

Sales Compensation: What to Use, Salary plus Bonus or Commission?

Sales compensation literature articulates clear-cut “rules” and selling situation examples for determining when a commission- or salary-only plan is the most appropriate sales compensation format. The insights are generally of little value, however, because the selling circumstances and talent requirements driving the need for these approaches are so obvious. For example:

- Salary-only – when it is difficult to associate sales resources’ efforts directly to sales results as might be the case in situations where a long design and trial process is required before orders are placed or where sales representatives’ hard work focuses on creating demand rather than selling to end-users.
- Commission-only – when sales cycles are extremely short, few factors beyond the individual’s “creative salesmanship” enter into sales success and hardly any non-sales activities need to be performed by salespeople.

The number of industries, companies, and sales positions where salary- or commission-only is appropriate are comparatively few. Consequently, there is a limited population of incentive design professionals who have to wrestle with commission- and salary-only incentive issues.

The vast majority of sales incentive plans in use today take the form of salary plus commission and salary plus bonus. In fact, the non-commission-only incentive-paying marketplace is about evenly split between these plan types. Why is this the case?

It is widely accepted that commission-type incentives are most suitable when the salesperson has the most influence on sales results – whether the sale is won or lost and/or its size and profitability. Therefore, the common assumption is that a company should go with a commission-type incentive when its salespeople have meaningful sway over the sale compared to the company’s other marketing mix factors and organizational competencies. The converse is also commonly accepted – a bonus-type plan is right approach when the sales representative has lesser effect.

But, today’s selling environment is complex. The salesperson’s direct influence on the sale is less clear. Across many products and services sold and companies sold into, non-sales marketing mix factors have considerable bearing on sales success because sellers’ go-to-market strategies have evolved in response to:

- customers’ well-developed product and product usage knowledge, need for bundled product/service solutions (that increase revenue, reduce costs and deal with their business challenges), and sophisticated buying methods; as well as
- the transparency of sellers’ costs and pricing strategies created by information technology.

Successful sales representatives spend considerable time and effort on non-direct selling tasks. For example, coordinating the non-sales resources (e.g., marketing, engineering, manufacturing, logistics and finance) that build the bundled product/service offerings to address customers’

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needs and generate sufficient profit for the selling company. Organizational capabilities – whether those of the selling company or its alliance partners outside the organization – play a key role in creating or modifying the product/service offering, differentiating the seller from its competition, winning the sale, and sustaining the customer relationship. When to use bonus or commission combined with base salary has, as a result, become cloudy.

If one abided by traditional thinking, commission arrangements would not be appropriate under today's prevalent selling model in which potential and current buyers' needs are met and sellers' profit is generated through the combination of sales representatives', product/service and organizational capabilities.

But, you might say this is the extreme. Not all salary plus commission paying companies sell this way. That's true. Some, perhaps many, rely heavily on their sales resources to:

- locate potential customers;
- educate and convince prospects of product benefits;
- close the sale;
- coax current customers into buying more;
- sell aggressively when the selling company has overcapacity;
- serve the buyer after the sale; and
- create relationships that facilitate future sales.

These companies have clearly met all, or a good part of, the traditional criteria for salary plus commission. But, the salespeople at salary plus bonus paying companies also perform these tasks. Then, what situations exist that compel companies to take the salary plus bonus approach?

Could it be that in difficult economic environments – when performance shortfalls abound – that it's easier under salary plus bonus plans to adjust territory designs, fine-tune sales representatives' goals or change the salary/incentive mix in individuals' pay? No. The type of incentive vehicle has nothing to do with the ease or difficulty of changing territory designs. Territory structuring is highly dependent upon: 1) the comprehensiveness and quality of market and customer intelligence and 2) knowing the workload required to cover a territory's current and prospective customers. Having both also provides a sound foundation on which management can set sales force members' performance goals.

Sales representatives' territory-specific sales goals are different when territories are adjusted and territory potential hasn't been equalized. Under a bonus or commission plan, and these circumstances, all sales representatives in the same position typically have the same incentive opportunity regardless of their different sales goals. So, under a bonus plan and with unequal territories, *Individual A* with a \$1.0 million quota might have a \$25,000 target incentive and *Individual B* with a \$1.1 million quota would have the same \$25,000 target incentive. With one

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exception, the same is true under a commission plan. That exception is one of communication. A salary plus commission company doesn't communicate the \$25,000 target incentive. Instead it tells each salesperson the commission rate for his or her territory – 2.5% for *Individual A* and 2.3% for *Individual B*.

Identifying and setting the company's preferred position-specific incentive payouts at "minimum acceptable" through "outstanding" performance as well as making pay mix decisions are independent from, and should be identical across, incentive plan types.

If ease of change isn't the answer for using salary plus bonus versus salary plus commission, could it be that the sales success of the bonus paying companies' isn't measured in immediate "incentable" dollar results? In other words, is it because they pay their sales representatives to spend time on tasks or to achieve milestones that don't yield instantaneous results but which contribute to eventual sales? If that's the case, base salary can bridge the gap between sales effort and results and bonus or commission could be paid when the results occur. Paying a bonus for completed tasks or milestones achieved toward a sale – the "if come" – can be expensive if for some reason there isn't 100% certainty that the bonused tasks or milestones result in a sale. Shouldn't companies pay for delivered results when they occur– aren't results the true acid test of performance?

Or, do companies use salary plus bonus because the same activities required to make the sale yield different results across territories? This could occur, for example, because of the difference in potential customers' size or because customers' needs are satisfied by buying different product models with dissimilar features and selling prices. Both situations might result in widely different earned commissions. However, bonuses too could be quite different if sales goals aren't equalized. Rather than using the incentive design to correct the situation, territories or account assignments should be made more equal and sales goals should be set with customers' buying patterns in mind.

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The real reason that the non-commission-only sales incentive market is evenly split between salary plus bonus and salary plus commission is, we believe, because bonus and commission are interchangeable. Virtually any bonus design can be replicated in commission form. The promise made in a bonus plan contains both the inputs required to frame a commission arrangement.

1. The incentive payout opportunity.
2. Performance expectation.

The former is the numerator and the latter is the denominator in calculating a commission rate. *Exhibit A* illustrates a rather straightforward annual bonus payout schedule. It incorporates some common design features, including:

- a performance threshold (the "minimum acceptable" performance level) at 85% of target performance;

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- incentive payouts that accelerate, in absolute terms and incrementally, at performance expectations above target in recognition of the increasingly difficult task of achieving ever greater results;
- prorated awards for results between performance levels; so, for achieving revenue of \$1.6 million, which is between target and excellent performance expectations, the earned award is \$42,500;¹ and
- a capped incentive opportunity.

Exhibit A

| Performance Level | Cumulative | | Incremental | |
|--------------------------|---------------|--------------|-------------|----------|
| | Revenue | Bonus Payout | Revenue | Payout |
| Outstanding | \$2,000,000 | \$100,000 | \$260,000 | \$40,000 |
| Excellent | \$1,740,000 | \$60,000 | \$240,000 | \$30,000 |
| Target | \$1,500,000 | \$30,000 | \$225,000 | \$5,000 |
| Minimum Acceptable | \$1,275,000 | \$25,000 | \$1,275,000 | \$25,000 |
| Below Minimum Acceptable | < \$1,275,000 | \$0 | | |

Exhibit B provides an example of how the *Exhibit A* bonus payout schedule could be reformatted as a commission. Commission rates have been rounded.

| Performance Level | Cumulative | | Incremental | | Commission Rate on Increment |
|--------------------------|---------------|--------------|---------------|-----------|------------------------------|
| | Revenue | Bonus Payout | Revenue | Incentive | |
| Outstanding | \$2,000,000 | \$100,000 | \$260,000 | \$40,000 | 15.4% |
| Excellent | \$1,740,000 | \$60,000 | \$240,000 | \$30,000 | 12.5% |
| Target | \$1,500,000 | \$30,000 | \$225,000 | \$5,000 | 2.2% |
| Minimum Acceptable | \$1,275,000 | \$25,000 | \$1,275,000 | \$25,000 | 2.0% |
| Below Minimum Acceptable | < \$1,275,000 | \$0 | < \$1,275,000 | \$0 | 0.0% |

As in the case of the bonus opportunity escalation in *Exhibit A*, earned commissions rise because commission rates go up between performance levels in *Exhibit B*. The commission rate between

¹ Calculated as follows: $\{ [(\$1,600,000 - \$1,500,000) \div (\$1,740,000 - \$1,500,000)] \times (\$60,000 - \$30,000) \} + \$30,000$.

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Target and Excellent is 12.5% and rises to 15.4% for performance from Excellent to Outstanding. The salesperson's aggregate incentive award is determined by totaling the commissions earned in each revenue increment.

Note also in *Exhibit B* that the commission at "minimum acceptable" performance is stated in "all or nothing" terms. That is, the salesperson begins to earn an incentive upon achieving revenue of \$1,275,000 – as in the case of the bonus schedule. This avoids the inadvertent creation of a first dollar commission that results in the payment of an award for below "minimum acceptable" performance (e.g., paying a commission of \$18,000 for achieving revenue of \$900,000, which is \$375,000 below the point at which an award begins to be earned in *Exhibit A*).

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Both bonus and commission are nothing more than predetermined and proportionate allocations of sales results. For example:

- setting a bonus opportunity of \$25,000 for achieving revenue of \$1,000,000 translates to a commission rate of 2.5% on revenue ($\$25,000 \div \$1,000,000$);
- elevating a bonus from 10% of base salary or midpoint to 25% for improving gross profit from \$1,000,000 to \$1,300,000 in a bonus payout schedule changes into a commission rate of .05% of base salary or midpoint for every \$300 of profit improvement;²
- paying a bonus of \$1,000 for bringing in one new account, \$3,000 for securing a second, and \$6,000 for landing a third needs no conversion because it's already a commission; and
- elevating a \$25,000 bonus opportunity on aggregate current customers' revenue of \$2,000,000 to \$50,000 when aggregate new customers' revenue exceeds \$500,000 transforms into "pass or fail" commission rates of 2.5% on the \$2,000,000 of aggregate revenue if the new business goal of \$500,000 is met and 1.25% if it isn't.

The applicability of salary plus commission for the vast majority of today's team and cross-functional selling models is only limited by the incentive designer's creativity. Yes, having the ability and discipline to credit results to individual contributors, teams, and team members are important. But, not more so for a commission plan than non-discretionary bonuses. In fact, using commission can help a company avoid overpaying on a specific deal or for aggregate results over time in those situations where incentive awards need to be split. This is because a commission rate sets a company's incentive economics in advance – how much the sellers get and how much the selling company keeps.

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Salary plus bonus and salary plus commission are both powerful vehicles for: 1) fitting pay to a sales strategy; 2) communicating performance expectations; 3) linking sales representatives' pay to performance; and 4) ensuring pay is aligned with the competitive marketplace. Incentive

² Calculated as follows: $(25\% - 10\%) \div [(\$1,300,000 - \$1,000,000) \div 1,000]$.

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plan designers need not get hung up on the assumed advantages and disadvantages of salary plus bonus versus salary plus commission because, as we've illustrated, they're virtually the same incentive instrument.

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