Sales Force Compensation: Focusing on margin isn't as easy as you thought

A friend of mine recently took over as president of a small manufacturing company that had recently experienced tremendous revenue growth coupled with shrinking profitability. He suspected that the revenue-focused sales force compensation program was at least partially culpable and wanted to re-focus the compensation program on margin. Since his organization is in quite a mature marketplace with limited growth opportunities and his sales force has significant impact on pricing, I concurred that increasing the sales force's focus on margin was a good idea in concept. But before he went off to change his comp plan, I told him to be mindful of the three rules of margin-focused compensation systems:

Rule #1 – Reward the right margin.

The term "Margin" is rather ambiguous. Should we use gross margin? Operating margin? Contribution margin? Good sales force compensation programs measure the value that the sales force creates. Generally, the value of a particular deal or transaction is best captured by contribution margin, the difference between revenues and variable costs. Some compensation experts argue that while contribution margin does represent value created by particular sales events, it is not all value created by or controlled by the sales force (e.g., shipping cost is part of the contribution calculation, but is generally not within the sales force's control); therefore, the margin used should factor in only those items in the sales force's control. The converse to that argument is that if you align sales force compensation with contribution margin, the sales force will find a way to influence those items that they don't control. Either way, the program needs to measure value.

Rule #2 – Make it simple for the sales force to understand.

Sales force compensation programs send a very specific message to the sales force: "I am going to reward you for behaving in a specific way". If a program is difficult to understand, two bad things are going to happen:

- The sales force isn't going to behave the way you intended because they don't understand what you want them to do.
- They're going to waste a lot of time calculating how different behaviors will impact their compensation. This is time they could have spent selling.

Make the impact of their actions very simple to understand. If the compensation program must be complicated, find an automated way to illustrate implications of various decisions to the sales force. Don't turn them into accountants.

Rule #3 – Be conscious of the impacts outside of the sales force.

Altering the sales force compensation program to focus on margin affects more than just the sales force. There are ripple effects throughout the organization, generally occurring in two types of areas:

- Cost centers[1] – When the sales force is paid on margin, they want variable costs to go down. Expect the interactions between sales and operations to increase dramatically. This is a good thing. Sales people will use their superior knowledge of customer needs to tell various cost centers how to lower costs in a manner that increases margins. For example, if margins on a particular product are dropping, motivated sales people may urge product management to eliminate features customers don't care about in an effort to get the costs down.
- Compensation management – The people who calculate sales force compensation (wherever they sit in the organization chart) will be heavily impacted. Calculating compensation based on revenue is pretty easy. Not so with margin-based programs. Getting to an accurate/ appropriate margin measurement can be painful. Depending upon the systems you have in place, it could double the workload and/or necessitate system enhancements.

The key is to get a handle on what the impacts might be before making the changes and be prepared to address them.

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For a lot of marketplaces compensating the sales force on margin will align the sale force's incentives with the organization's strategic and financial objectives, but it comes with some challenges that need to be thought-through before leaping in.

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[1] Examples include: manufacturing, distribution, support