Implementing an effective sales compensation plan

Accion Venture Lab
Your sales compensation plan is a critical component of effectively growing your business

- Your sales staff will **drive the growth of your business**

- Your compensation plan has the **ability to motivate the behaviors you desire**
  - Top performing firms offer 40% more of a sales rep’s total compensation as variable compensation than less successful firms

- Compensation plans **provide an opportunity to define what success looks like**

Crafting and implementing an effective sales compensation strategy is an iterative process

**Build**
- Determine % of compensation from base salary versus variable compensation
- Build a compensation plan that is aligned with your overall strategy, simple to understand, and immediately impacting your sales team

**Test**
- Build scenarios to ensure you’re comfortable with your cost of sales
- Compare your cost of sales and total compensation to other players in the market to ensure you’re competitive, but not overpaying

**Communicate**
- Build a communication plan for sharing the plan with the organization
- Create and publish a written document outlining the compensation plan’s alignment with overall strategy, performance objective, payout calculation, and governance

**Evaluate**
- Assess the effectiveness, employee engagement and market competitiveness of your plan at least once a year
- When change is required, ensure that you thoughtfully communicate and implement the new plan
You must determine what degree of variable compensation is appropriate for your business.

**Base Salary Only**
- Ensures valued sales staff members are compensated even when poor sales are driven by external forces (e.g., economic downturn).

**100% Performance Based Compensation**
- Incentivizes salespeople to sell new accounts because they will see the results of their hard work in their paychecks.

**Most companies choose a blend of both**

Source: Inc.: “How to Set Up a Sales Compensation Plan”
There are a number of considerations in determining the right amount of base versus variable compensation.

### Role of the salesperson

To what degree does a sales person influence a customer's decision to buy a product or service?

- If a sales person plays a critical role, a heavy commission percentage likely makes sense to drive them to optimize sales.
- Alternatively, if many team members contribute to the sale (e.g., sales, business development, and engineers), then you likely want to lower the commission ratios.

### Type of selling

What is your strategic priority?

- If selling new accounts is your top priority, then you likely want to offer a heavy commission ratio to encourage salespeople to quickly generate leads and follow up.
- If growing existing accounts is your top priority, a greater weight on base pay may make sense for your business.

### Sales cycle of business

How long is your sales cycle? How volatile is your market? How complicated is your product/service?

- If your sales cycle is short and product simple, then you likely want to offer a heavy ratio of commission based pay because salespeople will quickly see the impact of sales on their paycheck.
- However, companies operating in volatile markets or with long sales cycle or complicated products require a greater focus on base pay to provide continuity of income.

Source: Inc., “How to Set Up a Sales Compensation Plan”
The type of sales jobs on your team will drive the appropriate amount of commission.

<table>
<thead>
<tr>
<th>Base Salary Only</th>
<th>100% performance based compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>High base salary job components:</strong></td>
<td><strong>Moderate base salary job components:</strong></td>
</tr>
<tr>
<td>The sales rep is primarily managing existing accounts</td>
<td>The sales rep splits time between both account management and new account sales</td>
</tr>
<tr>
<td>Growing existing accounts and/or low customer churn are the top priority for the business</td>
<td>Growing existing accounts and selling new accounts are high priorities for the business</td>
</tr>
<tr>
<td>Near-automatic commissions (e.g., subscription customers)</td>
<td>Inherits / manages some accounts</td>
</tr>
<tr>
<td>- Typically in a later stage startup with an established customer base</td>
<td>- Typically in a later stage startup with an established customer base</td>
</tr>
<tr>
<td>Product / service has a long sales cycle</td>
<td>Selling new accounts is the top priority for the business</td>
</tr>
<tr>
<td>- E.g., airplanes take many years to sell making variable compensation challenging</td>
<td></td>
</tr>
</tbody>
</table>

Calculate a range of sales outcomes to ensure the business’s profitability is positive and growing with sales.

Evaluating the profitability of your sales compensation plan

- Cost of goods sold (for units sold by rep)
- Overhead (allocated on a unit basis)
- Base salary of rep
- Implied commissions
  - Implied commissions

Sales realized (in different scenarios) by a sales rep

Profit
Calculate a range of sales outcomes to ensure the business’s profitability is positive and growing with sales.

Example compensation plan: $40K base salary plus variable compensation of 15% of sales and a $5K bonus for reaching a $200K sales goal.

<table>
<thead>
<tr>
<th>Annual compensation and sales ($K)</th>
<th>$100K in annual sales</th>
<th>$150K in annual sales</th>
<th>$200K in annual sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Realized Sales</td>
<td>$100K</td>
<td>$150K</td>
<td>$200K</td>
</tr>
<tr>
<td>Costs</td>
<td>-$40K</td>
<td>-$60K</td>
<td>-$80K</td>
</tr>
<tr>
<td>Sales Comp</td>
<td>-$55K</td>
<td>-$63K</td>
<td>-$85K</td>
</tr>
<tr>
<td>Profit</td>
<td>$5K</td>
<td>$28K</td>
<td>$35K</td>
</tr>
</tbody>
</table>

Ensure you are profitable even if sales reps perform below expectations.

Ensure your profitability grows as sales reps are more successful.

Legend:
- **Sales**: Green
- Costs: Brown
- Sales Comp: Blue
- Profit: Yellow
- Base salary: Cyan
- Commissions: Light blue
- Bonus: Teal
A good sales compensation plan should result in a win-win for the business performance, company leadership, and sales reps.

- It is common for early stage startups to pay effective sales team members considerable amounts, often more than the founders, CEO and other senior team members.

- Evaluating potential sales outcomes’ impact on sales team compensation and business performance will ensure that the plan is effective.

- Many CEOs initially balk at the size of payouts, but ultimately conclude that a well designed sales plan can result in a win-win for all.

  “The first time I had a sales rep making a $1M W2, I remember the rep’s name, face, body language, and of course, the deals closed. We were all so excited. And because we did the compensation plan right, the board and CFO were equally excited. It was very profitable for us all.”

  Lars Dalgaard, Founder of SuccessFactors and General Partner at Andreessen Horowitz

Improved sales force performance increases sales payout, while growing the business - a win-win.

Effective sales compensation plans set metrics that are aligned with the business strategy, simple to understand, and with immediate impact on reps.

**Attributes of compensation plan metrics**

**Alignment**
- Determine what the most important goal the company needs to achieve in the next year
- Then determine how the sales compensation plan be aligned with this objective

**Simplicity**
- A plan with too many variables will confuse salespeople on what behaviors to focus on
- Create a plan that clearly incentivizes the behaviors you are rewarding

**Immediacy**
- Salespeople success or failure should be felt immediately in their through communications or their paycheck
- Immediacy will quickly encourage positive behaviors and discourage negative ones

Source: HBR: “The Right Way to Use Compensation”
For many startups, the compensation plan will have a greater impact on the business than any other lever.

It is critical that the plan is aligned with your vision for the business and incentivizes the needed behaviors.

Incentivizing many outcomes will result in diluting the achievement of all of your goals.

Successful sales compensation plans make tradeoffs - you cannot achieve every desired business outcome immediately.

HubSpot case study: HubSpot adapted their sales compensation plan to align with their evolving strategy

HubSpot is an inbound marketing and sales platform that helps companies attract visitors, convert leads, and close customers. Founded in 2006, the company has evolved from an early stage startup to a business with over $100M in revenue.

Evolution of HubSpot’s strategy

1. Acquire new customers
   - New Net Sales
   - Bigger Deal Size
   - Deals with New Products
   - Renewals of Current Products
   - Higher Customer Satisfaction
   - Lower customer churn
   - Greater profitability

2. Decrease customer churn
   - New Net Sales
   - Bigger Deal Size
   - Deals with New Products
   - Renewals of Current Products
   - Higher Customer Satisfaction
   - Lower customer churn
   - Greater profitability

3. Grow with the best customers
   - New Net Sales
   - Bigger Deal Size
   - Deals with New Products
   - Renewals of Current Products
   - Higher Customer Satisfaction
   - Lower customer churn
   - Greater profitability

Source: HBR: “The Right Way to Use Compensation”
1

**Acquire new customers**

**Impetus:** Early in HubSpot’s history they needed to acquire customers quickly so they could see how valuable the offering actually was to them.

**Compensation plan:** Salespeople were paid a base salary and $2 for every $1 in recurring revenue with a four month clawback period on commissions.

**Result:** In six months, the customer base grew from 100 to 1,000, and revenue from $300K to $3M.

---

Note: A clawback is a retraction of earned commissions on customers that churn in the short term

Source: HBR: “The Right Way to Use Compensation”
Impetus: After acquiring customers, HubSpot discovered customers were churning at an unsustainable rate. After finding a 10 fold difference in customer churn rate by sales person, the CEO shared churn data by salesperson and educated the team on the importance of low churn. He announced that the compensation plan would be adjusted in the next quarter to align commissions with customer retention.

Compensation plan: The salespeople were divided into four quartiles based on their customer retention and compensated by quartile:

- Top quartile (best performers): $4 for every $1 in recurring revenue
- 2nd quartile: $3 for every $1 in recurring revenue
- 3rd quartile: $2 for every $1 in recurring revenue
- 4th (bottom) quartile: $1 for every $1 in recurring revenue, and received training on customer expectation setting

Result: In six months, churn had dropped by 70%
Grow with the best customers

**Impetus:** Having addressed the immediate churn issue, the company now needed to achieve faster, profitable growth. This would require the sales team prioritizing both signing new customers, and achieving high retention rates.

Through analyzing the data, the CEO realized that customers committed to putting in the required time and investment to make HubSpot work were less likely to defect. Additionally, more committed customers were more likely to prepay annually versus paying month-to-month.

**Compensation plan:** Salespeople earned $2 per $1 of monthly recurring revenue. The commission was paid out as follows: 50% on the customer’s first month’s payment, 25% on the sixth month’s payment, and 25% on the 12th month’s payment.

**Result:** The average prepayment commitment was 2.5 months prior to the plan. After the plan was rolled out, that average jumped to 7 months.

Source: HBR: “The Right Way to Use Compensation”
### Example strategy

<table>
<thead>
<tr>
<th>Example strategy</th>
<th>Example compensation structures to consider</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Net Sales</td>
<td>• Provide flat payout per new sale</td>
</tr>
<tr>
<td>Bigger Deal Size</td>
<td>• Provide commissions by total sales volume</td>
</tr>
<tr>
<td></td>
<td>• Provide higher commissions on larger ticket sales</td>
</tr>
<tr>
<td>Deals with New Products</td>
<td>• Provide higher commission payout on new products</td>
</tr>
<tr>
<td>Renewals of Current Products</td>
<td>• Provide recurring commission payment with renewals</td>
</tr>
<tr>
<td>Higher Customer Satisfaction</td>
<td>• Provide portion of commission based on customer satisfaction survey</td>
</tr>
<tr>
<td>Lower customer churn</td>
<td>• Institute a retraction of commissions (a clawback) on customers that churn in the short term</td>
</tr>
<tr>
<td>Greater profitability</td>
<td>• Pay higher commissions on more profitable products</td>
</tr>
<tr>
<td>Teamwork and collaboration</td>
<td>• Base portion of commission payments on overall business performance</td>
</tr>
</tbody>
</table>

*Build your team with purpose and passion.*

**Alignment:**

- **Build:** Teamwork and collaboration
- **Grow:**
  - New Net Sales
  - Bigger Deal Size
  - Deals with New Products
  - Renewals of Current Products
  - Higher Customer Satisfaction
  - Lower customer churn
  - Greater profitability
- **Grow:**
  - Provide flat payout per new sale
  - Provide commissions by total sales volume
  - Provide higher commissions on larger ticket sales
  - Provide higher commission payout on new products
  - Provide recurring commission payment with renewals
  - Provide portion of commission based on customer satisfaction survey
  - Institute a retraction of commissions (a clawback) on customers that churn in the short term
  - Scale commissions based on sales rep’s past retention
  - Pay higher commissions on more profitable products
  - Base portion of commission payments on overall business performance

**Example strategy**

- **Teamwork and collaboration**
- **Grow**
In addition to standard compensation metrics, you can consider innovative ways to incentivize key enablers of the business strategy.

<table>
<thead>
<tr>
<th>Innovative compensation approaches</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Build a culture of collaboration</strong></td>
</tr>
<tr>
<td>• Base portion of commission payments on overall business performance</td>
</tr>
<tr>
<td><strong>Create teamwork within sales team</strong></td>
</tr>
<tr>
<td>• Provide 50% of compensation directly to sales rep and allow the rep to distribute the other 50% to other team member(s) that contributed to the successful sale</td>
</tr>
<tr>
<td><strong>Utilize your payout policies to further incent desired behavior</strong></td>
</tr>
<tr>
<td>• Utilize clawbacks - the retraction of commission payments - for customers who do not pay or who churn very early on</td>
</tr>
<tr>
<td>• Payout immediately the full compensation on customers that pay upfront for many months of the good or service</td>
</tr>
</tbody>
</table>
Building a simple, easy to understand plan will be critical to your sales team adopting the desired behaviors

Complex sales compensation plans promote negative behaviors from sales teams

- Sales reps can focus on the wrong objectives
- Sales reps can spend considerable time analyzing and thinking about how to reach sales targets
- Sales reps can become demotivated by lack of clarity in goals

Considerations during sales compensation planning

“If it takes more than two minutes for your **salesperson to explain** the plan to his or her spouse, it’s probably too complicated.”

HBR: “The Right Way to Use Compensation”

“Salespeople **should not need a spreadsheet** to calculate their earnings. If too many variables are included, they may become confused about which behaviors will lead to the largest commission check.”


“If you get that sinking feeling during the compensation planning process that this is too complicated, then it was already way too complicated...**you have a much higher threshold for things that are complicated and unusable than the people who sell for you.**”

Forbes, “Sales Compensation Beware You Get What You Ask For”

Positive and negative behaviors should quickly be communicated to sales reps, and easily trackable by your sales leader.

**Rationale for crafting an immediate sales compensation plan**

“Establishing a systematic link between a sale and reward/recognition is **more likely to build a positive feedback loop in sellers who are hitting their numbers and institute a sense of urgency in reps who are consistently missing monthly targets.”

BAI Banking Strategies, “Compensating Sales for Improved Performance”

“Having a **clear dashboard** boosts **motivation**...it can also alert managers to who needs help and coaching.”


**Tactical tools to consider for creating immediacy in your sales compensation plan**

**Compensation schedules** that quickly incorporate sales performance into sales rep’s payout
- Must balance immediate incentives with achieving objectives with longer time horizons (e.g., minimizing churn)

**Team communication tools** that readout on sales performance
- E.g., a weekly email with the sales rep’s expected comp and performance relative to other reps

**Sales leader dashboards** that enable quick identification of underperforming sales reps and broader sales challenges, so that leadership can provide coaching and support

**Regular sales team meetings** where sales performance is shared, and best practices and coaching are provided

Prior to implementing your plan, ensure that you are comfortable with the maximum payout and cost of sales.

**Testing your sales plan will ensure you are comfortable with the end result**

- You cannot retroactively change your compensation plan without risking lawsuits, considerable sales team churn, and decreased company morale.

- Build scenarios of sales compensation to ensure you are comfortable with the payout.

- When possible compare your sales team’s total compensation to others in your market to ensure that you are paying competitively, but not overpaying.

**Cost of sales can be used to compare how much you’re paying per dollar of revenue**

- **Salesperson Salary**
- **Commissions earned at 100% of quota**
- **Potential bonus opportunities**
- **Revenues earned at 100% of quota**
- **Cost of Sales**

Building a thoughtful communication plan is critical to effectively educating and motivating your sales team.

### Key consideration in building your plan

- **Plan adequate time for the Board and other mentors to provide feedback** and to iterate the plan prior to the ‘go live’ date.

- **Leverage the sales leader’s relationship with the team** to further clarify and champion the plan after the kickoff.

- **Provide an easy, accessible way for sales team members to provide feedback**

### Example communication plan for the first sales compensation plan

<table>
<thead>
<tr>
<th>Action</th>
<th>Owner</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share draft plan with Board for input</td>
<td>CEO</td>
<td>3-4 weeks before ‘go live’</td>
</tr>
<tr>
<td>Finalize plan</td>
<td>CEO / Sales leader</td>
<td>2-3 weeks before ‘go live’</td>
</tr>
<tr>
<td><strong>Plan ‘go live’</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plan announcement / kickoff</td>
<td>CEO and Sales leader</td>
<td>Week of ‘go live’</td>
</tr>
<tr>
<td>Share written plan document</td>
<td>CEO or Sales leader</td>
<td>Week of ‘go live’</td>
</tr>
<tr>
<td>Sales leader / Reps 1-on-1s</td>
<td>Sales leader</td>
<td>Week of ‘go live’</td>
</tr>
<tr>
<td>First payment</td>
<td>HR</td>
<td>2-6 weeks after</td>
</tr>
<tr>
<td>Sales rep survey follow-up</td>
<td>Sales leader</td>
<td>3-6 months after</td>
</tr>
</tbody>
</table>

Think through the value proposition for each sales position and communicate the proposition in written and in person communications.

**Example value proposition for high base salary / low variable compensation sales position:**
- Show that their base salary greatly exceeds peers with more variable compensation
- Explain the stability base salary provides during uncertain economic conditions or market changes

**Example value proposition for medium base salary / medium variable compensation sales position:**
- Show their opportunity to make more money than peers through the combination of base salary and commissions
- Explain the stability base salary provides during uncertain economic conditions or market changes

**Example value proposition for low base salary / high variable compensation sales position:**
- Describe that the sales rep’s effort will directly correlate with higher compensation
- Show that the sky is the limit in terms of compensation
- Emphasize the product’s attractiveness and it’s ability to be sold easily

A written and readily available plan document should be made available for all affected team members

A published plan document ensures the sales team can reference and understand the plan

- Your sales compensation plan should be written, documented and made available to the sales team
  - In some cases it makes sense to also provide an incentive calculator

- It is recommended that the front line manager of the sales team meet with their teams to explain:
  - How sales performance translates to compensation
  - The mechanics of the compensation calculation
  - Examples of payouts

Components of an effective written sales compensation plan

1. **Strategy**: Explain the overall business strategy and how the sales strategy fits into it

2. **Performance measures**: Detail the overall performance measures that you are targeting for the salesforce (e.g., decrease overall churn by X%, increase revenue by $Y) to guide the sales team’s focus

3. **Payout formula**: Outline how the sales team compensation will be calculated and when it will be paid out

4. **Governance**: Describe how questions or conflicts over compensation that are not detailed in the plan will be resolved

At least once a year evaluate the effectiveness of your compensation plan, and adjust as needed

There are three key elements on which to evaluate your plan

- **Strategic effectiveness**
  - How did you perform on your 1-2 strategic goals?

- **Market competitiveness**
  - How does your compensation compare to similar players in market?
  - Have you lost employees to competitors providing a more attractive offer?

- **Employee engagement**
  - What does your salesforce say about the plan?
  - Has the plan motivated them to adopt the desired behaviors?

If you decide to overhaul or adjust your compensation plan, a thoughtful approach is required

- Provide **at least 1 month of notice** prior to changing the plan
  - Providing time for the sales team to understand the new plan and adjust to the change will ensure the plan motivates the salesforce

- **Never retroactively change the plan** and respective compensation offer
  - This will erode the trust of your employees, demotivate your team, and potentially open you up to lawsuits

- **Build and execute on a communication plan** for all changes to the plan
Further reading on sales compensation plan

- HBR’s, “Incentivizing you salespeople by their relative performance”
  - [https://hbr.org/2012/07/motivating-salespeople-what-really-works](https://hbr.org/2012/07/motivating-salespeople-what-really-works)

- Andreessen Horowitz’s a16z Podcasts, “The Why, How and When of Sales”
This work is licensed under the Creative Commons Attribution-ShareAlike 4.0 International License.

To view a copy of this license, visit http://creativecommons.org/licenses/by-sa/4.0/ or send a letter to Creative Commons, PO Box 1866, Mountain View, CA 94042, USA.