Like 'Check Engine' Light, Use Compensation Cost of Sales to Look for Trouble

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Introduction

Here's a situation: You were recently hired as the director of global compensation for a fast-growth company. You've spent your first 30 days focusing on compensation levels for the sales organization, where the company plans to do the most hiring next year. You've been thorough, analyzing competitive benchmarks for particular sales jobs and geographic locations and information from recruiters to understand how well the company's overall value proposition resonates with prospective sales employees.

So when you meet the company's CFO for the first time at the company's holiday party, you're confident speaking of your first 30 days on the job. You know the company is paying competitively for key jobs and is able to recruit the talent needed to meet its growth objectives. "Great," the CFO says. "But why are our sales compensation expenses outpacing our revenue?" Gulp. You don't know. It could be that with all the hiring, there are a lot of new salespeople who aren't fully productive. But that theory does not necessarily make sense given that the company is targeting A-level players who can make an immediate impact. You are not prepared for the CFO's question. "I don't know," you say, "but I'll find out."

As a sales compensation professional, I'm constantly faced with questions regarding a sales organization's productivity and what a company spends for its sales production. Compensation cost of sales is the key metric for monitoring the two critical variables of sales compensation and production, or sales. On my operational dashboard, it is analogous to a car's check-engine light. It doesn't tell you what's wrong, only that something might be amiss.

The check-engine light, sometimes called an "idiot light," requires diagnosis. The derogatory term came about, I suspect, because some drivers, accustomed to monitoring the car's basic functions through its dashboard instrument cluster, didn't appreciate the implication of this one light now doing all the work. However, the modern car is far too complex for a three- or four-instrument cluster to provide sufficient

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diagnosis. So, too, is the modern sales organization. Most of the organizations in which I work have no shortage of data. Rather, the reporting is often overwhelming. Far be it for anyone to make sense of these data, let alone a busy executive.

Starting with the Ratio

Compensation cost of sales helps as a high-level summary of your sales compensation's relative effectiveness. Using only sales growth, market-comparative target pay ratios and hiring and turnover statistics can mask other, systemic issues. And like the modern car, these issues can range from simple, one-off instances to more fundamental, and costly-to-repair, time bombs. I felt like an idiot once because I discovered through a dealer that my car's check-engine light was from nothing more than a loose gas cap. Although it is reasonable that most drivers would have done the same, you as a sales compensation professional face considerably higher consequences in rushing to conclusions on a seemingly high or low compensation-cost-of-sales ratio.

The first tip is to use compensation cost of sales, and the related diagnosis, as a way to validate a suspected issue. Do not frame it as an issue itself. In the case above, your CFO speaks of a concerning trend with implications for compensation strategy and management. Another common perception from top executives is that the company is paying too many people on a single deal. Whether paying 20 people on the same deal is appropriate, or nuts, really depends on the cost of that sale relative to other deals. Compensation cost of sales helps provide objectivity and impact to the issue. If your company spends $200 million in sales compensation this year, each 1 percent increase in compensation cost of sales represents a compensation increase of $2 million, without any corresponding revenue.

You're back at your desk in search of what might be contributing to the increase in compensation expense. The first place you look is on pay actuals. Although your target pay, in terms of base salary and on-target earnings, checks out relative to competitive benchmarks, you discover some jobs are trending well above competitive benchmarks for actual (last full year) pay.

Other items on your diagnostic checklist should include:

- Plan eligibility and job roles. Are jobs for which actual pay is trending above the benchmark typically eligible for sales compensation per market practices? Are these jobs in a position of direct influence on customer buying decisions? Does the primary sales rep have a high degree of dependency on these jobs in order to close the deal?

- Performance measurement. Does the company measure and report performance on these jobs in a way that reliably determines individual accountability and contribution? Do performance trends suggest goal-setting that is habitually too low?

- Incentive pay approach. Do performance and pay results for individuals align with the plan rules? Are there frequent adjustments to goals or credits that distort the pay-and-performance correlation? Do the accelerator rates make sense given the quota attainment trends and what is provided for like jobs in the market?

Looking at the Competition

You might conclude the plan is paying competitively based on the plan rules and individual performance results. Yet members of the leadership team insist the company's compensation cost of sales is too high.

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Such perceptions can stem from familiarity with other sales organizations or from nothing more than an anecdote. In any case, you need reliable, competitive information.

The second tip is to use a competitive benchmark, but only after validating the appropriateness of the companies used for the benchmarking. Let's suppose your company is in the software-as-a-service (SaaS) business, has a compensation cost of sales of 22.4 percent, and its peer for pay group reports a compensation cost of sales of 14.6 percent. (This ratio was reported in the Radford Global Sales Survey, November 2014, based on a select group of software companies.) Before sharing the peer benchmark and the gap of 7.8 percent, you might want to better understand the companies comprising the peer group on factors that fundamentally influence compensation expense.

Some companies in your peer group might have a much lower growth rate and thus are not likely investing in salespeople at the same rate, or some of those companies might have a greater share of their business paid for up front instead of through subscription – both of which result in lower compensation cost of sales. Other companies might have a salesforce composition that contributes to a lower overall cost— for example, a higher share of inside sales representatives or a lower share of upper-level management. The goal is to understand and potentially refine the peer group so that you are using companies with expense profiles similar to yours.

Conclusion

I observe too many sales compensation practitioners ignoring what appears to be an uncompetitive compensation-cost-of-sales ratio because of a debate over the method for counting expense and/or sales; they say the method is not an apples-to-apples comparison relative to the competition. In benchmarking compensation cost of sales, Radford uses a consistent methodology for expense and sales. On the expense side, you should count all employees on the sales compensation program. For sales, count total revenue, unless your company has a material share of revenue coming from markets not covered by its sales organization. In these instances, consider doing more research to determine whether your peer group faces a similar dynamic.

To learn more about Radford's executive compensation, broad-based compensation, compensation governance, and salesforce effectiveness consulting services, please visit: radford.com/home/consulting/

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