

*Strategic Considerations
of
Incentive Management*



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Strategic Considerations of Incentive Management

Have you ever felt duped by the empty promises attached to the latest Sales Incentive Management tool? Years of business experience involving my own sales activities, managing other people and actually building software applications that were intended to bring credibility to the process have convinced me that few software vendors really capture the essence of incentive management in their products.

I recently reached the conclusion, however, that it was unlikely that the deception that I have personally sensed was actual deception at all. Rather, it could be more accurately described as the perpetuation of common misunderstandings and misinformation. Who builds the system and how this is accomplished has less influence on its usefulness and value than the concept behind it. I have yet to meet a CEO, CFO, Controller or VP of Sales who didn't want to effectively compensate his or her employees. Very few of these same executives actually feel that they do. The reasons for this ubiquitous disconnect lie in how incentives are defined and managed.

It's my experience that almost every company would like to move to some form of a pay-for-performance compensation model. The benefits of this are fairly clear: Employees feel that their contributions are recognized and their efforts fairly compensated; the company gains more confidence that it receives an honest day's work for an honest day's pay and corporate strategies become more meaningful as costs become more effectively aligned with revenues and productivity. Yet, the companies that successfully move to true pay-for-performance models remain in the minority. Why do businesses continue to fail in their attempts to modernize this critical element of profitability in spite of all of the technological advances that have modernized virtually all other aspects of conducting business? The answer to this question is more complex than one might think.

Achieving False Results

As company executives and board members strategize to achieve maximum results, they often base their strategies on summarized or filtered information. Given the amount of information available nowadays, this might seem normal if not necessary; but understanding how information is filtered is critical for developing effective strategies. Here is a case in point: A successful, well established communications services provider developed a strategy that would pay less commission to sales reps who sold its products outside of their designated territories. Why would such a strategy exist? On the one hand, the company wanted to encourage the sales reps to sell within their assigned territories in order to ensure desired market penetration. On the other hand, the company recognized that referrals were a valuable part of its sales revenues and didn't want to

overlook sales simply because a referral targeted a customer that resided outside of a particular sales territory.

The strategy was to reduce the “out-of-territory sales” commission by a certain percent. This was justified by the realization that sales resulting from referrals required less effort. Since it is common knowledge that sales forces commonly follow the path of least resistance, the company knew that it was critical to its long-term success that its sales reps were adequately motivated to sell within the areas they were assigned and not simply pursue the low hanging fruit wherever they could find it. In order to manage this rather critical strategy, given the large volume of sales, the company assigned one full-time employee to review every sales order to determine if the sale had occurred within a rep’s assigned territory. The initial review of the process revealed that far more “out-of-territory” sales were being made than was desired. After the implementation of the new strategy, however, subsequent reviews revealed that “out-of-territory” sales continually declined while “in-territory” sales increased. That means the strategy worked, right?

Wrong. But before explaining why the strategy wasn’t working and the consequences of its failure, let’s first examine some of the hidden components of the strategy. What was the overall objective of the strategy? Was it to reduce the number of “out-of-territory” sales while increasing “in-territory sales”? Was it to increase long-term revenues? Was the objective to motivate the sales force to contact every potential customer in every territory? Or, was the actual objective to increase profits? Anyone familiar with financial statements knows that activity without profit means little to the success of a company. So, simply shifting sales from “out-of-territory” to “in-territory” couldn’t be the ultimate objective. There is also little value in contacting every potential customer if only a small portion of them purchase your product or service. If the objective was to increase long-term revenues, it might be possible that referrals produced more loyal customers and should have been pursued regardless of their locations. That would indicate that the underlying premise behind the strategy was flawed. Assuming that “out-of-territory” sales caused a sales staff to be less productive and therefore impact profitability, it might be reasonable to assume that the objective justified the strategy. The question remains, however, was profitability the quantifiable measurement being used to evaluate the strategy? When we investigate this case further, we learn that other mitigating circumstances and motives make that question moot.

Let’s begin with the company’s decision to devote a new full-time resource to monitor this specific activity of its sales force. Given the costs of adding an additional resource to review each sale, would the strategy actually increase profits, cost more money, or simply result in a wash? If the employee’s loaded costs were greater than the commission reduction she detected, one could question the strategy’s validity. For the sake of argument, however, let’s assume that the commission savings were greater than the cost associated with detecting the status of each sale. The next question to surface becomes the most salient of all. What motivation did the company provide to the employee to fulfill her responsibility?

The employee's responsibility was to report on the success of the strategy. Her job security may rest on its success. So, how confident can the proponents of the strategy be that the information they receive regarding the strategy's results is accurate? In this case, any confidence they might have felt was totally unjustified. During an analysis of the commission process by an external entity, it was discovered that approximately eighty percent of the sales staff's commission payments were inaccurate due to sales that were made outside of assigned territories. The analysis further revealed that due to the high volume of sales, and the employee's perception that in-territory sales were desired, she chose to give the sales reps the "benefit of the doubt" rather than review each sale.

What were the consequences of the strategy? First, commission payments were higher than what the strategy dictated. Second, additional costs were incurred by deploying it. Third, the sales force saw through the company's inability to enforce the strategy and did not change its behavior. As disconcerting as these consequences were, however, they paled in comparison to the ripple effect caused by other strategies being based on the misinformation created by the erroneous data generated by the original strategy. At least on this aspect of the business, reality was fantasy; and the realm of fantasy fed upon itself.

When Is a Product Not a Product?

Before discussing the solution to the problem described in the first case study, examining a second scenario might prove helpful. In this case, the owner of a thriving novelties supplier, whose customers included over ten thousand convenience stores located throughout the US, generated so much business volume that he realized he needed an automated commissioning system. The initial analysis of this business's commission process revealed that forty sales reps received eleven percent of revenue for commissioned sales. On the surface, this appeared to be a very straightforward commission model.

A deeper analysis revealed, however, that this business sold approximately 90,000 different products. Since that number was too large for the company's manual commissions' calculation process to manage, the products were categorized into loosely-related groups, typically based upon their uses. During the analysis, the owner of the company was asked if all of the products being sold carried the same profit margins. The simple answer was no. The more involved answer revealed that some products were used as loss-leader products, while others might be sold in conjunction with other products, which carried a different profit margin than if they were sold separately. Since most of the products were manufactured overseas, profit margin could also vary for the same product, depending upon the costs to manufacture it over the course of several years.

The business owner was then asked to explain how he decided to use a flat commission rate for all of the company's sales. He explained that he concluded that it was an

acceptable portion of the overall cost of sales. Eleven percent of revenues seemed to be fair compensation and he was still very profitable.

This quickly emerged as a case of allowing what you don't know that you don't know to prevent you from leveraging what you didn't know. Yes--that is what I meant to say; and the explanation is just about as convoluted as the statement itself. By using specific examples, however, the scenario becomes clear. In order to introduce potential customers to the high-end products, the company sold similar, low-end products either at cost or below. This is a common practice in the retail industry. Unfortunately, given that the loss-leader products fell into the same product categories as their more profitable counterparts, it was difficult, or nearly impossible, to differentiate between them. Since the company didn't collect the product data for all 90,000 products, but only used summarized data collected through its invoices, the business decided that it was an acceptable loss to pay commissions on sales that did not produce profits; the thought being that the low margin items would eventually lead to sales of the high-margin products.

A complete analysis of the commission process revealed what was really happening. First, virtually all sales were generated by a small number of people. The company, however, hired people as account managers to interact with the retail outlets and maintain customer relations. Although the account managers provided an important service, the company eventually realized that they had very little to do with the actual sale of products. It was ultimately determined that only three of the forty commissioned employees actually influenced the sales process. Second, the analysis revealed that a higher than expected number of sales being made were tied to loss-leader products; and there was no direct correlation between their sales and increasing sales of higher-margin products. Rather, other buying influences had greater impact on present high-margin sales. Third, commission on revenues had little to do with an account manager's motivation to grow the business. Rather, activity-based incentives, which motivated the account manager to visit each store and build customer relations, proved to be more effective.

The analysis revealed that effective incentives required products to be identified by the value they brought to the company. In order to accomplish that, the company needed to define products using more than just a general description. Product definitions might include packaged elements within a product, territorial considerations, dependent or mutually exclusive relationships between products (e.g. selling a certain number of one product type before receiving commission on another product), promotional considerations and several other factors that would determine the value of a sale. A considerable amount of potential profit was overlooked just because of the limitations caused by the commissioning system the company used.

The second adjustment that the company made was to tie employee behavior to corporate objectives by modifying their performance measurements. Rather than pay commissions based on revenues, the company adopted a true pay-for-performance model. Account managers were compensated by the number of store contacts made within a specific time

period. They also received bonuses based upon a variety of activities that were related to customer retention, store manager evaluations, product turnover, etc. This exercise taught the business owner that commissions weren't simply an element of the cost of sales and his employees' overall compensation; they were a key element in his overall business strategy.

These two examples are indicative of the disconnect that exists between corporate strategies and how they manifest themselves through employee behavior. In both cases, the companies made decisions based upon filtered information. That information led to strategies that were ultimately counter to company interests. This same condition is what lies behind the frustration companies experience when they decide to automate the compensation management process.

Why Automate Flawed Processes?

Many software vendors and internal IT departments fall prey to the same pitfalls described in the previous case studies. Vendors build applications that are designed around the same filtered information the executives use in their flawed strategies. Internal IT departments build systems around requirements that are usually based on existing, flawed practices.

In the past eleven years, I have provided consulting services and built multiple commissioning systems for companies looking to improve their Incentive Compensation Management (ICM) processes. In every instance where company executives were disappointed with the results of trying to automate its commission process, frustration resulted from the technical limitations created by the automated system. Packaged software vendors typically take the approach that their solutions “can do anything”—as long as the customer is willing to adapt its commission management processes to the Vendor's perception of how to do business. IT departments usually are not commission experts; so what they often create is an interpretation of what they perceive the business wants. In both cases, complete solutions are seldom developed and often much more expensive than originally expected.

The only way to avoid automating present process flaws is to use a system that allows a company to first mirror its present practices, flaws and all; and then provides the capability to modify processes without a great deal of additional effort as more effective models surface. Otherwise, it leaves open the possibility of comparing apples and oranges when reconciling between the old and new processes.

CRM and ERP Solutions—The Inevitable Black Hole!

Over the past decade, there has been a shift from integrating multiple, disparate applications into one end-to-end solution to vendors that tout the ability to solve every business problem with one product. At first glance, this seems to be the lesser of two evils. In the past, systems integrators made billions of dollars by getting systems to speak to each other. These people, commonly labeled consultants, often took up residence at a client's location with the mandate to drink the cash cow dry. There were usually enough issues existing among the various applications, that the consultant's work was never done.

As companies became less tolerant of this model, however, other vendors emerged proclaiming that their systems could do it all. At first, the vendors became very adept at professing how their systems worked in the ideal world. When the ideal world was exposed as fantasy, however, vendors became skilled at creating an image of being able to offer technical solutions to company problems by using mocked up applications and telling companies what they wanted to hear. These solutions became commonly known as vaporware. Once the deal was done, the customer wouldn't see a working solution for well over a year while the vendor raced to build it. I was on a few of those "death marches" myself.

Following the era of vaporware, came the big players that actually did build Enterprise Resource Planning (ERP) and Customer Relationship Management (CRM) products. Such solutions were touted as capable of automating every business process. Some were much better than others at fulfilling that expectation. From the many products that once existed, there are now just a few being sold. Why are they not more prolific? It is because they are very expensive to purchase and install. Additionally, maintenance costs often exceed license fees many times over. Most are designed with such general functionality that they require significant modifications in order to accommodate individual business needs. Once these systems are installed, a company becomes so dependent on them that they become hostage to a monster no one completely understands—hence the inevitable black hole.

Lost amidst these issues, however, is the fact that such solutions are never built with incentive compensation as their emphasis. I know of no ERP or CRM solution that bases its value proposition on effective Incentive Compensation Management. Those that do provide ICM modules as part of their end-to-end solution include them as an afterthought. They are very generic and typically require additional customization. A common practice found in businesses that have installed these systems is to extract financial data from them and download it to spreadsheets in order to manage their commissions. The black hole expands every time a modification is made within the larger system; because the other peripheral systems (spreadsheets) need to be modified to accommodate the impact such changes have on them. Find a company with an ERP or CRM solution, and you will likely also find a team of consultants permanently on site supporting it.

No-man's Land Solutions

The other emerging competitors in the ICM market are those vendors who see the potential in the industry but aren't willing to pay the price to effectively realize it. They confuse sales force tracking with compensation management. Some start out as Sales Force Automation (SFA) applications, designed to track a sales person's activities; but then attempt to morph into a commission calculation application. These "solutions" create more havoc than the ERP and CRM solutions, because customers purchase them expecting that they solve a very specific need when most don't. The flip side of this scenario is the applications that start out as EIM solutions, but because they have inherent calculation weaknesses, they try to morph into SFA tools. They all suffer from the same identity crisis.

The SFA solutions professing to be able to double as ICM tools all share one common flaw. They attempt to merge two distinct business processes that must remain separate. An SFA tool's purpose is to track a sales person's activity and ultimately forecast the business that the activity will create. In order to provide this forecasting capability, a sales person enters pipeline and funnel information, along with estimates projecting the likelihood of sales being closed. As time progresses, the information is modified to reflect successes and failures—over time, even they can move from one category to the other. It is an ever-evolving process with no specific end point.

Since so much information can be contained about sales in an SFA tool, why not use that information to determine incentive compensation? Hopefully, the answer is very clear. There is no direct correlation to this information and a company's actual revenues. Many companies make the mistake to commission sales forces based on booked sales as they are recorded in SFA tools. Quite expectedly, however, not all booked sales progress into actual revenues. In some cases, sales are never actually closed; in others they become disputed; and in some industries the complexities of product bundling, inventories and third-party services can influence a sale so much that the final billed sale does not mirror the initial booked sale.

This approach generates two problems for the business. First, SFA tools inevitably set false payment expectations for the sales force. This only encourages shadow accounting and lost productivity. Second, such applications generate inaccurate information, which is often used to develop new business strategies. As the first case study revealed, this can be costly on multiple fronts.

The Actual Solution

You have probably heard the phrase, “The Devil is in the details.” In the case of incentive management, the solution is in the details; transaction details, which reflect actual revenue-related activity. These are usually captured in a billing, or other auditable revenue management system. Details entered by the sales force (as is the case with SFA tools), or other manual entry processes, are too prone to error or unauthorized data manipulation. Calculating accurate commissions and capturing meaningful sales information can only be accomplished if the tool doing it processes the right data. Since sales transactions will often contain a variety of factors that determine the value of a sale, overlooking any of those factors could redefine the perceived and actual value of that sale.

Another case in point: A large cable services provider pays its commercial accounts sales force based upon activities collected at the account level. The contract value for each account is totaled and a percentage of the revenue is paid to the sales person. Over time, however, additional services or products are being provided to the account. Commissions are paid based on the initial services sold and subsequent products and services that are added, or sometimes removed from the account’s contract.

After deciding to automate the commission process, the company realized that the summarized data it used for each account did not capture enough detail to determine on a monthly basis what changes to the account were actually impacting sales revenues. In some cases, products were simply being switched with other products. This “artificial activity” was not captured at the account level. It was contained in the detailed work order data. Since the detailed data was not the basis for the commissions, and only the new product being activated appeared at the account level, commissions were paid on non-revenue generating activities. Worse yet, the company was unable to verify effective dates on changes to the account at the work order level; so it was quite common for one change to appear as multiple changes at the account level. The result was that a sales person might be paid multiple times for the same sales activity.

Loose Performance Management vs. Objective Incentive Management

The final influencer behind successful incentive compensation is purely philosophical in nature. Over the past decade, a variety of approaches for managing performance have been touted as “the” solution for aligning employee behavior to corporate strategies. Few, if any, of these approaches have produced the results they promised. The reason for this is that they are built on shifting sand. As soon as the foundation for the new approach is built, the company or market landscapes change and the cracks appear.

The key to influencing employees is consistency. If they are confident that the rules won’t change, employees will usually play by the rules—as long as they believe the rules

are fair. Most performance management systems are compromised, however, because they allow for too many subjective influences. For example, I was once a mid manager for a large IT consulting firm. Each year, I would meet with my subordinates and explain our firm's annual objectives and how each employee was expected to contribute to the corporate goals. I would then outline their respective individual goals and the incentives attached to achieving them.

Without exception, when we reconvened at the end of the year to review their performance and inform them about their annual incentive bonuses, company factors beyond the employees' control would negatively impact their compensation. It sent the message, regardless of how hard you work or if you accomplished what you were asked to do, your compensation would ultimately be an arbitrary decision. The process proved to be a source of contention rather than motivation.

If a company wants to successfully implement a pay-for-performance compensation model, the measurements of performance must be quantifiable and based upon detailed criteria. Only when a sales person has confidence that the process is fair and accurate will it have the desired impact.

To achieve the desired results, companies must support their pay-for-performance strategy with a reliable, automated system that will document a person's performance and provide meaningful input into future compensation strategies. Basing a model on anything less than this can only generate grief and frustration. If you feel that your present manual process is not capable of handling the details you need or your present automated system limits your ability to adapt to real business issues, look for a system that focuses on the details. Next, ensure that it is also standardized, yet flexible enough to adapt to the ever changing marketplace. Without these features, any system you purchase will leave you feeling duped and frustrated.

About Glocenttm

GlocentTM, was developed to offer an alternative to the generic, less flexible and out-dated solutions promoted by the majority of the software vendors purporting to provide modern-day compensation management applications. It also provides a cost-effective alternative to the expensive, unpredictable and difficult to maintain custom solutions commonly built by large software development houses. By leveraging decades of experience in software development and incentive management consulting, the company set out to build a packaged application that would accommodate the most complex product offerings, incentive plans and sales structures without the uncertainty inherent in custom solutions, while still providing the flexibility necessary to meet the dynamic nature of modern competition.

The result, **GlocentTM** is a system that delivers:

- An application that requires no software modifications during implementation or subsequent to installation.
- A patented design that allows unlimited flexibility
- A user interface that eliminates dependence upon the IT department for modifications.

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