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DATA-DRIVEN COMMISSIONS:

The Easiest Way to Grow your Company's Sales by 20%+

SPIFF

In the 2018 college football season, team rankings outraged UCF fans. Michigan, with two losses, ranked one spot higher than undefeated UCF in the polls. But long-time football fans are used to this craziness. Nearly every season, you see a few teams with perfect records rank lower than teams with imperfect records.

What is going on here?

The key is that teams have different strengths of schedule. **Strength of schedule** refers to how hard a team's schedule is. If Team A plays against difficult teams and Team B plays against easy teams, Team A will have a higher strength of schedule. And judges will take this strength of schedule into account when they rank the teams.

In 2018, judges felt Michigan had a harder schedule than UCF. They felt Michigan's poorer record still merited a higher ranking.

I like this example as an analogy of being careful in your judgments. It applies to humans as in "be kind; everyone you meet is fighting a hard battle." You could rephrase that to

"Don't judge; every person you meet has a different strength of schedule."

It also applies to commission plans. It's easy to make incorrect judgments about which commission plans will be most effective. There are plenty of misconceptions out there. From the late 1970s to the early 2000s researchers haven't been clear about several important commission questions.

Over the years, we've all heard a bunch of common beliefs, or "myths"about incentive compensation plans. In the spirit of the Mythbusters TV show I'd like to determine the validity of six of these myths. I'll assign each myth to one of three categories: confirmed, plausible, or busted.

Here are the myths we'll examine:

1. Commissions don't much matter. Marketing and other forms of demand generation spending are more important than commissions in driving results.

2. Straight-line commissions are just as effective as the most fancy, complex plans out there.

3. Quotas aren't always effective.

4. Accelerators aren't worth the added complexity.

5. More frequent bonuses are better than less frequent bonuses.

Recent research from the Harvard Business School gives us much clearer answers to these questions. This research has helped clear up some of the apparent contradictions from earlier research.

Let's dive in.

Myth #1

Commissions Don't Much Matter

Some people feel like commissions don't much matter. They are a necessary evil. But companies shouldn't stress out about them because changing them won't have much effect anyway.

What does the data tell us?

There are about 20 million sales reps in the US. The market for sales compensation is greater than $800B, larger than the market for advertising. Most companies that have incentive compensation use it for more than just the sales team. Based on the data from our customer base, we find the following groups frequently have some form of incentive compensation:

- Sales (setters and closers)
- Account management (farmers)
- Customer support
- Sales managers
- Account management managers
- Customer support managers
- Occasionally marketing and other departments too
- Directors, VPs, and C-level executives

Spiff's data shows 35-40% of the employees at our client companies have some form of performance-based comp. If thats true of all companies, then 35-40 million in the US get incentive comp. And that means the market spend on incentive comp is over $1T (yes, trillion).

OK, so commissions affect a lot of people.

But that doesn't prove that changing commissions actually drives top-line revenue.

Researchers have studied the elasticity of sales and marketing expenditures. Mathematically, elasticity is the proportional change in one variable based on the change in another.

So the math is this:

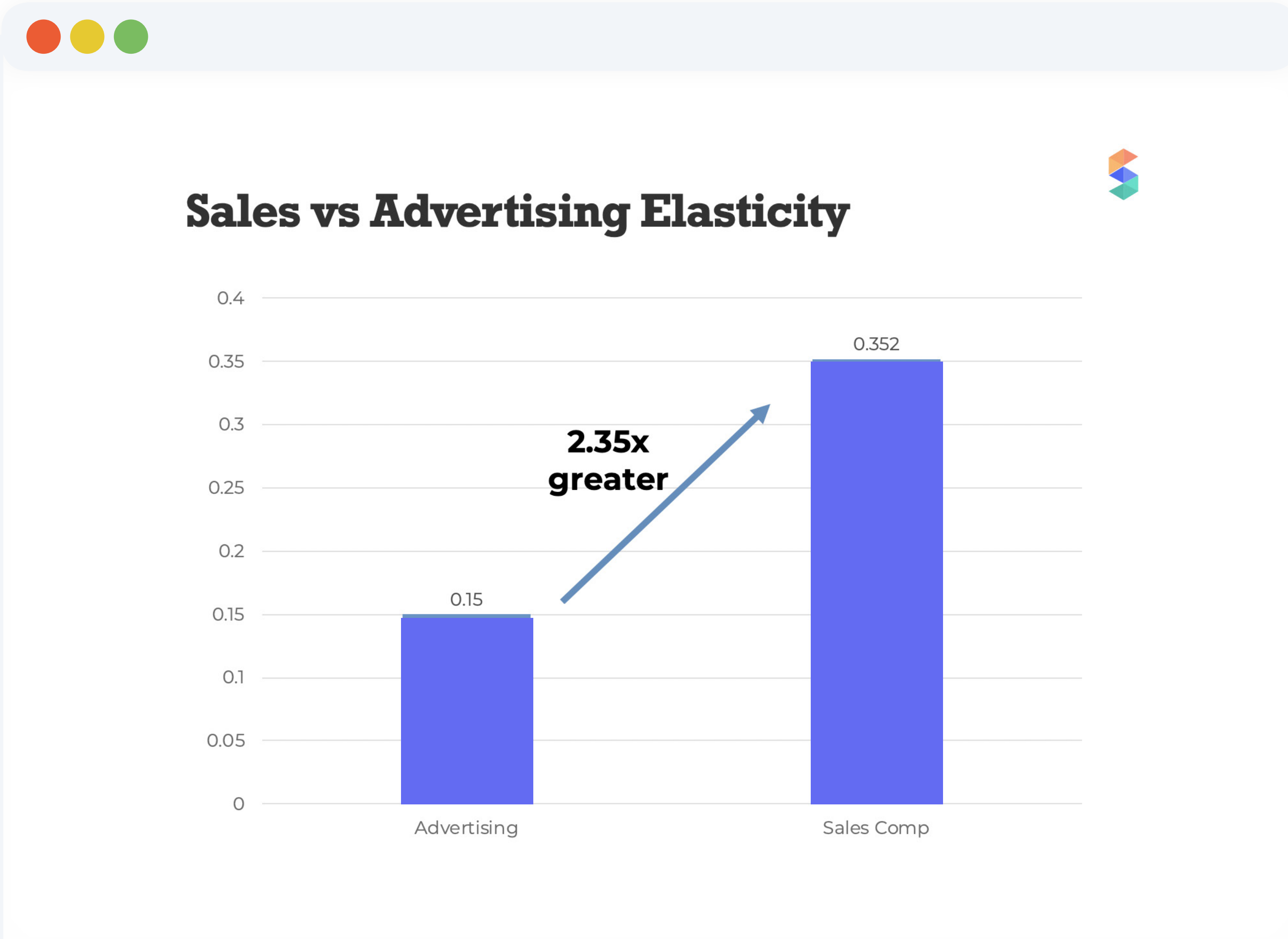
$$\text{Elasticity} = \frac{\%\ \text{Change in Variable A}}{\%\ \text{Change in Variable B}}$$

Most often economists measure price elasticity. Price elasticity is what happens to sales volume if you drop the price of a product.

But you can also measure increase in sales output based on an increase in sales commissions. At Spiff, we like to call this sales elasticity.

It turns out researchers have estimated personal sales elasticities for thousands of reps. The researchers assembled a dataset from 46 studies of personal selling's effects on sales outputs carried out during the past four decades. They found the average elasticity of sales commissions is 0.35. That means for 1% increase in sales comp, you can expect your reps to be 0.35% more productive on average.

That may not sound like much to you but it turns out that this is elasticity is more than twice as big as it with advertising (see the chart below).



So sales can definitely have a big impact on business performance.

Where does that leave our myth that sales commissions don't matter?

Well…commissions are a big part of most companies' budgets. They are a huge part of the overall economy. And they clearly have an important impact on business performance. Based on all of the data above, we are going to label this myth **busted**. Commissions are definitely important.

Myth #2

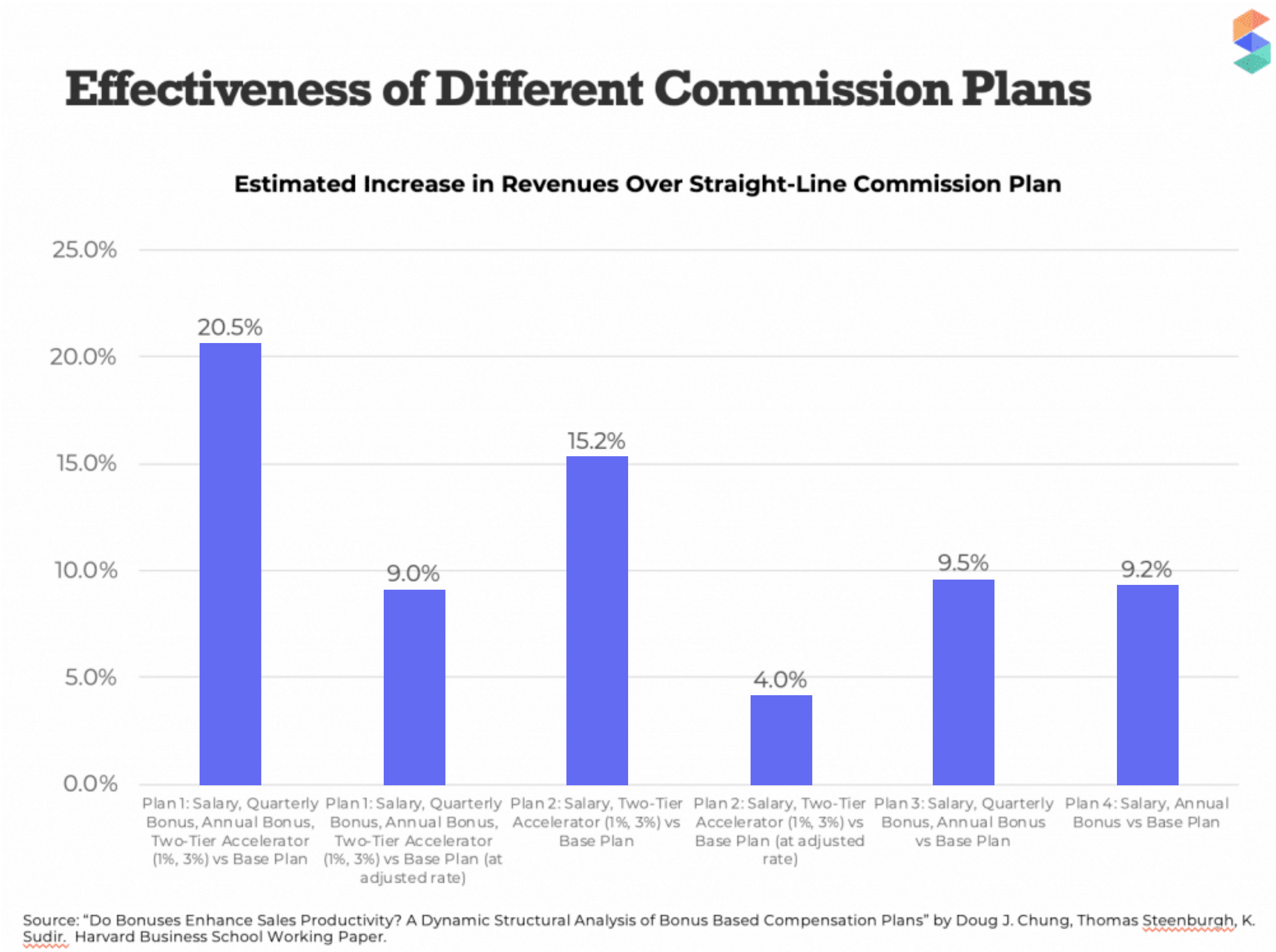
Straight-Line Commissions Are Just as Effective as Complex Plans

Twenty to thirty years ago some research indicated straight-line commission plans were all you needed. You could just pick a percentage and multiply it by closed revenue. But most companies didn't adopt this. Apparently, they felt more complicated plans worked better.

The benefit of straight commissions is obvious. It keeps reps from gaming the timing of closes. It provides a linear response to effort. And, it's dead simple. As we discussed in our post about the efficient commission frontier, simplicity is good in commissions.

The only reason you might want more complicated commissions is if it drives stronger results.

It turns out that's exactly what the latest research shows.



The chart above shows the relative difference between a Base Plan (with salary and straight-line commissions) against more complex plans. It shows the predicted difference in revenue that the target company would achieve using the different plans.

Here's the Base Plan:

Table 1: Firm's Compensation Plan

Type	Description	Payment period
Quarterly Bonus	$1500 Awarded if quarterly revenue exceeds quarterly quota	Mar, Jun, Sep
Annual Bonus	$4000 Awarded if annual revenue exceeds annual quota	Dec
Base Commission	About 1.5%* paid in proportion to the revenue generated each month	Every month
Overachievement Commission	About 3%* paid in proportion to the total cumulative revenue surpassing the annual quota	Dec

**These numbers are approximate for confidentiality reasons.*

NOTE: The authors also compared the more complex plans against a variant of the Base Plan where they adjusted the rate of the Base Plan upward so that reps received the same total amount of comp as they would on the more complex plan.

What this shows is that the more complex plans outperformed the simple, straight-line plans by a wide margin.

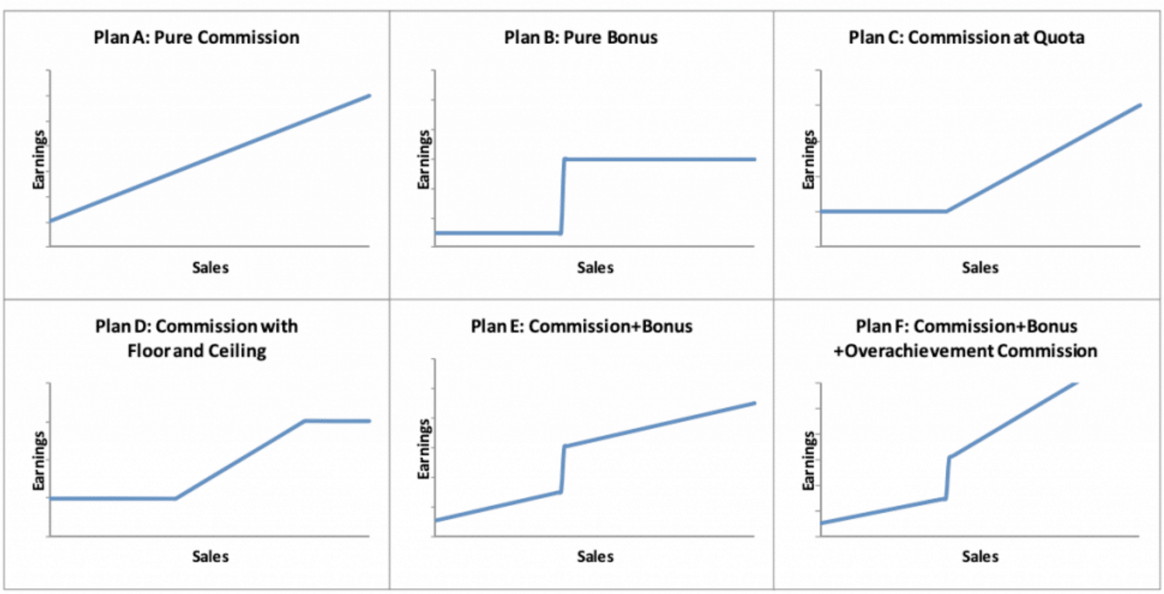
The researchers predicted the optimal plan would generate **20.5%** more revenue than the straight-line plan.

There are many reasons why this might not hold true for your company. However, this indicates that more complex plans can be and often are much more effective than straight-line plans.

So this myth is **busted**.

Modern software like Spiff also allows you to add commission complexity at lower cost. And it makes it easier for your reps to understand the returns for their additional effort by exposing what we call commission curves like these:

Figure 1: Plots of Incentive Compensation Schemes



So this myth is even more busted. With Spiff you have no excuse not to find and implement a more complex commission plan that can drive big top-line results.

Myth #3

Quota Bonuses Aren't Always Effective

Business scholars believe quotas were "invented" to help manage the agency problem. The agency problem is the conflict that arises because employees have different incentives than the firms they work for. If the firm doesn't take precautions, employees might "work the system." They might work just hard enough to collect a salary but not work as hard as they could.

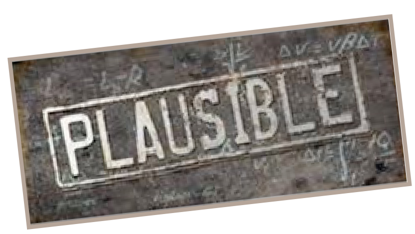
So companies invented quotas to give traveling sales reps a strong incentive to work hard even when they were far away from a manager.

So what does the research tell us about quotas? Do they work?

Some research indicates that quotas just lead to sales reps playing timing games with their deals. At least one researcher finds that quotas may actually decrease performance. Some research indicates that may boost performance less than other schemes but they are much easier to implement. But most research indicates that they work great.

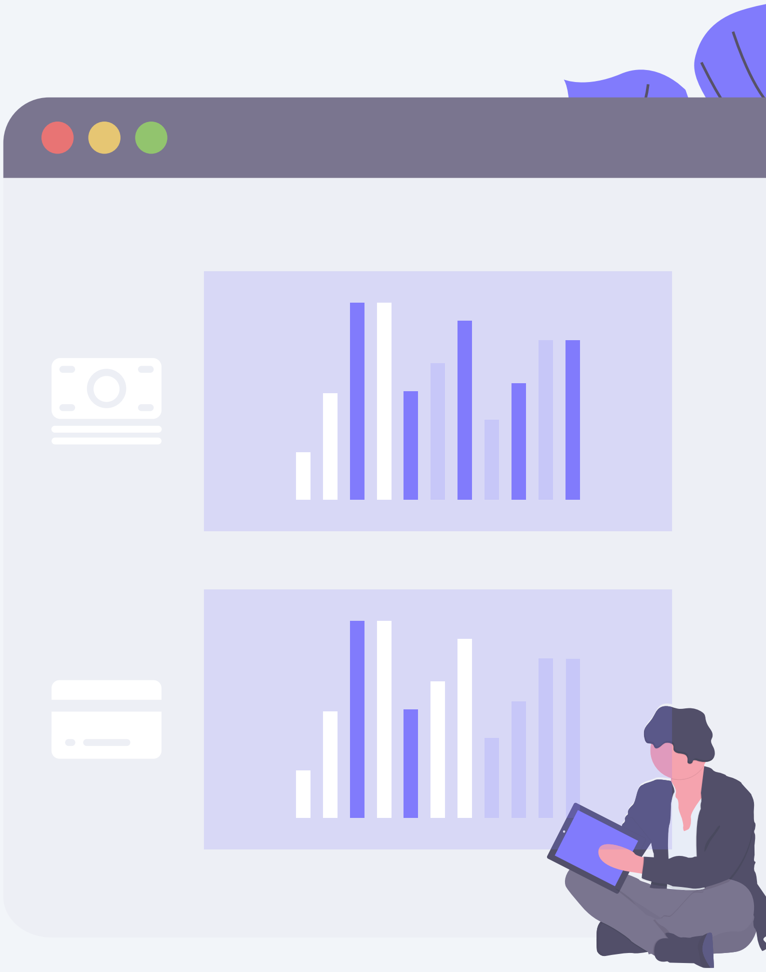
After reviewing a lot of the research here at Spiff, we believe quotas are generally effective but require careful design. The consensus from academic research shows quotas tend to help lower-performing reps more than higher-performing reps. Frequency and quantity of quotas can affect their effectiveness.

In general it seems like quotas work well. But some research indicates otherwise. So for now, we'll call this myth plausible.



Myth #4

Accelerators Aren't Worth the Added Complexity



Here at Spiff we are surprised at how few companies use accelerators.

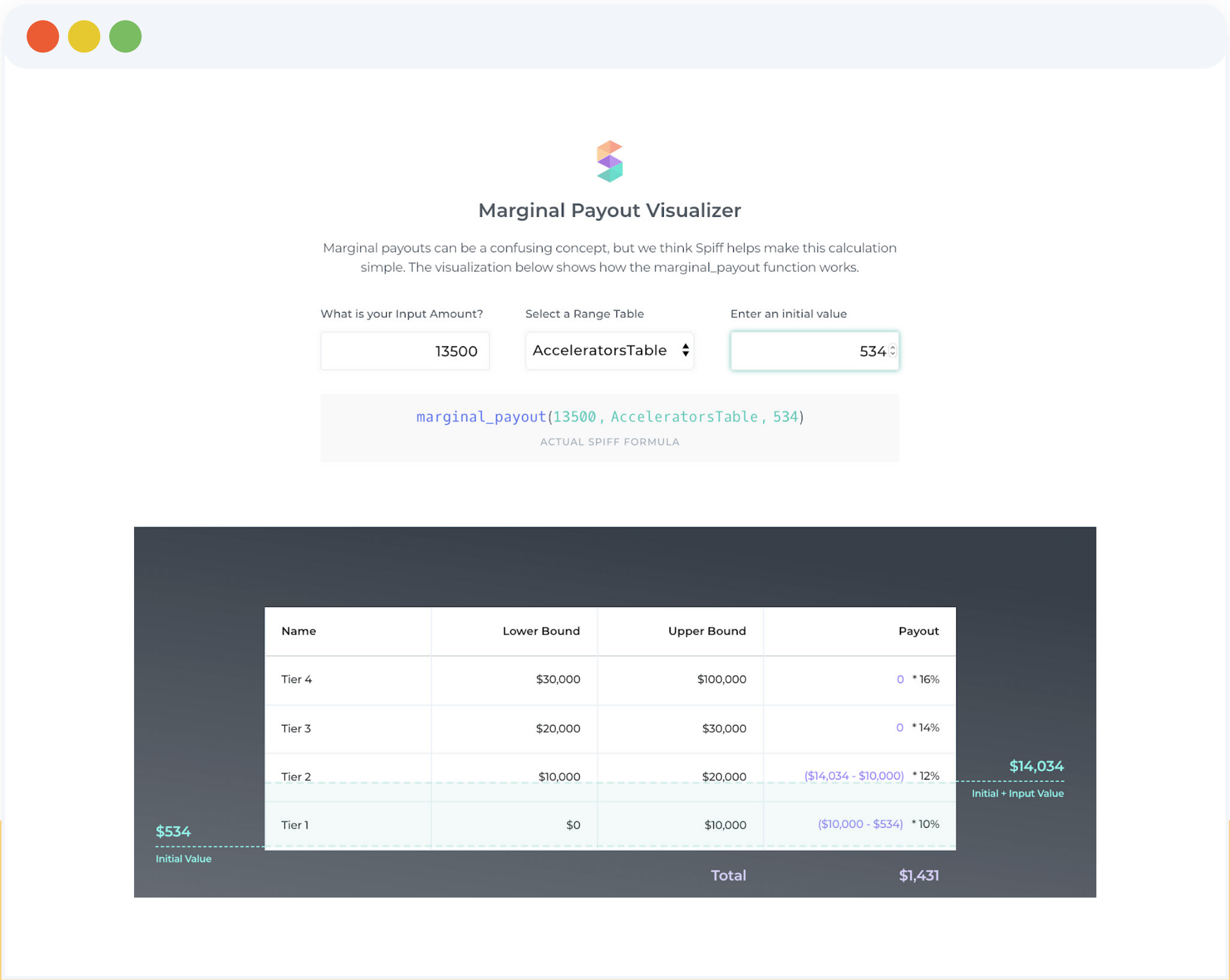
Based on this research, accelerators increase sales rep performance by 9.5%. Further the research finds that accelerators are especially important for keeping your top performers engaged after they hit lower targets.

At Spiff, we've found accelerators are one of the easiest ways to immediately increase revenues at your company. But many companies still don't use them.

We understand that accelerators can add complexity. Unfortunately, the most common accelerator involves some complex math. It requires understanding "tax-bracket-style", marginal percentages. Understanding how these work can take a bit of mental effort.

But modern software like Spiff can make these easy to implement and understand. We've built a tool that highlights how marginal accelerators work. Our tool takes most of the complexity out of managing these incentives for you.

Click here to play around with our marginal accelerator visualizer.



There is good evidence that accelerators work. And there are tools to make understanding and managing them easy. So we consider this myth busted.

Myth #5

More Frequent Bonuses Are More Effective Than Less Frequent Bonuses

It seems reasonable that more frequent bonuses would impact performance more than less frequent bonuses.

We found one study that indicates that extremely frequent bonuses might actually decrease performance. But most studies show the opposite.

After a careful review of the research, we would call this myth confirmed. More frequent bonuses tend to help lower-performing reps more than higher-performing reps. But even daily bonuses can drive incremental performance.

So we'll call this myth **confirmed**.

Interested in Spiff?

Schedule a demo with a commission specialist today.

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