

1964

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## Recommended Citation

Haskins & Sells Selected Papers, 1964, p. 319-325

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# Improving Incentive Pay Plans for Buyers

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*Presented before the 44th National Convention of  
the Controllers' Congress, National Retail Mer-  
chants Association, Hollywood, Florida—May 1964*

**I**N 1957 your organization published a report on "Salary and Bonus Payment Plans for Buyers . . .". At that time it was found that around 90 per cent of department and large specialty stores pay buyers with some sort of salary-plus-bonus arrangement. Finding an incentive pay plan of compensation for buyers that is fair to store and buyer alike is a continuing problem. It will always remain a problem, to some extent, since formulas, no matter how clever or how devious, have ways of "not exactly fitting the situation this year"; or they depend on data, such as share of market or trend of local economic conditions, that are difficult to develop.

We always hope to improve a little, over the years, and improving incentive pay plans is no exception. But we'll probably never reach perfection or approach utopia because of the many variables met with in evaluating a buyer's performance. Sometimes I think a sound-thinking merchandise manager who has watched a department's operations for the year, armed with a check list to be sure he has covered the main points, can reach an empirical judgment in the matter of incentive bonus that is as good as any formula. It may be better, as far as paying the buyer what he's worth is concerned, based on performance. But a review of performance, however sound, made after the fact without the bench marks laid down for the buyer a year ahead of time, won't achieve the maximum incentive.

## **POINTS TO CONSIDER**

So we come to a point to be stressed in improving incentive plans: To provide the most incentive throughout the year, inform the buyer what is expected and how his incentive pay will be calculated, so he can work toward as big an incentive payment as possible.

This point rather presupposes that the whole incentive plan is figured out in advance. In that survey of salary and bonus-payment plans for buyers made in 1957, 64 per cent of stores used salary plus year-end bonus with a definite arrangement between the store and the buyer, 28 per cent had no oral or written arrangement and 8 per cent paid straight salary only.

Of the stores with a definite bonus arrangement with buyers, about 75

per cent have set up one or more specific requirements to be met before any bonus is considered to be earned at all. I quote from the 1957 report:

The requirement most often taken into consideration by the stores in determining whether or not a bonus will be paid in the order of the frequency in which they were mentioned, are:

- a sales quota to be reached or exceeded
- a sales increase to be made
- a fixed gross margin percentage to be maintained
- a certain net profit to be made
- a fixed gross profit to be made
- satisfactory inventory condition and shrinkage
- a certain turnover rate maintained
- the standard markup maintained
- adequate discounts received
- service with the store of at least a minimum length of time
- a certain contribution of the department to the store.

Some stores require only one such factor, but the majority combine two or three in the arrangement. Sales quota or sales increase are contained in the "requirement clause" of nearly all the stores having a definite agreement plan. Usually there are gross margin percentages or profit requirements that must be reached in the department before the buyer is eligible for a bonus on the sales excess over quota.

Bonuses based on sales are the most common, of course. This approach, unless coupled with a penalty for not maintaining an adequate gross margin, can cause the buyer to sacrifice profit for sales volume. Since gross margin dollars are more useful than sales dollars, this is an important point to include along with sales. Another problem with using sales, or any like factor dealing with volumes, is that a buyer can earn or not earn a bonus because of factors outside his control.

This can work out unfairly to either the buyer or the management. For example, New York City stores will undoubtedly have a better than average selling summer owing to the World's Fair. This will increase many buyer's bonuses, resulting from outside environment. Contrari-wise, a city suffering a prolonged strike in a major industry, just before Christmas, could reduce sales significantly and reduce a buyer's bonus. If the buyer is on his toes in such a situation, and stays on top of his open-to-buy, cancels orders, and generally stays up nights to do a good job in a difficult circumstance, he may actually be deserving of a better bonus than usual, rather than ending up with a cut in pay.

This thought brings up another important point in improving incentive plans: *No mathematical formula is a substitute for sound judgment.* No formula can consider all eventualities. Plans should permit departures from formulas, if appropriate in the circumstances.

This situation suggests that there are at least three factors to any incentive pay plan:

- A base salary from which to start
- A mathematical formula, expressing the intent of the incentive
- A discretionary increment or reduction to cover unusual events.

As an approach, the paying of incentives based on maintaining gross margin percentages, or a fixed amount of gross profit, has some advantages over the use of pure sales volume or quotas. It does take into consideration that profits are as important, are really more important, than volume alone. We are, after all, in business to make money. It works well in more cases, with one major exception: If the criterion is a percentage of gross margin rather than the most dollars of gross margin, the buyer can keep prices and mark-ons up at the expense of volume and make less gross-profit dollars in the long run. The thing to shoot for, of course, is the right profit/volume relationship. \$100,000 at 40 per cent is \$40,000 in gross margin. \$110,000 at 37 per cent is \$40,700 in gross margin. A plan should take this into consideration.

If we move from a criterion of gross profit to net profit, then we hold the buyer responsible for another batch of factors—the operating expenses. This net-profit approach was the fourth most popular bonus factor in the 1957 NRDGA survey. As an aside, although the 1957 report is seven years old, a similar report, made in 1947, ten years previous—showed little difference in results. So if the change in the last seven years is similar to that of the previous ten, their data should still be representative. A new report is planned, I understand, within the next few months.

But come back to net profits. The interjection of the effect of operating expenses on volume and gross profits is a more inclusive measure of a buyer's performance than just volume or gross profit. It tells him that to earn a bonus he has to watch his expenses too. If he wastes advertising, or permits too large a sales staff, then at least some of this error in judgment will hit him where it hurts the most—in his pocketbook. So long as the buyer has enough control over expenses to have a reasonable control over net profit as well, then operating profit can be a fair and sound approach to paying an incentive bonus. But these operating expenses, subtracted from gross to arrive at net, bear a little analysis from the standpoint of who is responsible for what.

When a department is allocated expenses that the buyer cannot himself control, such as cost of space, credit department or accounting department overhead, and these expenses are in turn subtracted from gross margin to produce net profit, then fluctuations in these allocated expenses

can and will affect the buyer's bonus if the bonus calculation is based on net. This can be unfair to the buyer or the management. If these expenses increase, the buyer is perturbed; if they decrease, he gets something for nothing. If he can control expenses, fine. Then include them in a bonus calculation. If he cannot, it's probably fairest to leave them out. The point brings up another principle of incentive calculations: *Include only those items which the buyer can control, in developing incentive formulas.*

By way of illustration, Exhibit A attached shows a sample departmental operating statement using the "Controllable Profit Contribution" concept.

The "Controllable Profit Contribution" concept takes us a long way toward finding a good base for incentive bonuses. It takes into consideration sales volume, maintenance of margins, and expense control, where the buyer can in fact exercise it. It doesn't completely close the circle, but it's a good start. The information is also readily available.

There are other factors worth considering. A quick list of other factors might be:

- Inventory condition and shrinkage
- Inventory turn
- Employee turnover within the department
- Penalties for poor performance in particular areas
- Share of market
- Economic trends
- Performance ratings on duties and responsibilities, and the whole subject of establishing the base salary itself.

Of the list above, the one receiving the most attention is usually the area of inventories. In calculating gross profits for bonus purposes some stores include a penalty for old merchandise. A typical penalty might be: Inventories over two seasons at inventory time shall be included at 50 per cent of the then marked retail price. Some plans provide for a penalty if stock losses exceed an established standard figure. Likewise, some plans provide penalties if inventories do not reach a budgeted turn. The purpose of all this, of course, is to encourage the buyer to maintain fresh stock under good control. The penalty for stock losses may be going a little too far.

### **EVALUATING A BUYER**

Employee turnover can be important in evaluating a buyer. It can also be misinterpreted. Some buyers are hard to work for and clerks quit be-

cause of it. Sometimes turnover is high because of storewide policies the buyer cannot control. Occasionally, the turnover is too low because the job is too easy for the pay. One approach that on an occasional basis appears to me to be useful is to have the department shopped from the standpoint of department morale and training—shopped from the standpoint of evaluating the effectiveness of the salesclerks, their knowledge of their products, their friendliness, their helpfulness, and the speed with which they carry out a transaction. Shopping reports should go back to the buyer so that he can correct things that may be going wrong.

Probably one of the most difficult and one of the most useful evaluations for a buyer has to do with the problems of his particular department in relation to similar departments in competitive stores in that area. The most useful indication in this regard is a figure indicating his share of market and whether he is gaining or losing his share compared to the immediate competition. But the data for share of market is hard to come by. Another difficult problem is to separate increases and decreases in business due to the efforts of the buyer as compared to the effect of the store itself or to the economic climate. Sales can be compared to local economic curves and the effect of the movement of the economy can be factored out of the sales/volume picture. Likewise, if the total store is gaining or losing its share of the market, this gain or loss can be factored out of the department figures so as to come down to a raw sales increase or decrease most closely approximating the performance of the buyer himself. Again, this isn't easy to do. Even if it can be done, the problem of explaining the validity of the statistical computations to the satisfaction of the buyer remain. If you can do these things, it's worth the effort. If you can't do them well, it's probably better not to let them affect incentive compensations.

### **BASE SALARY**

One more point: The function of the base salary, in my opinion, is to represent a guaranteed predetermined salary for doing an average job. A bonus for incentive should be reserved for the buyer who does an above-average job. The incentive bonus is something extra because the buyer gave something extra.

The base salary should be in line with area wages for the degree of experience and age of the buyer. It should take into consideration his length of service. It should be increased as the buyer improves, based on an overall evaluation of how the buyer carries out his responsibilities and authorities, but should not be increased beyond the worth of the position itself.

In evaluating base salaries, a rating sheet summarizing the buyer's

responsibilities is a useful tool. A sheet listing typical responsibilities of the buyer is attached as Exhibit B. If each item on this list is carefully rated as to average, above average, or below average, this should represent a good profile for establishing base pay.

### CONCLUSION

Probably the best incentive is that if a man does a good job he gets to keep it. The purpose of base pay is to provide a competitive salary for an average job. It is a cleaner policy if base pay and incentives are not mixed.

#### EXHIBIT A

#### SAMPLE DEPARTMENTAL OPERATING STATEMENT

(Illustrating "Controllable Profit Contribution" Concept)

	<i>Budget</i>	<i>Actual</i>	<i>Better or (Worse)</i>
NET SALES	\$ _____	\$ _____	\$ _____
GROSS MARGIN AND CASH DISCOUNTS	\$ _____	\$ _____	\$ _____
CONTROLLABLE EXPENSES:			
Salaries—Buyers and assistants			
Salaries—Clerical and stock			
Selling payroll			
Direct advertising charges			
Travel			
Communications and delivery expenses			
TOTAL CONTROLLABLE EXPENSES	\$ _____	\$ _____	\$ _____
CONTROLLABLE PROFIT CONTRIBUTION	\$ _____	\$ _____	\$ _____

(Note—Salaries include Fringe Benefits at 4¢ per dollar of payroll)

EXHIBIT B

*FUNCTIONS AND RESPONSIBILITIES OF THE BUYER*

These duties are arranged in order of importance to stores doing an annual volume of over 10 million dollars. Percentages of stores requiring the buyer to perform each listed function are shown by volume groups.

Function	Over 10 million	5-10 million	1-5 million	Under 1 million
Develop merchandise plan	100%	100%	90%	57%
Select and buy merchandise	100	100	100	100
Set price of merchandise	100	100	98	100
Plan promotions for department	100	100	98	100
Check department's merchandise assortments	100	95	98	100
Provide merchandise training for salespeople	100	100	77	57
Plan advertising for department	95	90	82	71
Supervise stock keeping	94	95	93	100
Supervise interior display	90	85	77	57
Assign duties to salespeople	85	95	99	100
Plan department's window display	80	85	65	57
Assist salespeople in closing sales	80	90	89	100
Supervise reserve stock room	76	90	89	100
Provide salesmanship training	66	98	57	57
Supervise merchandise control	67	90	68	85
Supervise informative labeling of department's merchandise	57	90	82	57
Supervise receiving of department merchandise	42	50	46	71
Supervise marking of merchandise	38	65	51	71
Make own sales on floor	38	70	75	100

\* An excerpt from the report "Salary and Bonus Payment Plans for Buyers and Divisional Merchandise Managers", published in 1957 by The Merchandising Division, National Retail Dry Goods Association.

