelerated payouts if the Salesperson had shown growth over recent quarters rather than for simply beating that quarter’s target. Specifically, our plan paid at the target rate of up to 100% (as in our example), then would apply an accelerator if the Salesperson had shown growth over recent quarters. A simple way to implement this type of accelerator is to take the rolling average of growth for the previous three quarters and pay against that.

  Sustained growth is a sure sign that good things are happening with the customer and therefore something you’re happy to pay for. It also provides a way for Salespeople to smooth their earnings a bit. For example, if they have a down quarter in the midst of a growth trajectory, the growth accelerator will increase the payout for that quarter (though the average will drop for the following quarters).

  Our team became big fans of using revenue growth as a way of providing accelerated payments because it effectively tied results to rewards. No growth, no acceleration. I’ve only been able to sketch the outline of a growth accelerator here so if you’re interested in discussing implementation, give us a call here at InSite.

  Key Point: *If your business is characterized by sharp changes in the revenue patterns at the customer level, using revenue growth over previous quarters is* *an effective way to provide accelerated payments for exceeding the revenue target.*

Another strategy to deal with variability is to put a portion of the revenue incentive towards achieving an annual number (or rolling annual) rather than a quarterly number. Achieving an annual target will reduce the impact of short term variability with the added benefit of aligning Sales toward hitting the company's Annual Operating Plan.

- **Cliffs and Caps -** A cliff is a low-end threshold below which the Salesperson gets zero payout. The theory behind a cliff is that the Salesperson should generate a certain level of effort (hence result) before being eligible for any incentive pay. Cliffs may make sense in a business with no repeat revenue such as our earlier door-to-door example, but they don't make sense in Major Account incentive plans.

  Major Accounts usually have a substantial existing revenue run rate so a very low performance to target usually signals a collapse in the customer's business. In this case, not getting an incentive check simply discourages a Salesperson and may create a retention issue.

  Caps represent a threshold on the top end of the plan. Almost all incentive consultants will recommend against caps, making the point that the occasional "plan buster" payout provides a considerable incentive to the rest of the team. This is why Casinos put jackpot winners on roadside billboards, as gamblers are more likely to visit Casinos paying out the biggest jackpots.

  Caps on the high end are okay for the same reason that cliffs on the low end are a bad idea since blowing out revenue on the high side is almost always driven by an unforecastable increase in a customer's business rather than the performance of the Sales team. A cap also builds in limits to your cost of sales. That said, a cap should still allow for reasonable plan leverage and should be no lower than say, 150% of target.

  If you do decide to implement a cap, an effective way to think through it is to make sure it accommodates any "home run" scenarios, plus a little, you could envision occurring.

- **Global support -** Adequately covering a Major Account often requires more than one Salesperson to support the same revenue stream. The most common example occurs when the customer's product development team is in a different location than the manufacturing location.

  The incentive plan needs to allow all salespeople providing significant support to a revenue stream to have that revenue included in their plan. The simple approach is to split the revenue between the salespeople covering the product development, booking, and billing locations.

More sophisticated schemes can be implemented to allow for the total revenue number to be included into each Salesperson's plan but they're outside the scope of this newsletter. Contact the InSite team for a more detailed discussion on this topic.

Key Point: *The Revenue component of your plan is the most important and most complex plan element to design and administer. Getting this right requires careful thought given to the upside available (what gets the team focused) and patience in building plan acceleration curves that you can afford.*

Goals

Including goals in the plan encourages good management practice by driving managers and their Salespeople to learn how to write good goals. Goals also provide an incentive for non-quantitative results such as bringing on a new channel partner or for other financial priorities that didn't make the cut for a dedicated plan element such as Design Wins or Gross Margin.

If you do include Goals as a plan element, you will need to provide training on how to write them and be patient with the quality for several quarters. Early on, the goals will be too easy or goals will be suggested for activities that are clearly just a part of the job. In addition to providing training, you can manage around these issues by personally approving all goals and only allowing Goals to be a small percentage of the incentive target, in the range of 10 to15%. This will require an upfront time commitment on your part, but it is a good investment to ensure quality and to develop your team's skills.

In terms of mechanics, a good approach is to allow the Salesperson to suggest 3 to 5 goals with total weighting that adds to 125%. The goal should be crafted so that "good execution" yields a payout at 100% and if they knock it out of the park they get a modest acceleration to the payout up to 125%. Defining "good execution" to 100% performance isn't easy, which is another reason why you should leave them as a minor portion of the incentive target.

I'm a big fan of having goals in the Incentive Plan. Setting aside 10-15% of the incentive budget to develop a goal oriented Sales team is an excellent investment. Goals are an important topic that I'll talk more about in the next newsletter.

Key Point: *Including Goals as a plan element creates a goal driven organization and provides a way to include metrics that don't merit a dedicated plan element.*

Design Wins

Given that closing new business is the lifeblood of your company, Design Wins need to be included in the plan. They can be included as a specific plan element with mechanics based on performance to a target (like revenue), or they can be included in a bonus program. A third option is to include them in the Goals portion of the plan.

A clear definition of what constitutes a Design Win is crucial to maintaining plan integrity. Production purchase orders or signed (billable) contracts are the best options. You also need to think through how to deal with the quality of the revenue for each win. Specifically, while all Design Wins are important, getting wins in new product categories is more difficult and given these wins drive your growth, you may want to provide a richer incentive for them.

There are many issues that need to be agreed upfront, including which opportunities are eligible for an incentive, can an opportunity be split into two pieces (and two payouts), who makes these decisions and many more. In summary, Design Wins need to be a part of your plan, but they need to be thought through carefully.

Recognition Programs

There are a number of ways to provide incentives outside of the compensation plan, both positive and negative. These programs are driven by the idea—an idea that I believe deeply—that salespeople are primarily motivated by recognition. Even money, at root, is a form of recognition.

On the positive side, the most effective approach is some sort of Executive recognition such as a President's or CEO Club. These programs only work if the sponsoring Executive takes this on personally and has an active hand in the design and personalization of the program.

There are many ways to do it, but it must be exclusive, so that participating sets the winners apart. If it can involve the Salesperson's spouse, such as a vacation for all the winners with the CEO and their spouse, you'll increase the number of people generating pressure for results!

Our CEO and Founder at National Semiconductor, Charlie Spork had such a club, titled "Charlie's Club". Winners were treated to a vacation in Hawaii, capped by a dinner at Charlie's beachfront home on the north shore of Oahu. These were memorable experiences and big motivator to those few who earned the right to be members of the club.

As noted in the discussion regarding Guiding Principles, these types of programs only work if they're essentially the CEO's idea and this is another area where opinions vary widely.

Data-based recognition programs can also motivate if done carefully and in a professional manner. An example of data-based recognition is publishing performance to plan for the entire sales team on a regular basis.

Key Point: *Recognition programs outside of the compensation plan can be powerful motivators, particularly those sponsored by the President/CEO.*

CONSTRUCTING THE PLAN

The first rule is that the plan should be simple, both in terms of the number of plan elements, and the complexity of those elements. Fewer plan elements will increase the focus on those plan elements chosen.

Key Point: *The plan should be simple, with few plan elements and calculations that preferably can be done in the Salesperson's head. Simple plans set clear priorities and salespeople must find it is easy to know exactly where they stand. Remember, when in doubt, leave it out.*

Figure 2 below outlines a sample plan that includes three elements: Revenue, Design Wins, and a Goal component.

Plan Element	Terms
Revenue	• No Acceleration in payouts of up to 100% of Revenue Target. • Payout at 150% for revenue over 100% of Revenue Target. • Plan caps on the top end at 175%. No cliffs on the bottom end. • 85% of Incentive Target applied to Revenue Performance.
Goals	• Eligible goals must be approved by Direct Manager. • Total Weighting of Goals to sum to 125% (maximum payout). • 15% of Incentive Target applied to Goal Performance.
New Business Win Bonus	• Bonus applies only to Strategic Products (published list). • $3000 bonus for each win.

Figure 2-Sample Plan with Terms and Payouts

The example plan aligns well with the Guiding Principles developed earlier. Revenue performance is the primary priority, yet Design Wins are considered important enough to drive a bonus on top of the incentive plan. Goal performance receives a modest payout and will provide some discretionary focus to be approved by the Salesperson's manager. One of the goals must be a Gross Margin target, so that the third guiding principle is included in the plan.

A different option that still aligns with our Guiding Principles would be to eliminate the Plan Element for Goals and replace it with an element for Design Wins. Weighting for Revenue could be dropped from 85% to 70% creating substantial priority for Design Wins but not require an additional bonus payout.

There are a number of possibilities, but be sure to make the hard choices and keep the plan simple, including no more than three Plan Elements.

To demonstrate the calculations for the example in Figure 2, consider a Salesperson with a Total Compensation package of $100K with a 70/30 split between base and incentive. In this case, performance to revenue targets would account for 85% of the $30K incentive ($25.5) and the balance would apply to performance to Goals.

Figure 3 shows how the payouts would be calculated assuming 125% performance to target on revenue, 110% performance to goals, and one New Business Win. The calculations are for one quarter of performance ($7500 total incentive at 100%).

Plan Element	Payout Calculation
Revenue	• Payout Available-$7500 X .85=$6375 • Payout for 125% performance= $6375 for hitting target (up to 100%) + 25% of $6375 (for exceeding 100%) X 1.5 • Calculation- $6375 + $2390= **$8765**
Goal Performance	• Payout Available $7500 X .15=$1125 • Payout for 110% 1.1 X $1125=**$1238**
New Business Win Bonus	• One Approved Win – **$3000**
Incentive Payout Totals	• Revenue Component **$8,765** • Goal Performance Component **$1,238** • New Business Win Bonus **$3,000** • **Incentive Payout Total $13,003**

Figure 3-Example Payouts for the Sample Incentive Plan in Figure 2

Shorter plan periods and hence more frequent payouts drive more interest in the plan but this needs to be balanced against the resources needed to administer the payouts. Also consider how your company closes periods. Quarterly payouts are common in public companies given they close on quarter boundaries. This also strikes a reasonable balance between payout frequency and administrative costs.

When constructing your plan make sure to involve your Sales Management and Sales team in the process. It is your job to set the priorities and approve the plan, but your team cares a lot about the incentive plan so you'll surely get thoughtful feedback if you include them. Involving your team will increase the odds that the plan will both meet your objectives and be well received by the team.

ADMINISTERING THE PLAN

Plan Hygiene

Because Incentive Plans affect compensation, problems with the plan can cause serious morale issues or worse, end up in court. The first defense is to have a well-documented plan. In addition to clearly stating terms, the plan should show examples of all calculations used to determine the payouts.

Be sure to have a disclaimer that makes clear that the plan can be changed at any time by the plan administrator and that any decisions made are final and binding. If forced to make a ruling on an incentive question, it's a sign that there is some ambiguity in your plan, so make sure to circle back and amend the plan to reflect the precedent set by your decision.

Making incentive payouts as soon after the close of the incentive period as possible will maximize motivation, but at least be sure to deposit incentive checks when promised. Late checks are a huge negative.

Key Point: *Good hygiene, such as clear, well-documented plans, and incentive checks paid on time is expected. Any sloppiness around administration of the plan will be a de-motivator for your team.*

Managing During a Plan Period

Obviously, you'll generate the most positive energy around targets that your team believes they can beat. However, sometimes the market turns down after performance targets are set. In these cases the team will be given difficult and perhaps nearly unreachable targets.

In these cases, you'll surely be asked by your team to reduce the targets. "No", is the answer to this question and make sure to do it quickly. It is, after all why it is called "at risk" income. If you change targets once, the expectation is that they will be dropped in every downturn. The Lord giveth and the Lord taketh away, as the good book says. I have, by the way, never had the sales team ask to have targets increased during an unforecasted upturn. The only exception to this rule is the rare case where corporate targets are changed, in which case incentive targets should be changed to stay aligned.

Key Point: *Never make changes to the Plan Targets based on market conditions. It is the quickest path to destroying the credibility of your plan.*

Occasionally, there will be incentive cases that are not clearly covered by the plan that need a ruling. When making these decisions keep two rules in mind: 1) the ruling should be consistent with the spirit of the plan, not what seems fair at the time and, 2) be very concerned about the precedent set by your decision. A bad decision will come back to bite you and become "the gift that keeps on giving".

If you run a large team, and are therefore likely to get several issues needing resolution in a plan period, you may want to consider an Incentive Review Board. Conceptually, this is a court, with the "plaintiff" presenting their written case for relief. A Review Board composed of representatives from the Sales team, Sales Management, HR and Finance, reviews the cases. After meeting to review the cases, the Review Board provides an opinion to the Plan Executive who makes the final decision.

Evolving the Plan

As the Sales Executive, it is good practice to review all payouts at the end of each plan period to determine if the company is getting a good return on its Incentive Plan investment. Specifically, did those who got large payouts deserve them, and did the reasons for significant misses make sense?

When you encounter payouts you're not comfortable with, drill into the situation to understand why, as this may lead to changes in your plan. Reviewing payouts was what generated my concern for our plan which led to the development of the growth accelerator discussed earlier.

Key Point: *It is good practice to review payouts after each plan period to make sure you're comfortable with them. If not, understand why and make sure to fold needed changes into next year's plan.*

SUMMARY

Your Incentive Plan will definitely impact your team's performance either positively or negatively. Designing and administering a great plan will require a substantial time commitment, but it is well worth it.

Before choosing from among the many options to include in your plan, you need to align with the other Executives on the priorities for the coming year and from that, develop a set of Guiding Principles to keep the plan aligned as it develops.

At the end of each plan year, you should review the incentive payouts to confirm that payouts were consistent with the company's performance. That review, and consideration of any rulings that were made during the year will inform whether you need to consider changes to the plan for the next year.

If your team is going to "break the bank" with your incentive plan (as you hope they do), they'll need to win the big, high value deals. In the next newsletter, I'll present a process for leading the team to those wins.

