TARGET PRACTICE

How to Realign Your Comp Plan Design and Performance Expectations

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Targets. In the world of variable compensation, no matter which way you look there are targets. Retention targets, sales targets (aka quotas), service-level targets, turnover targets, average base salary and range targets, variable compensation targets, new logo targets … and a partridge in a pear tree. There are so many variations in the world of compensation that there's no point in saying the word "target" without adding prefix words to define the type of target to which you're referring.

The reason so many targets exist in compensation is because they matter. Jobs require responsibilities. Responsibilities require performance expectations. Performance expectations, particularly when quantifiable, become performance targets in many flavors. Incentive compensation plans typically are built to use these targets to pay more or less. That gets us to another type of target: compensation targets. Employees expect to know what they will get paid for doing a job. At its most basic level that means employees know their hourly wage or annual salary. For most positions, though, there is some variable component to the plans, which either explicitly or implicitly includes a variable compensation target.

Base compensation targets, which usually include some wiggle room in the form of a range, are only as effective as a company is disciplined to make sure the base wages for different employees in that role all fall around the base wage target as designed. In other words, if benchmarking has been done with a decision that a certain role should have a target base salary of $55,000, but with an acceptable range of $48,000 to $62,000, then you should enforce that range accordingly by ensuring you hire employees with the average qualified employee being close to that target of $55,000.

The same should be true on the variable compensation side, but very often it's not. Like base compensation targets, variable comp targets should be benchmarked as part of a job role's total compensation. In turn, variable comp plans need to be designed so that the plan rewards the employee the benchmarked, strategically selected variable comp target for "on-target" performance.

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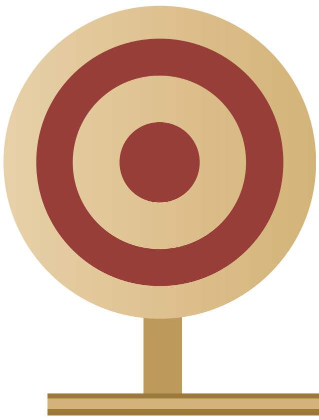

Problems arise when compensation plan design issues lead to differences between nominal compensation targets and effective compensation targets.

Why Comp Plans and Comp Targets Are Misaligned

Compensation plans and targets frequently misalign because a plan is commission rate-based (rather than bonus-based), and something in the commission rate formula changed without looking at the complete picture. For example, consider we have determined our variable compensation target to be $10,000 annually and we want each sales rep to sell 1,000 widgets. Without complicating matters with any acceleration tiers, this plan should pay $10 per widget.

What happens, then, if the next year the performance expectation (quota) is increased to 1,100 widgets but the commission rates in the compensation plan remain as-is? Suddenly the "effective" variable compensation target for this role has become $11,000, even though nominally the compensation target as listed is $10,000. That's because with this new performance expectation, on-target performance will now deliver a payout of $11,000 because the commission rate stayed the same. Therefore, when the performance expectation was increased, a decision should have been made: Is the previous compensation target still applicable, or do we think the compensation target should go up with the performance expectation increase? If the former, then the per-widget commission rate would need to go down. If the latter, then it's OK that the compensation target increased, and it makes sense to increase the nominal compensation target from $10,000 to $11,000.

Another reason compensation plans may not be aligned with compensation targets is if the plan not only uses a rate-based payout calculation, but also has variances in territory size — and, therefore, performance expectations. For instance, for a business with subscription-based sales, there could be an account management role responsible for renewing those subscriptions. Let's assume the books of business that the account managers are responsible for renewing are measured in widgets, with an average book of business size and performance expectation for the average account manager to renew subscriptions worth 1,000 widgets per year. If that role had an annual compensation target of $5,000 and the plan paid on a per-widget-renewed basis, that would mean paying $5 per widget renewed.

Suppose, though, that while the average book of business size is 1,000 widgets, there are some account managers (AMs) with books of business of only 500 widgets, and others with 3,000 widgets. If everyone were on the same plan with the same per-widget renewed rate, just for renewing their assigned book of business AMs with the 500-widget book of business would get $2,500 for renewing every widget that year. And AMs with the 3,000-widget book of business size would get $15,000. In that scenario, different AMs with the same job but different size books of business would have completely different effective compensation targets for delivering on-target performance. This would be the consequence of a flat per-widget renewed compensation structure and the wide variance of territory sizes.

Problems Caused by Comp Plan Design Issues

Several problems arise when compensation plan design issues lead to differences between nominal compensation targets (the ones on paper that were benchmarked and selected) and effective compensation targets (the one amount actually paid to each rep for delivering on-target performance).

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- Comp plan design issues make nominal compensation targets effectively worthless. Any time spent benchmarking and deciding what the right pay mix and variable compensation targets becomes wasted when compensation plans pay completely different effective compensation targets than nominal ones. Moreover, this means some employees may be dramatically overpaid or underpaid relative to the benchmarked compensation target.
- Employee expectations are set based on the effective compensation target because that's the one they become accustomed to actually earning for on-target performance. If it's way off from the nominal compensation target, getting back to that nominal compensation target is difficult to do quickly without creating other issues.
- Employees talk, and if employees with smaller effective compensation targets learn about other employees having larger effective compensation targets without there being actual performance differences, employee morale and retention problems can be created. If an employee perceives that another employee has a significant advantage because of factors outside of his or her control, employee relations problems can occur.
- Other factors in the compensation plan design, like deceleration/acceleration, upside and downside, can be thrown off or made irrelevant if the upstream effective compensation targets are not aligned in the first place.

How to Prevent Plan Design Problems

We can avoid these problems by carefully thinking through performance expectations, compensation targets, territory management and plan design in a holistic way. All these variables affect one another. If a plan is very simple and rate-based, it's critical to examine the territory management to see the different sizes employees may have. Can we design territories to be equal in size? If not, are we OK with employees in larger territories having significant compensation advantages in a flat rate-based model?

We can avoid this issue in the first place with a plan structure having different rates based on tiers of territory size, or a plan structure with pay based on percentage of quota attained instead of the raw per-widget sold method. For example, you may have clear groupings of large, medium and small territories. If your benchmarked and fully vetted variable comp target for the role is $40,000, you may consider Table 1.

If the role is differentiated by territory/quota size, it allows you to be intentional about the comp target for each type of territory. The plan design would still need to account for those separate variable comp targets.

Remedies

How do we fix this if we know it's a problem at our company?

- **Figure out the root causes of the issue, starting with the plan design.** If you're using a flat per-widget model in some form while sales reps are in a large range of territory sizes, you must move toward a plan design that does not have this problem, or simply accept that your nominal compensation targets are not the effective compensation targets.
- **Re-examine your territory management process and evaluate it for any size groupings that need to be accounted for in your plan design.** Avoid having too many tiers or groups as it can be

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Table 1 | Comp Target Tiers

Size of Territories	Range of Quota or Book of Business Size	Variable Comp Target
Small	0-1,999 widgets	$35,000
Medium	2,000-4,999 widgets	$40,000
Large	5,000+ widgets	$45,000

administratively challenging to have too many compensation targets to manage. If territories or account assignments are relatively fluid, you want enough tiers for employees to feel like there is upside to them taking on more responsibility and potentially moving up a "tier" to a higher compensation target.

- **Re-analyze your compensation targets based on these territory- or book of business-size tiers or groups.** Based on benchmarking data, consider whether you think the larger territories should have a different compensation target, such as the large territory variable comp target of $45,000 (say, per the example) instead of $40,000. Consider whether your territory sizes are different simply because of geographic market differences, or because of employee capacity and experience. Geographic market differences are less in the employee's control, and therefore should lead to smaller differences in variable compensation targets. By contrast, if quota or book of business size is purely based on employee ability to handle the larger amount of responsibility, then a wider range in compensation targets is justified.
- **Identify the employees who would be most affected by the comp design and target changes you intend on implementing.** Examine the size of those planned changes. You will want to work with management to consider the effects on all employees that will have a potential drop in variable compensation targets, especially if the decrease is more than 20%. If an employee's effective variable compensation target in the old model was $100,000 and, in your new model, in a large territory, it is now $70,000, that's a significant decrease (30%) that may require individual planning.
- **Consider what to do, if anything, about the employees who would receive any drastic decreases in their variable compensation targets.** Several options exist, but they depend on how large of a potential morale or employee retention issue you anticipate based on your intended changes. Phasing the changes in the compensation targets for a group is possible by spreading the changes over a two-year period. You may want to build sufficient upside in the plan so that if those employees experiencing comp target decreases outperform their performance expectations, they see greater upside relative to the compensation target than before. Engage closely with HR and change management professionals inside or outside of your organization to help make these decisions and work closely with management to understand how great the risk is if transition approaches are not implemented.

Pull Off the Blinders

Don't let your organization be blind to compensation target misalignment! Compensation targets are only as real as they are built into your organization's compensation plans. If your incentive compensation plans are improperly built so they don't use your chosen targets, then there may be effective compensation targets that are larger or smaller than your organization intended, setting up for long-term difficulties.

Pull off the blinders sooner rather than later and face the problem. Examine the compensation plan to fix the issues causing the misalignment and use change management processes to get realigned to the real, intentional compensation targets that you want to use. WS

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