SALES & MARKETING MANAGEMENT

A BILL PUBLICATION

ARE GOOD SALESPEOPLE BORN OR MADE?

For the answer, see page 74.

COMPENSATION
Don't Be Too Quick On the Draw

TECHNOLOGY
Sales Force Productivity Tools

SALESMANSHIP
So You Think You Have A Tough Sell?

Draw programs can be valuable, but move too quickly and you may wind up with one that ***demotivates*** your sales force.

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Things are not going well at Electro Inc. For the past four months, orders have been so slow that the earnings of salespeople, who are paid commissions, have barely covered their personal monthly expenses.

To help the sales force through these rough times, Electro (a fictitious, but all too typical company) has decided to introduce monthly draws. A salesperson whose commission earnings fall below a specified monthly amount will receive a loan, or draw, against commissions. When sales and commissions improve, they will repay the cash advance from future earnings.

The salesperson thus has some cash flow protection, but does Electro have a compensation arrangement aimed at achieving its sales strategy?

It depends. Draws can be useful in smoothing the peaks and valleys of a sales representative's earnings. They also can be a valuable compensation tool to stabilize income when establishing new businesses or territories, or during new employee transitions, when a sizeable portion of employee income is at risk. However, draws may not always accomplish what management wants to achieve in terms of directing the sales force behavior.

To avoid a decline in motivation and productivity, the following steps should be taken before deciding whether or not to introduce a draw program:

1. Determine the right salary/incentive pay mix.

Begin by evaluating the pay mix of your sales force. As a general rule, don't use a draw program if you have a small amount of pay at risk. Conversely, only use draws when 30% or more of your salespeople's pay comes from incentives, or when the base salary program is not sufficient to cover immediate personal or business expenses.

The correct combination of salary and incentives for a sales position depends on the importance of personal selling in the marketing effort. Personal selling is probably very important if pricing, product quality, brand awareness, advertising, national promotions, etc., are not critical in selling your product or service. Generally, if you strongly emphasize personal selling, you should place a greater proportion of pay in incentive compensation.

Personal selling is frequently less critical to the overall sale process when a large part of the job involves customer service, customer training, technical or administrative work. In these cases, a greater portion of compensation should be tied to base salary, and draws probably should not be considered.

2. Consider cash flow situations.

After establishing the appropriate salary and incentive mix, you should consider how a salesperson's cash flow is affected by your compensation program. Cash flow refers to the frequency and size of payments made to an employee throughout the year.

A draw is not usually necessary when incentives are paid frequently (weekly, biweekly, or monthly) and in consistent quantities. "Consistent" means that a typical salesperson's earnings vary less than 20% from month to month. If pay varies by more than that, your salespeople may benefit from a draw program. If you find that pay varies significantly only for new hires, it is best to limit draws to them, rather than include the entire sales force.

3. Assess the strengths and weaknesses of draw programs.

If you have a large amount of pay at risk and more than 20% variation of pay from month to month, you need to decide if the benefits of draw programs outweigh the negatives. Here are some of the reasons for not implementing a draw program:

- People don't like to owe the company money.
- Draws can introduce too much comfort.
- Managing debit and credit balances with draw accounts can increase the administrative workload.

Case Study

How Krystar Found The Right Draw Program

There's no "best" way to use a draw program for sales compensation. Companies vary their approach depending on market conditions, specific sales goals, and their ability to attract talented salespeople.

Take the case of a hypothetical company that we'll call Krystar. A start-up in the computer industry, its strategy is shaped by the tightfisted doctrines of founder Barbara Krymsky, who's committed to growing rapidly through an aggressive direct sales effort, rather than spending heavily on advertising and promotion.

Sales vice president Ed Thompson, however, has run into problems in paying his sales force. As with many entrepreneurial ventures, Krystar has traditionally kept salespeople on straight commission so that the company pays them only when they make a sale. But, because there's no consistent pattern to the company's sales, earnings of salespeople have been fluctuating dramatically from month to month and there's been a lot of grumbling in the ranks.

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- It is hard to rectify negative draw balances when salespeople leave the organization.
- Your salespeople can manage the complexities of wide variations in pay from month to month.

On the positive side, draws provide four major benefits in that they:

- Smooth out variations in pay levels that result from inconsistent sales patterns or seasonal sales cycles.
- Provide a way for new salespeople to start selling in the business.
- Create a more attractive and competitive pay package.
- Allow salespeople to stop worrying about how they're going to pay their bills and help them focus their attention on selling.

These benefits tend to be realized in companies where sales patterns within individual sales territories are unpredictable. Such businesses usually have long sales cycles or inconsistent sales frequencies, making them good candidates for draws.

4. Choose the right type of draw program.

If your sales force, or a certain segment such as new hires, still seems to be a candidate for draws, you now need to choose from among the following three types:

A ***"recoverable draw"*** is a loan or cash advance that must be repaid to the company from the employee's future incentive earnings. This type of draw is normally used to even out the peaks and valleys of a salesperson's earnings, which may occur if sales are sporadic. Recoverable draws are the best way to focus maximum attention on selling. They are strictly loans, however, not earnings guarantees. The onus is on the salesperson to maintain a specific level of income by selling hard at all times.

A ***"non-recoverable (forgivable) draw"*** is a cash advance against an employee's future incentive earnings, which is normally reconciled at the end of the draw period. If the sum of all draw payments exceeds the earned incentive, the outstanding balance is not owed to the company. If the earned incentive exceeds the sum of all draw payments, the difference is paid to the employee.

Case Study *continued*

To remedy this cash flow situation, Thompson introduces a recoverable draw program that provides $5,000 a month to each sales representative. Here's how it works for Don Pierce, who's just been assigned to a territory in Toronto:

MONTH	COMMISSION EARNINGS	MONTHLY PAYMENT	DEFICIT DRAW BALANCE
January	$ 0	$ 5,000	($5,000)
February	$ 6,000	$ 5,000	($4,000)
March	$10,000	$ 6,000	$ 0
April	$ 8,000	$ 8,000	$ 0
May	$ 2,000	$ 5,000	($3,000)

As shown, Pierce gets off to a slow start in January, earning no commissions at all, so he receives a recoverable draw payment of $5,000. The next month, he earns $6,000 in commissions, but he owes the company $5,000 as a result of his previous draw. Thus, he nets $1,000 for the month. Since the program provides for a minimum cash flow of $5,000 per month, however, Pierce gets a $5,000 payment for February. He now owes the company $4,000.

March is a different story. A number of tough accounts that Pierce has been working on for weeks come through with orders. He earns $10,000 in commissions and, after paying the company back $4,000, is left with a payment for the month of $6,000.

Things go reasonably well in April, and Pierce brings in $8,000 in commissions. He keeps the full amount, because he no longer has a deficit draw balance.

The following month, business tapers off. Pierce earns only $2,000 in commissions and receives the minimum $5,000 draw. He is now running a $3,000 deficit, which hopefully will be erased by higher earnings in the months ahead.

But what if those heftier commissions fail to materialize? Krymsky and Thompson worry that a general slowdown in the computer business may put their new sales representatives in a bind, so the following year they decide to try a non-recoverable draw program for three months. Not a bad idea, but their first effort is a disaster.

The problem lies not with the draw itself, but with how it's calculated. Instead of reconciling a sales representative's balance at the end of the three months, Thompson chooses to do it on a monthly basis. The following table, based on the performance of Bob Loder in Chicago, shows why this is inappropriate:

MONTH	COMMISSION EARNINGS	NON-RECOVERABLE DRAW	MONTHLY PAYMENT
January	$ 2,000	$ 5,000	$ 5,000
February	$ 12,000	$ 5,000	$ 12,000
March	$ 0	$ 5,000	$ 5,000
TOTALS	$ 14,000	$ 15,000	$ 22,000

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If the non-recoverable draw is reconciled each month, the company may pay out more money than it intends. For this reason, non-recoverable draws are usually not reconciled until the end of the draw period, unless the intent of the company is to divide the incentive program into separate performance periods. (Example: When the salesperson starts every month with a clean slate.)

An ***"income supplement"*** is provided to a salesperson to replace the opportunity of earning incentive awards until the individual begins participating in an incentive program. As soon as the sales representative is eligible to earn incentive awards, the supplement ceases. Income supplements are similar to non-recoverable draws in that they are normally provided to new employees. However, a salesperson cannot earn more money than the stipulated amount of the supplement.

Choosing the type of program that will work for your sales force depends in large part on the behavior you are trying to elicit. If learning is important, non-recoverable draws and income supplements may be the better options. They provide the best way for salespeople to learn about the company, its products and services, and how to apply them. They minimize the risk of low earnings for people when their attention needs to be focused on the process of selling rather than on actually closing sales.

Conversely, recoverable draws are not appropriate arrangements if salespeople are learning on the job. Under such a program, people are usually more interested in selling than in learning. As a result, they may jeopardize their long-term knowledge for short-term incentive earnings.

Non-recoverable draws can cause severe problems if not properly managed. Participants may lack the motivation to sell during the specified time period because the amount of the draw will be paid whether or not a sale is made.

Even worse, non-recoverable draws can be a strong incentive for not selling during the draw period. Since any earnings resulting from a sale will usually be written off by the value of the draw, a person might earn more money by delaying the sale until the end of the draw period.

For example, a sales representative who qualifies for a $5,000 non-recoverable draw in January, but not February, could put off closing a big sale until February and then collect the applicable $3,000 commission, netting $8,000 for the two months.

Had the sale occurred in January, the person's earnings would have been only $5,000 for the two months.

These problems can be avoided by emphasizing the importance of building a solid base of business before the non-recoverable draw program ends. Some companies do this by setting specific targets that must be reached before the salesperson qualifies for the non-recoverable draw payment.

Draw programs differ considerably in terms of income security, motivation to sell, and risk to the company in the event the salesperson does not sell. Think about what you need to accomplish, then see which program best meets these objectives. The table on page 5 should help in your analysis.

Case Study *continued*

In January, the minimum earnings guarantee means that Loder receives a $5,000 payment, even though he earns only $2,000 in commissions. Since the non-recoverable draw is reconciled at the end of the month, the company simply writes off Loder's $3,000 "debt" instead of carrying it forward.

This kind of reckoning can make a big difference in the eventual cost of a non-recoverable draw program, as can be seen in the succeeding two months. When business picks up in February, for instance, Loder earns $12,000 in commissions and is paid the entire amount because his $3,000 shortfall from the previous month hasn't been carried forward.

In March, Loder's fortunes turn sour and his commissions drop to zero. He gets another $5,000 payment, however, raising his total for the quarter to $22,000. That's fine for him, but costly for Krystar. The total is $8,000 more than Loder's actual commissions and $7,000 above the intended non-recoverable draw.

Sensing that this arrangement isn't producing the kind of results they want, Krymsky and Thompson meet hastily over breakfast one morning at a coffee shop in the Nashville airport. "Is this the only way we can attract sales talent, Ed?" asks Krymsky, reminding him of why they'd introduced the non-recoverable draw in the first place.

"We can tinker with it, Barbara. No problem," Thompson responds. "The concept is sound. We just need to change the timing of when we reconcile."

"Speak English, please."

"Well, when we got into this, we agreed that it was advisable to guarantee new salespeople an income of $15,000 for their first three months. This was the best way to attract potentially successful people who might have some concerns about surviving the initiation period, right?"

"Okay," replies Krymsky, "but another one like Loder and we're all going down the tubes. Reconcile that!"

"I will, if you give me a chance. Let me show you what would've happened if we'd reconciled Loder's non-recoverable draw at the end of the quarter instead of doing it monthly." Thompson takes a paper napkin and writes down some figures among the coffee stains:

MONTH	COMMISSION EARNINGS	NON-RECOVERABLE DRAW	MONTHLY PAYMENT
January	$ 2,000	$ 5,000	$ 5,000
February	$ 12,000	$ 5,000	$ 5,000
March	$ 0	$ 5,000	$ 5,000
TOTALS	$ 14,000	$ 15,000	$ 15,000

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Relative Influences of Draw Programs

	INCOME SECURITY	MOTIVATION TO SELL	RISK TO COMPANY IF SALES FORCE DOESN'T SELL
Recoverable Draw	Medium	High	Low
Non-recoverable Draw	High	Medium	Medium
Income Supplement	High	Low	High

Given this information on draws, let's examine Electro's decision to use them. Under steps 1 and 2, it appears that the company is a good candidate for a draw program. The straight commission program places more than 30% of salespeople's pay at risk, and the sporadic sales pattern causes great fluctuation in earnings.

A look at the sale process tells a different story, however. Electro's sales cycle demands substantial post-sale customer service, which to date is being ignored because the commissions motivate only selling. Also, the company does a lot of advertising to consumers, so the salesperson's role with the retailers involves more order-taking than personal selling. In fact, the salesperson has relatively little control over the sale.

Given this sales process, Electro may be better off eliminating draws altogether and introducing a base salary component to the compensation program to provide earnings stability. Guaranteed incomes will allow salespeople to pay attention to customer service, especially if salary increases are tied to customer satisfaction.

In addition, since salespeople have little influence on whether or not sales are made, their incomes actually depend more on luck than performance. Thus, because advertising produces most of the sales, the company needs messengers or order-takers rather than aggressive salespeople. A higher base salary component attracts that type of person.

For Electro, then, draws are inappropriate, even though some of the criteria were met. It's the sales compensation program that needs re-designing.

Overall, the company will be better served by offering a sizeable base salary to attract and retain the necessary individuals. Salaries can be set in accordance with a person's experience, skills, past performance, and level of responsibility. Salary increases can be granted annually based on individual results, and a good performance management program employed to reward non-financial activities.

In addition, a modest quarterly bonus program may be introduced to inspire salespeople to maximize their sales opportunities. (For example, they can still influence retailers to stock more merchandise.) Thus, if sales representatives meet their targets, they can earn an extra 15% of salary. If they exceed it, they could earn up to 30%.

Draws present a number of advantages both to the salespeople and sales management. Unfortunately, companies often use them as stop-gap measures to try and correct deficiencies in their compensation programs. Consequently, rather than solving a problem, they may create new ones. Under these conditions, a thorough investigation of the basic problem is advisable. When planning compensation strategy, it doesn't pay to shoot from the hip.

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Case Study *continued*

"By keeping the monthly pay to $5,000, we don't over-commit ourselves," Thompson continues. "The salesperson gets enough to live on, and, at the end of the draw period, we even things up. In this case, since Loder's earnings fell short of the total draw, we would've written off $1,000. That's not first choice, but it sure beats $8,000. And, you can look at it as a one-time investment, because after that you'll put a new salesperson on our main program, which is based on earned commissions and a recoverable draw."

"All right, but what happens if the new person's commissions for the three months are larger than the total non-recoverable draw?" Krymsky asks.

Thompson takes another napkin and draws the following table:

MONTH	COMMISSION EARNINGS	NON-RECOVERABLE DRAW	MONTHLY PAYMENT
January	$ 8,000	$ 5,000	$ 5,000
February	$ 6,000	$ 5,000	$ 5,000
March	$ 9,000	$ 5,000	$ 13,000
TOTALS	$ 23,000	$ 15,000	$ 23,000

"This is what you hope happens with everyone," he says. "At the end of the three months, the new salesperson's commission earnings exceed his non-recoverable draw. We simply pay him the $8,000 he's due and send him on to our main program. He obviously won't suffer from a recoverable draw."

"Fine, Ed," says Krymsky. "I guess I'm convinced. But, I just have one more question."

"Which is?"

"Why didn't you think of this sooner?"