NOVEMBER 2024
ISSUE #7

1989 - 2024
Sales Resource Group
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REWARDING SALES EXCELLENCE

ISSUES & BEST PRACTICES REGARDING EARNINGS CAPS IN SALES COMPENSATION PLANS

Rewarding Sales Excellence

ISSUES & BEST PRACTICES REGARDING EARNINGS CAPS IN SALES COMPENSATION PLANS

Earnings caps in sales compensation plans are often contentious, as they can lead to dissatisfaction. Caps are typically used to prevent overpayment, manage risk, or control uneven performance distribution. They're suitable for new products with limited sales data, avoiding overpaying on multi-contributor deals, discouraging excessive sales beyond beneficial levels, and preventing risky sales behaviors. To maintain motivation, alternatives to full caps can be used, as caps may reduce sales effort once income limits are reached.

Capping total earnings once an incentive ceiling is reached sends a message to the salesperson that it is time to stop selling.

1

Earnings Caps: Risk Control Without Demotivation

Implementing earnings caps into a sales compensation plan can be a highly contentious and often focal point for discontent with the plan. No feature of an incentive plan causes more resentment than a cap. In most cases, the application of caps is a result of perceived overpayments in the previous year or as a risk avoidance measure when there is the potential for large deals or significant over achievement on targets. Experience says that in fact, very few performance levels where caps are reached occur with any frequency and when they are reached, they have limited payout significance. In those cases where the caps do come into play, they often elicit strong negative reaction and are viewed as an effort on management's part to avoid paying out earned incentives. Furthermore, most cap situations are more a reflection of poor target setting than of poor plan design. There are however valid reasons for implementing caps in plans and several ways to achieve the desired results.

When is appropriate to implement caps in a sales compensation plan? The situations that call for caps are:

- When new products or services are being introduced and there is insufficient sales history to set accurate and consistent targets.
- To avoid overpayment for large deals and/or where several individuals or departments participated in the sale and the salesperson was only one contributor and the payout was not indicative of the effort for delivery of the sales result.
- As mentioned above, to limit the effects of wide performance distribution due to poor targets.
- To discourage sales where above a certain level, the incremental volume is not in the best interests of the company.
- To reduce the potential for salespeople to take unacceptable risk or engage in inappropriate sales behaviour.

There are probably several other reasons, but where deemed appropriate, how do we limit runaway earnings using caps without diminishing the enthusiasm and motivation for the salesperson to continue to aggressively sell to the end of the performance period?

1

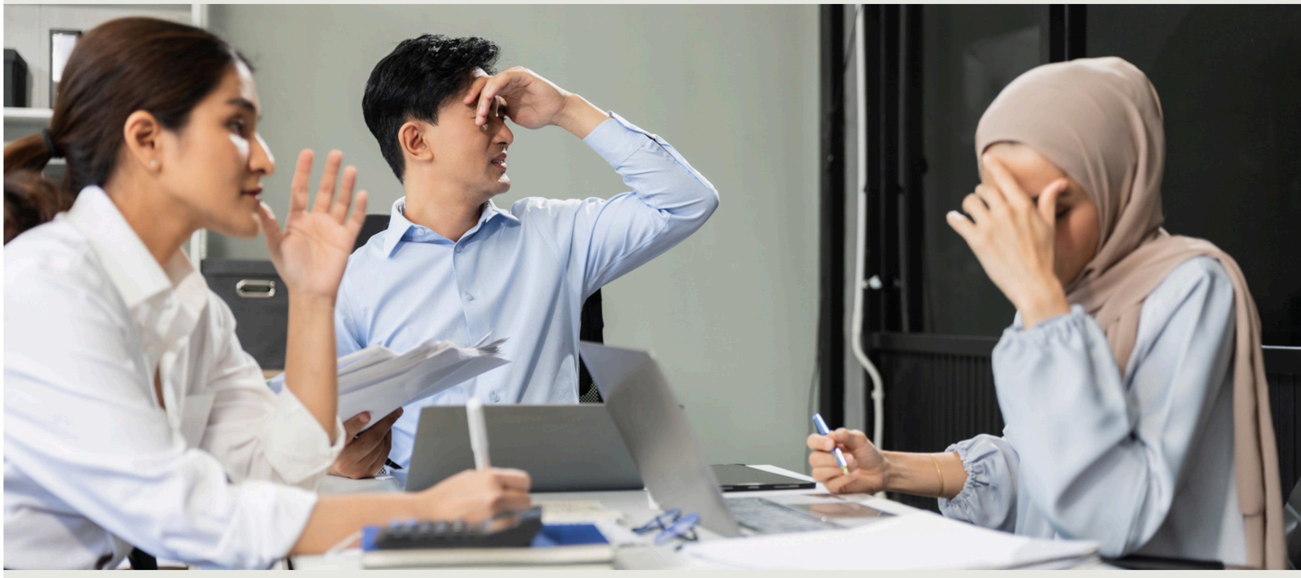
Earnings Caps: Risk Control Without Demotivation

Above all else, the sales compensation plan is a communications tool. Capping total earnings once an incentive ceiling is reached sends a message to the salesperson that it is time to stop selling. While some salespeople will continue to sell even if their income is capped, most will reduce their sales effort if there is no financial benefit for delivery of further sales. Methods other than applying a full cap on income include:

1. Cap on Deals/Transactions

This situation considers the contribution and influence of the salesperson in securing the contract. If the salesperson is the only company contact and they personally close the sale, it is hard to cap using this approach. However, the more people that are involved in the sale, or there is less personal influence by the salesperson in closing the sale, the more likely that this method would work. It limits the potential of overpayment in situations where the salesperson contributes but doesn't individually deliver the contract. It should also align somewhat to the sales cycle to ensure that the salesperson is rewarded for the sale commensurate with the time and effort required to deliver it.

This also works for large deals, where as above, it is unlikely that the salesperson is solely responsible for the sales result. Large deals also are often more complex to implement and unless commissions are capped, the gross margin on the large deal could be eroded.



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2. Cap by Product

When there are more than one set of products that the salesperson can sell, the tendency is to drive sales of the product that is easier or quicker to sell. This lets them move on the next sale, but the products sold may have less gross margin in it. In these situations, companies cap at a reasonable level above target to allow for some overachievement but not runaway earning on a single product. This also is important if the capacity of the company is limited and incremental sales beyond the cap are either unprofitable or the cost/capability to deliver with high customer satisfaction is difficult.

3. Capping by Client/Customer

In situations where there is recurring revenues/business or renewable contracts that must be serviced to be retained, a way to manage payouts and align payouts to sales effort is to place a cap on the account. By this means, the salesperson is rewarded for add-ons and renewal effort but is capped at the point where the selling effort is aligned to rewards for the time spent selling to a customer.

4. Measure Caps

Where the salesperson has more than one measure (optimum is up to 4 for plans with significant incentive opportunity), the weighting of each measure typically indicates the value of that measure to the company and the importance of the product/service being sold. If the desire is to achieve balanced selling, you may want to set a cap on how much overachievement can take place on any one measure. This allows the salesperson one they have achieved the cap level on one measure to focus on other measures to continue to optimize their earnings while the company gets balanced selling across other measures than the just the one that becomes capped.

5. Gate Soft Caps to Achieve Balanced Selling

If there are products with varying degrees of difficulty to sell or differences in gross margin that need to be aligned with rewards, it is best practice to set a "soft" cap on easier to sell or lower margin products until other more difficult or more profitable have reached as certain level of sales and then the cap comes off. If product "A" (easy to sell or lower margin) is capped at 115% until Product "B" (harder to sell or more profitable) reaches 100% of target then the salesperson has to ensure that product "B" reaches target in order to continue to sell product "A" and be rewarded.

6. Plan Clause to Address Windfalls

Where there is the opportunity for the salesperson to achieve a windfall (usually defined as any large and/or unusual sale or a sale that did not require effort commensurate with the reward), best practice is to include a clause in the plan terns and conditions that limit or cap payout on a given deal. The difficulty is to accurately define what is a windfall. Some companies reserve the right to review all individual sales that represent more than 10-15% of a salesperson's quota to determine if it is a windfall sale. The key criteria here are effort expended, degree of risk, fairness, precedent and unique or unlikely to be repeated circumstances.

7. Deceleration Caps

Where the potential for wide variation in deal size exists, but you want to salesperson to drive hard to deliver all sizes of sales providing the gross margins are good, then you need to address progressive caps to limit risk. In this situation you set limits beyond which the credit toward commissions/bonuses is reduce for incremental revenue/margin.

For example, if one deal has $5,000,000 of revenue (with $2,500,000 in gross margin) the commission on this deal could be very high and may overpay relative to the effort and the size of the deal. In this case, the first $1MM of revenue or gross margin might be credited 100% toward commission, the next $1MM is credited at 75% and anything after that is only credited at 50%. This slows down the commissions payout to something that aligns to the sales effort and the value of the deal to the company. The key in this method is that it must be established up front.

2

Benchmarking

Acquiring credible benchmarking for sales compensation practices is difficult because organizations differ in their approach to policies and practices regarding incentives as well as having business objectives and cultures that are unique to their business. To demonstrate an example, a study that was done some time ago by WorldatWork (a global Compensation, Benefits & Work Life organization) and Radford (a large survey organization) conducted a large incentive plan practice reported the benchmarks that are shown on the figure below. The performance achievement levels are in the left column with the incentive payout levels (relative to 100% of incentive target) for each of Executive Management, Line Management and Individual Contributors under the Average % column. The company counts are the number of organizations (most are global organizations) that responded for each level. While this data is a couple of years old, it is the only reputable information available.

Table 4: Sample Radford Sales Incentive Plan Practices Output for Accelerator Levels

All Companies	Sales Executives (VP and above)		Field Sales Mgmt. (Directors/Managers)		Field Sales Individual Contributors	
	Average %	Company Count	Average %	Company Count	Average %	Company Count
% of Target Paid at 50% of quota	46.6%	83	45.1%	96	45.1%	102
% of Target Paid at 75% of quota	70.0%	93	70/0%	106	69.4%	112
% of Target Paid at 100% of quota	100.0%	99	100.0%	111	100.0%	116
% of Target Paid at 110% of quota	124.2%	96	122.0%	108	119.4%	113
% of Target Paid at 120% of quota	144.5%	94	143.3%	108	137.8%	112
% of Target Paid at 125% of quota	154.4%	90	154.3%	105	145.5%	109
% of Target Paid at 150% of quota	204.7%	88	203.7%	104	194.2%	107
% of Target Paid at 200% of quota	299.8%	83	295.0%	97	279.5%	102

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3

Conclusion

In Summary

If there is an absolute need for a hard cap on earnings, make sure that set it high enough that few, if any sellers are likely to hit it and that you can still address unique sales (e.g.: high gross margin, high value client) with exciting payouts. A "rule-of-thumb" for setting a cap is that any cap that is at or less than 2.0 to 2.5 times target will create a very negative perception with your salespeople and reduce the motivational value of their plan. In my experience over many years of conducting focus groups with salespeople, the number one comment on their wish list is "Remove the Cap!!" even though few if any ever hit it. ■

David Johnston, with over 35 years of experience in sales compensation and strategy, brings a wealth of knowledge and expertise to the field of intangible asset sales. As a seasoned professional, Dave has helped numerous organizations navigate the complexities of selling intangibles, driving revenue growth and market success. For more information or to review the status of your current program, reach out to Dave at djohnston@salesresourcegroup.ca or by phone at (416) 805-0208.

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