

Assessing The Impact of Sales Incentive Programs: A Business Process Perspective

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The following is a landmark study that presents a financially sound rationale for ROI measurement of sales and non-sales impact of sales incentive programs.

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Overview

This research represents an extension of a previous study sponsored by the Incentive Research Foundation that described ROI (return on investment) assessment of sales incentive programs. The present study adopts a business process view of sales incentive programs noting that their impact can extend well beyond the sales function to other constituents within the organization.

Central Challenges

The presence of several confounding effects poses a major challenge in accurately measuring ROI. It is critical to establish benchmarks to assess performance gains that are directly attributable to a sales incentive program and the process depends heavily on the availability of historical data on important variables.

The Research Setting

The research setting involves a manufacturer of hand tools seeking to boost sales growth through a distributor incentive program during January–September 2003. The firm had never used sales incentives before. Sales and other data collected during 2000–2002 serve as the basis to establish benchmarks to evaluate incentive program effectiveness.

A Sales Focus Alone: Negative ROI

Developing an incentive program with a focus on sales growth alone reflects a myopic view. Analysis shows that such an approach will likely deliver poor economic returns. Specifically, in this case, the firm's expected ROI was projected at -92%.

Preoccupation with sales growth may adversely affect cash flow, an important business metric. Cash flow is related to two important indicators – accounts receivable (managed by Finance) and finished goods inventory (handled by Operations). Our analysis shows that the expected negative impact on the firm's cash flow was nearly \$208,000.

Non-Sales Aspects Included: Positive ROI

The firm's distributor incentive program included rewards to keep accounts receivable and finished goods inventory in check. Adding these elements to the incentive program produced a positive impact on cash flow estimated at nearly \$227,992. The cash flow aspect of the incentive program yielded an estimated ROI of approximately 15%.

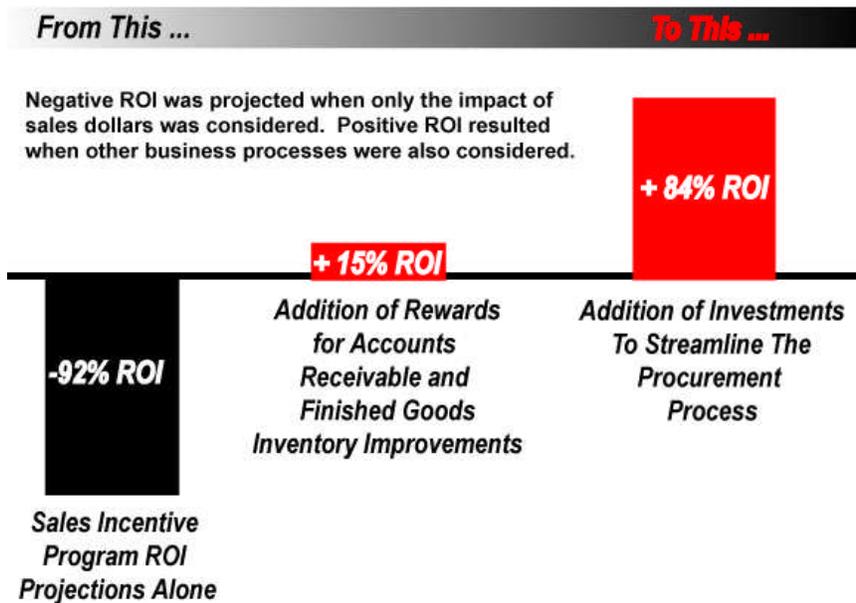
Other functions within the organization experience the effects of a sales incentive program. In particular, procuring additional raw materials, often at short notice, (to support higher sales arising from the incentive program) can disrupt supplies. This may require extra investments by Procurement such as signing exclusive agreements with vendors to maintain steady supplies. Similarly, the sales organization may need to gear up to manage and service the distribution network to generate and support higher sales volume, requiring Sales to invest in additional infrastructure.

Importance of Impact Analysis

Such indirect effects on other functions are critical in determining the success of a sales incentive program. Careful documentation of the anticipated impact on other areas of the business, through “Impact Analysis”, helps identify needed investments in additional areas to support the program.

In this case, the firm invested \$360,000 to streamline the Procurement activities and \$210,000 to support the Sales function. These investments resulted in significant reductions in COGS and SG&A expenses and together with the sales incentive program budget, produced an estimated overall ROI of 84%.

In A Nutshell ...



A Process View

The study reported here shows that sales incentive programs can generate strong, positive returns but it is worthwhile to have a process view of the business. Exploring and documenting the likely impact across the organization, ahead of time, is a valuable first step. The results are consistent with the positive qualitative assessments about the program, obtained through employee surveys before and after the incentive program.

From a financial accountability standpoint, ROI measurement is important for the incentive industry. Systematic analysis to document the value of sales incentive programs can be a source of competitive advantage.

The measurement, availability and access to appropriate data are serious matters needing attention by firms interested in measuring ROI. The credibility and accuracy of ROI assessment largely depend on the nature, scope and quality of the data that is used for analysis.

The Motivational 'Nudge'

In many organizations, the greatest single investment is in the people who help achieve overall business objectives. Firms devote considerable resources to develop elaborate compensation and marketing programs to motivate their employees (agents) to perform at (or exceed) a targeted level. But even the most comprehensive compensation program needs an extra push from time to time. Sales incentive programs, by way of offering the opportunity to earn extra rewards, afford firms an opportunity to realize additional gains by providing a “motivational nudge”. Whether the goal is incremental sales, improved employee effectiveness, higher dealer preorders or simply a faster start to a new sales promotion, motivational “value added” programs are often viewed by sales managers as a useful tool in the belief that if used judiciously, they can support the achievement of specific goals.

Quantified Economic Returns Are Critical

Sales incentives are a multi-billion dollar industry (Kalra and Shi 2001, Stolovich et al 2002) and their use is quite extensive among businesses (Murphy and Sohi 1995). Incentives take many forms such as recognition awards, cash bonuses, travel or merchandise. Despite the typical managerial intuition that incentive programs are valuable when used under the right circumstances, there is limited work in the marketing literature that documents their value and effectiveness by quantifying the economic returns. Much of the analysis on incentive program impact is treated as “proprietary”. However, the findings are often clouded because of two important limitations (a) the absence of a meaningful benchmark against which program effectiveness can be judged and (b) a myopic view of considering merely the sales effects as opposed to the broader impact of the incentive program across the entire organization. In other words, a systematic analysis of incentive programs must encompass the entire business process to gain a fuller perspective of their overall effectiveness.

About The Company

In this research, the author reports on a case involving a well-known United States based hand tool manufacturer. The management of this company was well aware of years of slow sales growth and ever-increasing competition. They had never tried incentives, other than simple cash discounts, to motivate their distribution channel to sell their products. The company was, of course, interested in increasing sales and profits but did not realize, at first, that a straightforward implementation of a sales incentive program was *not* the answer. There were important resource implications with an enormous impact on the normal day-to-day operations of the business. For example, procurement of additional raw materials to meet higher production requirements due to the sales incentive program would be a challenge. Without adequate planning, raw materials would have to be procured in the spot market, at higher prices, which would raise the costs of production and squeeze margins. Similarly, cash flow could be severely undermined at higher sales levels because inventory and accounts receivable were already at high levels.

Why This Research Is Important

The present study offers a systemic, business process perspective that helps establish greater credibility and accountability for sales incentive programs. Several unique aspects of the research include the strong empirical foundation for the analysis, the use of benchmarks for a comparison of results and a cross-functional perspective to evaluate program effectiveness.

ROI Measurement

Measuring the return on investment (ROI) for sales incentives (and for marketing programs in general) is a topic of intense discussion in corporate boardrooms these days. The key aspect in ROI measurement is having an appropriate benchmark to measure results against. A typical question is “What would sales have been, had we not employed the incentive program?” Incremental sales can then be compared to this benchmark. The process, however, is a bit complicated due to the presence of confounding factors - both internal and external. For example, the increase in sales may have occurred due to the firm’s increased advertising, promotion, or changes in price that occurred during the same period. It may also be due to external factors such as an economic upturn or a competitor withdrawing from the market. In the normal course, it is difficult to separate out these effects. One approach to link incremental sales directly to the incentive program is experimentation. This involves creating an experimental and control group that are reasonably “well-matched” on several characteristics. However, this approach is expensive and is generally viewed with anxiety and skepticism by the participants (dealers and salespeople). Another approach is to examine historical data on select variables before and during the incentive program period. Thus, the pre-incentive period becomes equivalent to a “control setting” that permits the creation of suitable benchmarks, which then enables the assessment of incremental sales and other effects.

Impact On Other Functional Areas

Finance

As noted earlier, the impact of sales incentives is not restricted to merely generating a (likely) sales increase. Several functional areas across the organization may be affected:

The acquisition of new customers, generally considered a good outcome for any business, also involves other subtle aspects such as customer quality. In many instances, the short-term sales focus of incentive programs may generate higher sales volume but accompanied by a lower quality of new accounts.

Some of the new accounts may delay paying their bills, causing an increase in accounts receivable. This can hurt bottom-line profitability, specifically cash flow and the management of short-term capital.

Operations

A related aspect is the demand pattern of new sales. New customers entering the sales system may order products at highly erratic schedules. Such variability has the potential to create serious imbalances in the finished goods inventory and shipping costs. Without careful planning, excess inventories will have an adverse impact on cash flow hurting profitability.

Procurement

Often overlooked is the fact that more products must be *produced* to handle the sales increase. This places greater demands on procurement, whose primary goal is to secure all necessary materials, supplies, and services for the company at the optimum quality, in the right quantity, in a timely manner, and at the best possible prices. A sales increase due to an incentive program implies more raw materials and supplies to accommodate the higher level of production. Procurement may incur greater costs (higher prices in the spot market) if the higher production levels were not planned for in advance.

Production

Higher production volume (short-term) may necessitate additional labor hours to produce the extra goods. These costs are often non-linear and most managers have no idea of how the costs (for raw materials and labor) behave with increased sales. It is also possible that the percentage of defects in the production process may increase (due to the hiring of less skilled, temporary labor or inferior raw material quality) resulting in higher costs and lower margins.

Human Resources

Planning for additional workers (even though it may be temporary labor) involves considerable expense. Beyond the cost of hiring, the cost of training the new workers must also be considered.

Benchmarking

The above discussion offers a broader view of the impact of a sales incentive program on other parts of the organization. It points to the need to carefully study the entire business process to understand the likely potential impact of the incentive program across the organization. It underscores the importance of establishing guidelines ahead of time and involves the setting of sales as well as non-sales benchmarks.

The Research Setting

The research setting involves a well-known hand-tool manufacturer based in the United States. The firm had never employed incentives with their distributor network believing that “it would not be worth the investment”. However, management had become concerned about the growing competition within the industry and the rather slow growth in company sales over a three-year period (2000 to 2002). They were clearly interested in achieving higher sales and better profitability and wanted to consider a properly structured incentive program in 2003 for their distributors.

2003 Goals

The specific goals for 2003 were to:

- Increase incremental Net Sales by \$1 million
- Improve gross margins from 30.4% to 32%

Research Steps

The research approach involved two important steps outlined below:

Step 1 -- Business Situation Review

Before proceeding further, several aspects of the company’s business situation needed review:

External: This part involved an analysis of the business cycle and general industry trends. The business cycle review suggested that there were functions within the organization (such as Procurement and Production) that would not be able to support additional workflow without causing harm to product quality. Moreover, new product releases were severely behind projected schedules resulting in late or cancelled customer orders throughout the period. The review indicated that overall industry sales growth averaged 6% over the past three years and that three competitors had an average sales growth and net profit that was about 3.5% higher than the subject company.

Internal: This involved a closer look at the company’s financial statements and talking to employees in key functional areas.

The financial statement analysis indicated a trend of extended accounts receivable and inventory turns, and reliance on a line of credit to support accounts receivable and inventory growth patterns. An employee survey indicated a lack of understanding, by this group, of the company's mission, annual objectives and plans for future growth. Employees felt they did not receive sufficient support from the company in order to effectively perform their job and, to a large extent, felt that they were not recognized for their job performance by management.

The above review suggested that a sales incentive program that focused on sales growth alone without considering inventory and accounts receivable would require additional infusion of cash and may reduce already low margins. It also indicated that investments in two important areas within the organization would be necessary to support any likely gains from the incentive program. These areas were identified as Procurement and Sales.

Step 2-- Design of Sales Incentive Program

Based on this initial knowledge, the incentive program was designed in a manner that would involve the distributor owners/decision makers as well as their staff. The thrust of the program was on four dimensions - increasing the sales/purchase volumes of products, improving the invoice aging, providing the manufacturer with shipping date flexibility and increasing distributor knowledge and understanding of specific products to support sales objectives.

Rewards were based on points and the program had clearly defined and communicated rules for earning those points. Awards included Caribbean cruises and a number of high-end merchandise awards and sporting event ticket packages. Achieving the goals to attain the various awards was designed to be neither easy, nor impossible. The rules were centered on performance targets and involved the earning of points for the following activities:

- Sales Volumes (tiered—maximum 600 points if sales target was met)
- Accounts Receivable (tiered—maximum 300 points if paid within 45 days)
- Ship Dates (maximum 100 points if shipping was flexible)
- Distributor Staff Education (maximum 100 points)

The staff education rules were based on completing activities that would increase the staff's knowledge of the product attributes. To earn awards, a minimum of 1000 points were necessary. The incentive program was run during January–September 2003.

In addition, management was apprised of the need to make investments in seeking out long-term contracts with raw material suppliers. This would reduce production problems and avoid stock-outs at the distributors. Similarly, the management agreed to invest in an additional sales manager to streamline and help with distributor sales and service issues.

Analysis Variables

Since the incentive program was run during January–September 2003, historical data was assembled for the years 2000–2002 for the same time frame i.e., January–September. The following variables were considered for analysis:

- Monthly sales aggregated across the distributors
- Monthly Cost of Goods Sold (COGS)
- Finished Goods inventory at the end of each month
- Accounts Receivable at the end of each month
- Cost of the incentive program

Analysis and Results

The analysis proceeded in several stages. First, we established reasonable benchmarks for various indicators. In other words, we predicted how the situation would have been if the sales incentive program had not been employed. Based on a trend analysis and taking into account the economic and industry conditions, the subject firm had forecast sales of \$19,221,035 for the period January–September 2003. With this forecast in mind, we estimated the likely level of COGS for the same period. To accomplish this, a regression analysis was performed relating monthly COGS to monthly Sales based on 27 months of data (from January 2000 to September 2002). A linear and a non-linear model were fitted to the data and both produced good results. The linear model was chosen for simplicity and provided the following relationship:

$$\text{COGS} = 0.6907 * \text{SALES}$$

Predictions of Cost of Goods Sold

Based on this function, we predicted the Cost of Goods Sold for each month of the incentive program period (January to September 2003) which amounted to \$13,275,968. Since the SG&A expense was available only at the yearly level, the average value of SG&A as a percentage of sales during 2000–2002 (29%) was used as a basis to make a prediction for 2003.

This came to \$5,574,100 resulting in a projected net income of \$370,967. (See Appendix A for details). These estimates served as the benchmark for comparison since they represented the likely scenario that would have occurred if the incentive program had not been in place.

Examination of Actual Sales Levels

Next, we examined the actual sales level that was achieved during the incentive program (\$20,661,199). If the additional investments in Procurement and Sales had *not* been made, the COGS and SG&A expenses would have followed the same trajectory as described above. After projecting these numbers to the actual sales figure noted above, we see that the estimated net income would have been \$398,761. This yields an estimated incremental net income (comparing against the benchmark) of \$27,794. Figure 1 is a graphical representation of these projections. Notice that the cost of the incentive program (\$545,637) consists of two components – the sales part (\$347,223) and the non-sales part (\$198,414). As noted in Figure 1 (and further explained in Appendix A), our analysis concluded that if this program had been conducted with a focus on sales only, without regard for the costs associated with the sales increase, it would likely have resulted in negative outcomes for the company in terms of profit. Appendix A provides the calculations that were used to arrive at this conclusion.

The Cash Flow Impact

We then considered the impact of the incentive program on cash flow. For this purpose, a reasonable model that relates inventory (and accounts receivable) to sales is necessary. In Appendix B, we describe a simple model that captures the dynamics of this relationship. Stated in simple terms, inventory in a given month depends on the inventory in the previous month and the sales that happened during the current month (a similar model was used for accounts receivable). Data on inventory, accounts receivable and sales for 27 months (during January to September of 2000–2002) were employed to estimate the model parameters. Given the actual sales figures for each month and the actual starting inventory in January 2003, we used the inventory model to predict the likely inventory level in each month of the incentive program. Note that this exercise is an attempt to generate an inventory performance benchmark.

Expected Impact on Cash Flow

After predicting the likely inventory level for each month, we estimated the expected impact on cash flow. If the predicted level at the end of the month was higher than the starting level of inventory i.e., there was a projected increase in inventory from one month to the next that suggested a negative impact on cash flow. Similarly, a decrease in projected inventory over the course of one month implied a positive cash flow impact. When aggregated over the period January–September 2003, the total negative impact on cash flow (projected) was \$1,556,779 essentially driven by excess inventory levels projected for every month. By carrying out a similar exercise for accounts receivable, we estimated that the projected total cash flow impact of accounts receivable over the same period (January–September 2003) would have been a net negative effect of \$3,979,876 caused by the higher levels of accounts receivable that needed to be sustained every month. Thus, the total expected negative impact would have been \$5,546,655 which translates into a negative net cash flow of \$208,000 (at 5% annual interest).

Turning to the actual results --which involved incentives to manage inventory and accounts receivable, we noticed that both operational indicators were at lower levels in several months during the same period. Thus, the actual impact on cash flow was positive as shown in Figure 2 (\$177,820 for inventory and \$355,310 for accounts receivable over the same period). Including non-sales incentives therefore provided a net gain for the system of \$6,079,785 -- which translates into an estimated cash flow savings of \$227,992 for the period January–September 2003 (see Appendix B for details). Relating this to the non-sales incentive budget of \$198,414 we note that creating the positive cash flow impact produced an ROI of nearly 15%.

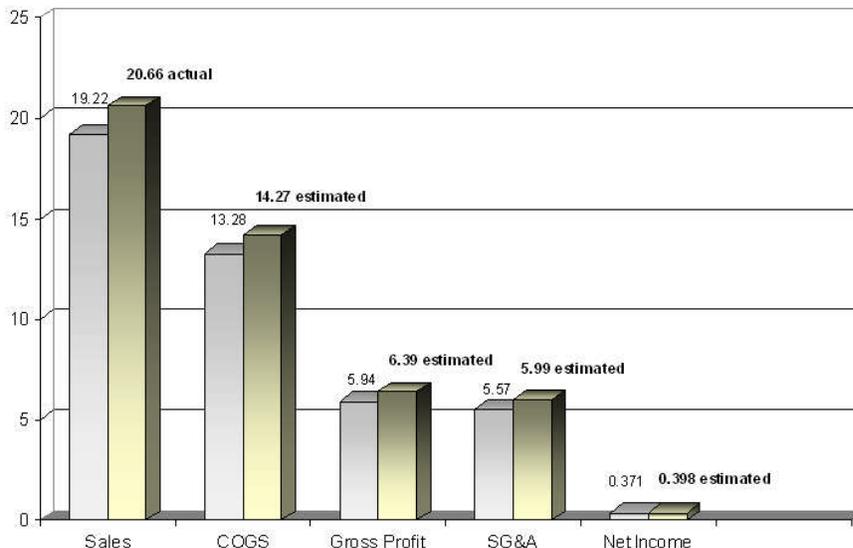
Overall Results

Looking at the actual results in terms of sales and net profit, we note that the incentive program generated a net incremental income of \$1,695,154 (see Figure 3). Observe that additional investments were made in Procurement amounting to \$360,000 and in Sales amounting to \$210,000. Thus, the net ROI for the incentive program by adopting a business process approach is approximately 84%. Appendix C offers details about the calculations.

Greater Effectiveness When Sales And Non-Sales Impact Are Explored

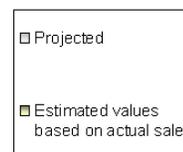
This research study demonstrated that sales incentive programs can be very effective in delivering positive results from the standpoint of bottom-line measures. However, the central thrust of the approach employed in this research suggests that a business process view can be an extremely important factor. The analysis, in this instance, clearly shows that simply plunging into a sales incentive program without any regard for the likely impact on other parts of the organization might be a naïve approach. Such a shortsighted view can generate serious and often unanticipated side effects for the business operation that may turn out to be detrimental in the long run.

A systematic process of designing and executing a sales incentive program would involve a careful study of different parts of the organization to assess the likely impact. This approach enables the planning and creation of the needed infrastructure and additional investments wherever necessary, to support the results arising from the sales incentive program.

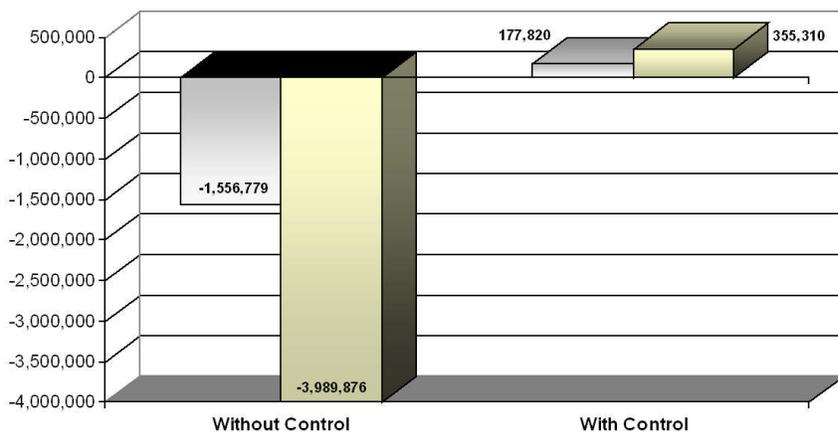


**Figure 1 --
Expected
Profitability
Based on Sales
Gain**

January – September 2003

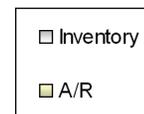


Net Cash Flow Impact = \$6,079,785
 Estimated Savings (at 5% interest for 9 months) = \$227,992
 Incentive Program Cost (allocated to non-sales objectives) = \$198,414
 Expected ROI = +15%



**Figure 2 Cash
Flow Impact**

January – September 2003



Note: Estimated COGS, Gross Profit, SG&A and Net Income values are based on projections from actual sales)
 Estimated incremental net income = \$27,794
 Incentive Program Cost (allocated to sales objectives) = \$347,223
 Expected ROI = -92%

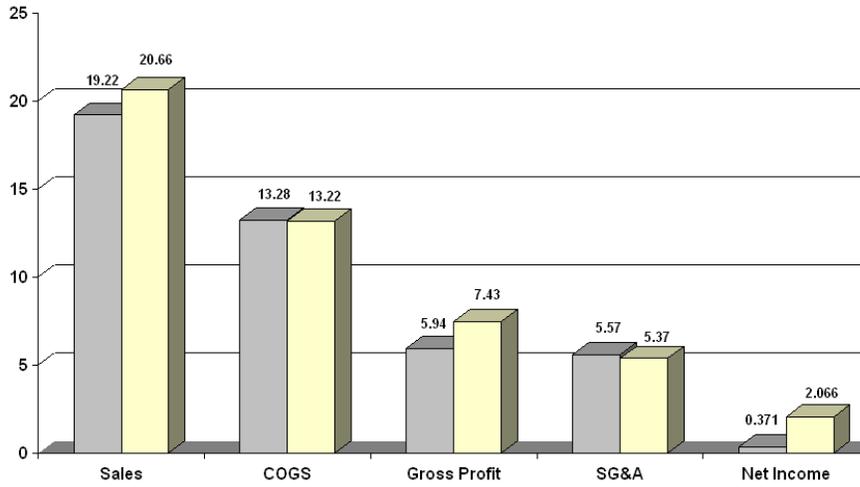
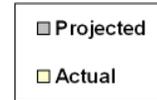


Figure 3
Profitability
Based on Sales
Gain and Cost
Control

January – September 2003



Note: COGS and SG&A are actual values)
 Estimated Incremental Net Income = \$1,695,154
 Incentive Program Cost Plus Investments = \$917,223
 ROI = +84.8%

Appendix A – The COGS Model

Methodology

Regression analysis was performed relating monthly COGS to monthly Sales (data from January 2000 to September 2002 i.e. 27 months). One linear and one non-linear model were fitted and both produced good results. The linear model was chosen for the sake of simplicity.

$$\text{COGS} = 0.6907 * \text{SALES}$$

Cost of Goods Sold Prediction

Using this function, the Cost of Goods Sold was predicted for all months of the incentive program period (January to September 2003).

Projected Sales 2003 (Jan-Sep)	\$19,221,035	Actual Sales	\$20,661,199
Predicted COGS (sales x 0.6907)	\$13,275,968		\$14,270,690
Predicted Gross profit	\$ 5,945,067		\$ 6,390,509
SG&A (sales x 0.29)	\$ 5,574,100		\$ 5,991,748
Estimated Net Income	\$ 370,967		\$ 398,762

Expected Incremental Net Income

$$\$398,761 - \$370,967 = \$27,794$$

Cost Of Incentive Program

\$545,637

Dealer Incentive Points

Dealer incentive points were split as follows:

- Sales 600 points
- Inventory 300 points
- Accounts Receivable 100 points
- Product Knowledge 100 points

Assumptions

We assumed that points gained from ‘Sales’ and ‘Product Knowledge’ categories are relevant for sales-related objectives i.e., 700 points out of 1100 are allocated for sales objectives. Thus, the incentive budget for sales objectives is $\$545,637 * (7/11) = \$347,223$.

The expected ROI for the incentive program is $(27,794 - 347,223) / 347,223 = -92\%$

Appendix B – The Inventory & Accounts Receivable Models

Methodology—The Inventory Model

Inventory data for each month in 2000 to 2002 (January to September) was used to estimate a linear regression model as follows:

$$\text{Inv (t)} = \alpha \text{ Inv (t-1)} + \beta \text{ Sales (t)}$$

The model gives reasonable statistical results with $\alpha=0.7503$ ($p<.05$) and $\beta=0.3827$ (n.s.)

Using these parameters, we predicted what the inventory levels would have been in every month of the incentive program that covered the period January–September 2003. We then computed the estimated total cash flow impact of these inventory levels over this time period that amounted to - \$1,556,779 (negative impact).

Looking at actual inventory levels, which were lower, the cash flow impact over the time period January–September 2003 was \$177,820 (positive impact).

Methodology -- The Accounts Receivable Model

A/R data for each month in 2000 to 2002 (January to September) was used to estimate a linear regression model as follows:

$$\text{AR (t)} = \theta \text{ AR (t-1)} + \delta \text{ Sales (t)}$$

The parameter estimates are $\theta=0.505$ ($p<.10$) and $\delta=0.6095$ ($p<.10$).

We predicted what the A/R levels would have been in every month of the incentive program covering the period January–September 2003. We then computed the estimated cash flow impact of these A/R levels, which amounted to -\$3,989,876 (negative impact).

Based on the actual A/R levels, the cash flow impact over the time period January–September 2003 was \$355,310 (positive impact).

Data Analysis

So, without using incentives for Inventory and A/R reduction, we would have seen a total negative impact on cash flow of $1,556,779 + 3,989,876 = \$5,546,655$. Assuming a 5% rate of interest, this amounts to \$208,000 (over January-September 2003).

The incentive budget for the non-sales objectives (Inventory and AR) was $545,637 * (4/11) = \$198,414$.

The estimated gain for the system was $(1,556,779 + 177,820) + (3,989,876 + 355,310) = 1,734,599 + 4,345,186 = \$6,079,785$. At 5% annual interest, the estimated savings are \$227,992 (over January-September 2003).

Thus, the ROI from placing inventory management and accounts receivable on the incentive program is $(227,992 - 198,414) / 198,414 = 15\%$.

Appendix C – Actual Operating Results For Incentive Program Period

Incremental Net Income

Actual Sales (Jan-Sep 2003)	\$20,661,199
Actual COGS	\$13,223,167
Actual Gross profit	\$ 7,438,032
SG&A	\$ 5,371,911
Net income	\$ 2,066,121

Thus, incremental net income = 2,066,121 – 370,967 = \$1,695,154

Additional Investments

- To reduce COGS by signing exclusive contracts for raw material procurement = \$250,000 + \$50,000 + \$60,000 = \$360,000
- To ensure better dealer service (to handle higher anticipated sales) and by appointing another sales representative = \$150,000 + \$60,000 = \$210,000

Total additional investment = \$570,000

Cost of incentive program plus additional investments = \$347,223 + \$570,000 = \$917,223

ROI = (1,695,154 – 917,223) / 917,223 = 84.8%

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