

# TECHNICAL TOPICS in sales comp

## *Compensation Cost and Pay Mix*

### The Question:

*If we want to keep our fixed cost low and only pay sales people when they “perform,” is it smart to have a lower base and higher variable pay to control compensation costs?*

Many sales leaders, and perhaps most Chief Financial Officers, feel there are real business benefits to a high-risk / high-upside comp plan. Those who advocate aggressive pay mixes generally believe that:

- More risk and more upside make for more focused, effective and productive sales people, and
- Less base pay means less fixed cost and less total compensation cost in case of underperformance.

In this paper, we explore a case example for a direct sales force on a simplified typical compensation plan for software sales. For this analysis we will leave the motivational aspects of pay mix aside and focus on the cost of compensation for different pay mixes.

### The Answer:

*The perhaps surprising finding from this analysis is that a more aggressive pay mix results in a higher compensation cost over the expected range of performance (organizational quota attainment of 90% to 110%).*

The results of this analysis are presented in the following sections

1. The assumptions
2. Summary conclusions
3. Details of the analysis
4. Other scenarios (changing a few of the key assumptions, and how the results change)

## The assumptions

For this analysis we considered an individual contributor sales role with the following compensation plan parameters:

**Annual bookings quota:** \$5,000,000

**Annual target total compensation:** \$200,000

**Pay mix<sup>1</sup>:** Three cases are considered: 50/50, 60/40, 70/30

**Acceleration over quota:** The plan accelerates for bookings over the annual quota up to 150% of quota, then decelerates somewhat over 150%, but continues uncapped based on the following table:

<i>Performance vs. Quota</i>	<i>Payout % Target per percentage point in range</i>	<i>Payout at Top of Range</i>
150% or more	1.5% of Target Payout per 1% of quota	Uncapped 275% Target at 200% quota
100% to 149.9%	2% of Target Payout per 1% of quota	200% Target Payout
0% to 99.9%	1% of Target Payout per 1% of quota	100% Target Payout

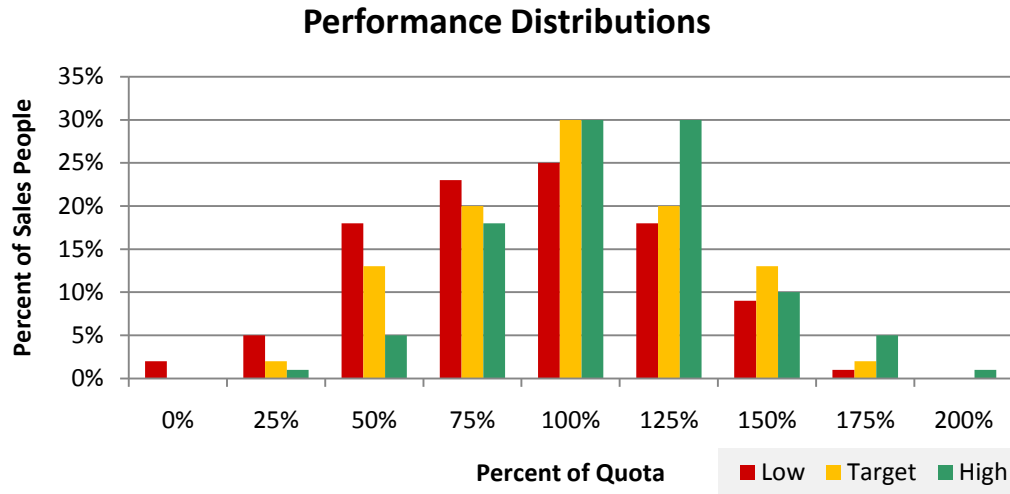
So, for the middle case, the 60/40 pay mix, the payout table in dollars with commission rates would be:

<i>Performance vs. Quota</i>	<i>Commission Rate in Range</i>	<i>Payout at Top of Range</i>
\$7.5M or more	2.4%	Uncapped \$220,000 at \$10M
\$5M to \$7.49M	3.2%	\$160,000
\$0 to \$4.99M	1.6%	\$80,000

**Performance distributions:** To predict the cost of compensation, we will need to recognize the fact that even at 100% of the organizational quota, some of the sales people will have under-performed

<sup>1</sup> Percent of target total compensation in the base/incentive at target

and others will have over-performed. For the purpose of this example, we have constructed three performance distributions: Low (90% of overall quota), Target (100% of overall quota) and High (110% of overall quota). The histograms for these distributions are shown in the following table.

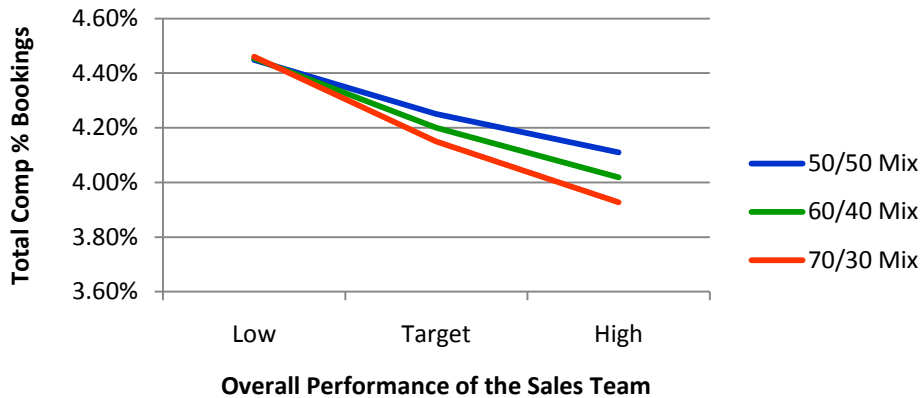


The cost of compensation in all cases for a person earning exactly their target total compensation (\$200,000) by achieving exactly their quota is 4% of bookings (\$200,000 / \$5,000,000). However, the cost of compensation for the “Target” case above, which yields exactly 100% of the organizational target bookings, is 4.15% to 4.25% of bookings (depending on the pay mix).<sup>2</sup>

<sup>2</sup> The cost of compensation for a team of sales people who together deliver exactly 100% of their collective quota will be somewhat higher due to the acceleration in the plan. The over-achievers will earn leveraged upside, and the under-achievers will not offset this leverage in their payouts. The result is that the expected total compensation cost is over 4% of bookings at target.

**Conclusions**

The more incentive-rich the pay mix (that is, the less is in base and the more is in the incentive at target), the higher the total cost of compensation as a percent of bookings for at-target and over-target organizational performance. For under-target organizational performance, the difference is negligible.



**Compensation Cost % Bookings**

Pay Mix	Performance		
	Low	Target	High
50/50 Mix	4.45%	4.25%	4.11%
60/40 Mix	4.45%	4.20%	4.02%
70/30 Mix	4.46%	4.15%	3.93%

If the sales team’s overall performance is close to or above target, the lower the base, the higher the cost of compensation, by as much as 5% of total compensation (base + incentive). In a low-performing scenario, the compensation cost as a percent of bookings is negligibly higher for the more base-rich pay mix (4.46% > 4.45%).

***This analysis demonstrates that there are no meaningful cost savings resulting from a more incentive-rich pay mix.*** In fact, the more pay at risk, the more aggressive the acceleration over quota, and the higher the cost of comp for the over-performers, which is not fully offset by the reduced pay delivered to the under-performers.

## Details of the analysis

Annual Quota            5,000,000  
 TTC                        200,000

<i>Pay Characteristic</i>	<i>50/50 Mix</i>	<i>60/40 Mix</i>	<i>70/30 Mix</i>
Base	100,000	120,000	140,000
TIC	100,000	80,000	60,000
Leverage Factor	2	2	2

<i>Act % Quota</i>	<i>Incentive Payout % TIC</i>		
	<i>50/50 Mix</i>	<i>60/40 Mix</i>	<i>70/30 Mix</i>
0%	0%	0%	0%
50%	50%	50%	50%
100%	100%	100%	100%
150%	200%	200%	200%
200%	250%	250%	250%

<i>Act % Quota</i>	<i>Variable Pay</i>		
	<i>50/50 Mix</i>	<i>60/40 Mix</i>	<i>70/30 Mix</i>
0%	-	-	-
50%	50,000	40,000	30,000
100%	100,000	80,000	60,000
150%	200,000	160,000	120,000
200%	250,000	200,000	150,000

<i>Act % Quota</i>	<i>Total Compensation (Base + Vbl)</i>		
	<i>50/50 Mix</i>	<i>60/40 Mix</i>	<i>70/30 Mix</i>
0%	100,000	120,000	140,000
50%	150,000	160,000	170,000
100%	200,000	200,000	200,000
150%	300,000	280,000	260,000
200%	350,000	320,000	290,000

# Technical Topics in Sales Compensation: Compensation Cost and Pay Mix

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<b>Act % Quota</b>	<b>Distribution of Performance</b>		
	<b>Low</b>	<b>Target</b>	<b>High</b>
0%	2%		
25%	5%	2%	1%
50%	18%	13%	5%
75%	23%	20%	18%
100%	25%	30%	30%
125%	18%	20%	30%
150%	9%	13%	10%
175%	1%	2%	5%
200%			1%

Bookings % Quota                      90%                      100%                      110%

Actual Bookings            4,512,500            5,000,000            5,475,000

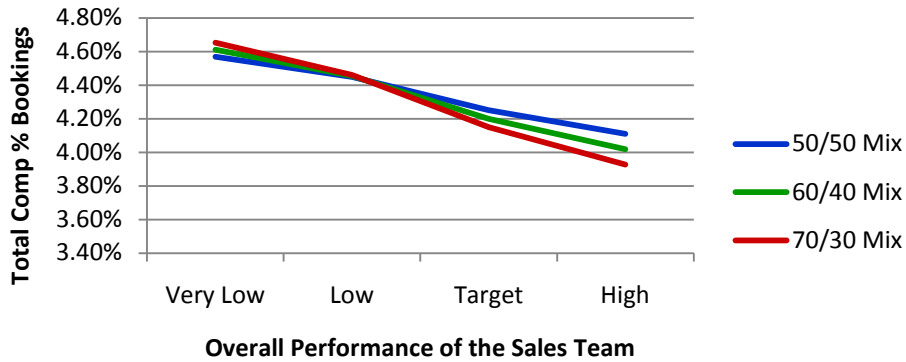
<b>Performance Distribution</b>	<b>Total Compensation Based on Distribution</b>		
	<b>50/50 Mix</b>	<b>60/40 Mix</b>	<b>70/30 Mix</b>
Low	200,750	201,000	201,250
Target	212,500	210,000	207,500
High	225,000	220,000	215,000

<b>Performance Distribution</b>	<b>Total Compensation % Bookings</b>		
	<b>50/50 Mix</b>	<b>60/40 Mix</b>	<b>70/30 Mix</b>
Low	4.45%	4.45%	4.46%
Target	4.25%	4.20%	4.15%
High	4.11%	4.02%	3.93%

<b>Performance Distribution</b>	<b>Total Compensation Based on Distribution for 50 reps</b>		
	<b>50/50 Mix</b>	<b>60/40 Mix</b>	<b>70/30 Mix</b>
Low	10.0M	10.1M	10.1M
Target	10.6M	10.5M	10.4M
High	11.3M	11.0M	10.8M

Other scenarios

If the cost of comp is slightly less for a more incentive-rich mix in a 90% of target scenario, what would happen in an 80% of target scenario?



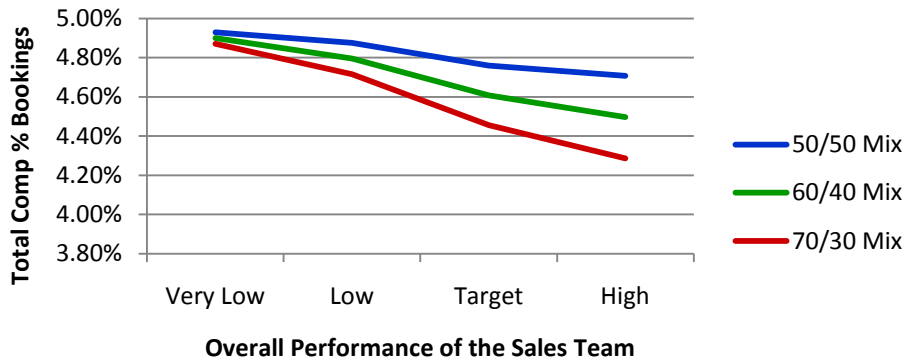
Compensation Cost % Bookings

Pay Mix	Performance			
	Very Low	Low	Target	High
50/50 Mix	4.57%	4.45%	4.25%	4.11%
60/40 Mix	4.61%	4.45%	4.20%	4.02%
70/30 Mix	4.65%	4.46%	4.15%	3.93%

The lines do indeed cross below 90% of the organizational quota. So if a seriously underperforming year is anticipated, there may be some cost savings associated with a more incentive-rich pay mix.

How do the results change if the plans offer greater acceleration over quota, for example a 3.0 leverage factor<sup>3</sup> as is often the design in high-quota new business sales roles?

*Cost of Compensation with a Higher Leverage Plan*

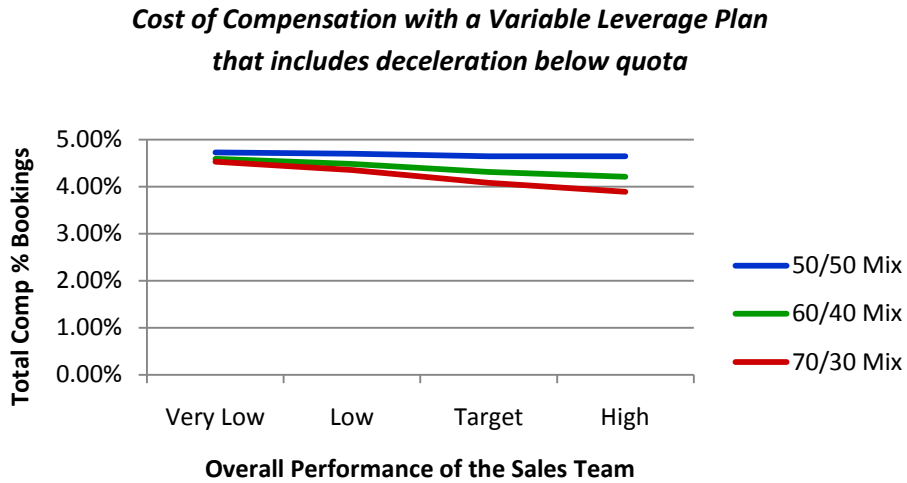


If the leverage factor is as high as 3.0, the more aggressive (incentive-rich) pay mix is more expensive across the full range of outcomes for organizational performance (80% of quota to 110% of quota).

<sup>3</sup> The Leverage Factor is the ratio of top performer (90<sup>th</sup> percentile) variable earnings to typical performer (50<sup>th</sup> percentile) variable earnings.



What about a more sophisticated plan in which the leverage factor increases with pay at risk, and the payout curve below quota decelerates at low levels of attainment, and accelerates somewhat as quota is approached?



Once again, across the full performance range considered, the least costly plan is the plan with the highest base as a percent of total compensation at target. Details of this analysis are included below.

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Annual Quota            5,000,000  
TTC                            200,000

	<b>50/50 Mix</b>	<b>60/40 Mix</b>	<b>70/30 Mix</b>
Base	100,000	120,000	140,000
TIC	100,000	80,000	60,000
LF	3	2.5	2

<b>Act % Quota</b>	<b>Incentive Payout % TIC</b>		
	<b>50/50 Mix</b>	<b>60/40 Mix</b>	<b>70/30 Mix</b>
0%	0%	0%	0%
50%	25%	25%	25%
100%	100%	100%	100%
150%	300%	250%	200%
200%	400%	325%	250%

<b>Act % Quota</b>	<b>Variable Pay</b>		
	<b>50/50 Mix</b>	<b>60/40 Mix</b>	<b>70/30 Mix</b>
0%	-	-	-
50%	25,000	20,000	15,000
100%	100,000	80,000	60,000
150%	300,000	200,000	120,000
200%	400,000	260,000	150,000

<b>Act % Quota</b>	<b>Total Compensation (Base + Vbl)</b>		
	<b>50/50 Mix</b>	<b>60/40 Mix</b>	<b>70/30 Mix</b>
0%	100,000	120,000	140,000
50%	125,000	140,000	155,000
100%	200,000	200,000	200,000
150%	400,000	320,000	260,000
200%	500,000	380,000	290,000

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<b>Act % Quota</b>	<b>Distribution of Performance</b>		
	<b>Low</b>	<b>Target</b>	<b>High</b>
0%	2%		
25%	5%	2%	1%
50%	18%	13%	5%
75%	23%	20%	18%
100%	25%	30%	30%
125%	18%	20%	30%
150%	9%	13%	10%
175%	1%	2%	5%
200%			1%
Bookings % Quota	90%	100%	110%
Actual Bookings	4,512,500	5,000,000	5,475,000

<b>Performance Distribution</b>	<b>Total Compensation Based on Distribution</b>		
	<b>50/50 Mix</b>	<b>60/40 Mix</b>	<b>70/30 Mix</b>
Very Low	199,625	194,000	191,425
Low	212,000	202,300	196,450
Target	232,000	215,400	203,900
High	254,125	230,200	212,825

<b>Performance Distribution</b>	<b>Total Compensation % Bookings</b>		
	<b>50/50 Mix</b>	<b>60/40 Mix</b>	<b>70/30 Mix</b>
Very Low	4.72%	4.59%	4.53%
Low	4.70%	4.48%	4.35%
Target	4.64%	4.31%	4.08%
High	4.64%	4.20%	3.89%

<b>Performance Distribution</b>	<b>Total Compensation Based on Distribution - 50 reps</b>		
	<b>50/50 Mix</b>	<b>60/40 Mix</b>	<b>70/30 Mix</b>
Low	10.6M	10.1M	9.8M
Target	11.6M	10.8M	10.2M
High	12.7M	11.5M	10.6M