
Sales Incentive Plan Design: Setting A Performance Threshold

Marketplace data indicate a considerable portion of companies incorporate performance thresholds ⁽¹⁾ in their sales incentive plans and typically set their performance thresholds at 75% to 90% of quota or target performance. Sales incentive plan designers should consider a number of issues before following the marketplace.

The first question to answer is: “Should there be a performance threshold at all?” A key step in answering this question is a determination of the amount of revenue necessary to cover the cost of the sales effort given a company’s profitability. Consider the following example developed from the pre-sales cost structure of a capital equipment manufacturer. All dollars are millions.

Annual Revenue Goal	\$400.0	Number of Sales Reps.	35
Sales Effort Cost (2)	\$10.4		
Pre-Sale Proposal Effort Cost (3)	\$12.0	<u>Per Sales Representative</u>	
Total Sales Effort Cost Burden	\$22.4	Annual Revenue Goal	\$11.4
EBIT Margin (4)	12%	Breakeven Revenue	\$5.3
Breakeven Revenue	\$186.7		
		Breakeven Revenue % of Annual Revenue Goal	47%

The total cost of this company’s direct sales effort is \$22.4 million. At an EBIT Margin goal of 12%, each sales representative must generate annual revenue of \$5.3 million to cover the cost of the sales effort at the margin. This breakeven amount of revenue is about 47% of a salesperson’s \$11.4 million annual revenue goal. It would be appropriate to include a performance threshold in the sales incentive plan for this sales organization given the company’s pre-sales cost structure.

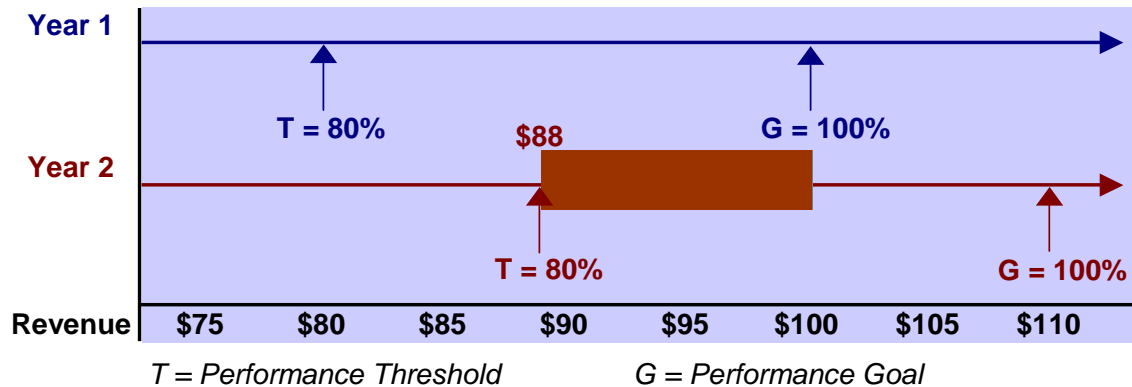
A performance threshold may not be appropriate when the salesperson is the key driver of sales results relative to all other marketing mix factors. This would include, for example, sales roles encompassing: 1) significant new market selling in which the salesperson helps create the demand for a product and/or 2) responsibility for identifying buyers who can make purchase decisions (particularly when selling complex products or services).

Assuming a performance threshold is appropriate, “Where should it be set?” In making this determination, thought should be given to the amount of stretch built into performance goals.

- (1) The performance level at which bonus and/or commission payout begins.
- (2) Cost of base salary, non-recoverable salary draw, target commission, T&E, car allowance, benefits, occupancy and variable channel commission (as sales personnel receive commissions on leads generated by the external channel).
- (3) The proposal development effort including applications engineering.
- (4) EBIT Margin is earnings before deductions of interest payments and income taxes divided by revenue.

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Consider the following example, which assumes a 10% year-over-year increase in goal and a performance threshold set at 80% of goal. Assume also that the salesperson achieves the revenue goal in years 1 and 2.



Setting the performance threshold at 80% creates a situation in which the salesperson is paid twice for the shaded revenue range between Year 1 threshold and Year 2 goal. A proper threshold minimizes the overlap in revenue achieved in the prior year considering the stretch in sales goals, the nature of the sales task (e.g., new business development versus customer management) and the composition of revenue (new versus repeat sales).

In addition to cost coverage and minimizing performance overlap, the motivations for incorporating a performance threshold in a sales incentive plan include the:

- Ability to communicate culturally acceptable minimum performance standards and motivate sales resources to achieve that level of goal attainment.
- Interest in influencing the compensation risk inherent in a sales incentive plan. A low threshold lowers the risk as it increases the number of sales representatives earning a payout. A high threshold increases the risk of not receiving a payout.
- Capability to create metric-specific performance expectations in plans having multiple performance metrics. For example, no threshold for a metric geared toward new customer or new product selling but including a threshold for “bread and butter” products whose price, quality, and acceptance in the marketplace may create some predictability in sales results.