

# How Much Is Your Advertising Agency Worth To You?

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## ABSTRACT

*The subject of advertising remuneration has always been a controversial subject despite the advertising industry coexisting with other industries for over a century. Both clients and agencies have different views on the subject depending on their objectives. Business needs however, have compelled both, to call a truce to these altercations, since both cannot exist without the other, especially the agencies. This paper examines the various options of remuneration prevalent in the industry, how these have evolved as time has elapsed and how clients and agencies have adapted to it over time. It critically examines the motivations and conflicts arising in the evolution of a suitable remuneration system and the means of resolution available to both parties for amicable settlement.*

## INTRODUCTION

Most self-respecting companies have often tormented themselves with this vexing issue of remunerating their advertising agency fairly. Often it is a tug-of-war between the agency and the client, with the odds favouring, whoever needs the other more. The issue gets further vitiated given that the output is most often very subjective, is open to multiple view points and very often gets determined by the authority which controls the purse strings. Should the agency be paid on the quantum of work done, or on the output? Should it be on the results of the campaign in the market or on the ability to communicate effectively to the market and consumers? These are the questions which clients have long been burdened with and are still groping for satisfactory answers. While clients wax eloquent on the virtues of a product or service, there seems to be very little acknowledgement to the agency, when the campaign is responsible for bringing in great topline numbers or increased appreciation owing to improved brand equity . On the other hand, there seems to be severe blood-letting, when a campaign goes under and most flak is drawn by the agency, never mind the fact, that every piece of paper responsible for the campaign had the blessing of the client before it saw the light of the day. This article attempts to examine the cantankerous issues of agency remuneration from both sides – the agency and the client.

Clients would like to be sure they are getting value for their money. Agencies would like to remain profitable and viable. Since there is an inherent conflict between the objectives of both parties, it is not surprising that remuneration and compensation is the primary area where the advertiser and the agency are at odds at most times. In a 1995 study by the U.S. Association of National Advertisers (ANA) ‘Trends in Agency Compensation’ when reviewing trends in agency compensation, advertisers’ concerns ranged from the mechanics and procedures of agency compensation in the late 1980’s, to the quality and stability of the client-agency relationship in 1992, and finally to promoting the business health of the advertiser by motivating the agency to perform to its potential, reflecting on the company results, in 1995. Therefore, the issue is - what is a ‘fair’ remuneration? The ANA and the European Association of Advertising Agencies (EAAA) have deliberated and arrived at a consensus that a 15%-25% operating profit is ‘fair agency profitability’. This translates to 2%-4% of billings on media and production and is comparable to other service businesses such as lawyers, contractors and chartered accountants (ICA, 2005).

## **INDUSTRY REMUNERATION PRACTICES**

Three basic approaches to remunerations has been practiced by clients so far – commission, fee and payment-by-results (PBR). Each of these methods we shall discuss in detail. Although the last method is ideally liked by clients since it gives a direct linkage of the advertising input to the end result, most likely profits or market share or brand sales, in actual practice it is very difficult to implement such a system. Since advertising is not the only input that goes to produce the end result, isolating the effects of advertising and measuring its contribution to the end result, can be only a conceptual discussion and hotly challenged by those that do not have a charitable view for advertising's contribution to corporate performance. Agencies, used to the commission system for so long, are now rudely being asked to be more accountable and are just about adjusting to a fee-based system. To ask for a PBR system is like the proverbial last straw on the camel's back. Fortunately for agencies, since implementation is so difficult, the idea has still not caught on in a big way by advertisers, although many clients insist on an element of PBR in some way or the other, in current agency agreements (Lauterborn, 1992; Lace, 1998). In a major study in the UK, over 20% of all advertising agreements included an element of PBR with an additional 10% of clients expressing an interest in including PBR into their agreements in the future (Lace, 1999).

### **THE COMMISSION SYSTEM**

The business of remunerating agencies dates back to the nineteenth century when advertising agencies merely used to hawk media space for which they used to be paid a commission from the media owners from the above-the-line (ATL) payments made to them by the advertisers – the ubiquitous 15% (Briggs, 1998). Till date it remains a secret, why this figure was exactly that, nothing more, nothing less, except perhaps it was thought to be a reasonable recompense for the efforts made by the ad agency for the advertisement to reach the media vehicle. Media commission as expressed by the Indian Newspaper Society (INS) was meant to be compensation from media owners to agencies, for placement, coordination collection and timely payment. But as the advertising industry evolved, this was used as a norm to charge for other below-the-line (BTL) work done by agencies, as a cost plus 15% for billing purposes. With competition and tougher business conditions, all these extra costs got merged into the commission paid to agencies by media owners.

Over the last twenty five years, the agency structures have undergone major changes. Media buying and planning, originally part of the 'full service' agency, are now no more an integral part of most advertising agencies. With the rising complexities and imponderables in the media business, this part of the business has really transformed itself into an independent entity requiring specialized expertise and knowledge of media and its potential (Jacobs, 1995). Advertisers acknowledging the superior expertise available with media independents have hived off substantial media business into the hands of these media shops, thereby squeezing the earnings of the advertising agency, which progressively depend on their creative and strategic expertise to compensate for this substantial loss in revenues from media (Rainey, 1997). With the induction of the Agency-of-Record (AOR), it further chipped off 2.5 %, leaving 12.5 % for the agency which included all costs (Subramaniam, 2002).

The commission system is an arbitrary one. It rewards the agencies handling successful brands and penalizes agencies handling fledgling brands. Successful brands tend to have larger advertising spends compared to not so successful brands where often it can lead to reduced expenditure thus reducing agency income (Best, 1991). However, it does not recognize that successful brands need not necessarily require large budgets just as fledgling brands, many times need a higher dose of advertising to get it going (Broadbent, 1989). Brand managers already hard pressed for resources, are under greater scrutiny for their marketing expenditures with the time horizon, shrinking to the next quarter's results. To beef up revenues, a much greater proportion of the marketing budget is going away to non-advertising expenditures and therefore that much less for advertising. Brand managers of such big brands suspect that agencies divert their best people from their accounts to other more lucrative accounts, whereas smaller clients think that the agency's best brains are allocated to the bigger spending clients. Sheer competition compels agencies to cut commissions thereby affecting profitability and in turn affecting their ability to retain and hire talent. With a plethora of options available to the advertiser, most agencies have very little choice, but yield to the advertiser's dictates.

The commission system of agency remuneration does not do justice to either client or agency. It defies logic. Why 15%? Why not 20% or 10%? What about quality versus quantity? Is the same effort required for repetitive assignments? Perhaps a whole lot of other questions could be added to this. Agencies have almost always found it extremely difficult to justify their remuneration on a straight commission basis.

## **THE FEE SYSTEM**

Precisely, for this reason, most advertisers have always advocated a fee for the advertising assignment, which is a lump sum figure decided mutually by the agency and the client depending on the nature of the assignment and the duration. Not, that this does not pose a problem. The nature of the advertising business being such, imputing values to various advertising tasks and then deciding on a fee to compensate fairly for the efforts taken can prove to be a highly complex and time taking chore and is open to question because of the subjective nature of the assignment. How does one value the work of the creative department? What is the price of an advertising copy? Should there be a charge on only the final copy or all the options that went before and were trashed, before the final one was selected? Many agency heads have had to deal with their furious creative heads, when in one stroke, the client rejects weeks of painstaking effort by the creative department or worse, probably insists on inserting an element into the campaign which has been summarily rejected by the creative department because it was felt inappropriate to the brand or the context. It is at such times that agency heads have had to toe a very fine line in keeping the client happy and prevent a major mutiny in the agency.

Both agency and client have a lot to gain since they stand on surer ground and each party is aware of the value to be ascertained for each activity taken up by the agency. The system is similar to a retainerhip given to a law firm or a consultant, possibly on a monthly or a fixed time period basis. The fee could be calculated based on the time spent on the brand by the agency, the resources employed, the output generated, or a combination of all these factors. No doubt, pricing each activity and coming to a consensus on the value of an activity can be time consuming and complex, but administration becomes that much easier. The agency can plan and commit its resources since it knows exactly how much each activity is going to earn for the agency. Similarly the client can project profitability much more accurately since it has already bounded such expenditures which cannot exceed the limit and knows exactly what it is going to receive from the agency in return. It encourages productivity and performance and good agencies, which are surer about their performance, are encouraged to adopt this system, especially when there is substantial non-media work, as against mediocre agencies, which might feel more comfortable in a commission system.

Though many agencies realize the benefits of the fee-based system, yet the prevalence of this system is still not very popular. Mainline advertising continues to be primarily commission based, whereas most BTL assignments are fee-based. Smaller agencies seem to favour this system since they are at most times disadvantageously placed to bag the bigger media assignments, which go on commission basis. This way, at least they would know exactly where they stand and accordingly control their costs and allocate their sparse resources wisely. It absolves the agency from the criticism of arbitrary high media spends to increase their earnings. Clients feel comfortable that in some way they are able to control their advertising expenditures since it is limited to the fee and some even misconstrue this as a discounted form of the commission system.

The evolution of Integrated Marketing Communications (IMC) further necessitated the agencies to have a strategic perspective on the communications requirement and devise a total communications strategy to cater to all the clients' requirements- especially in international and multinational environments. Much of the motivation to be involved in such exercises stem from the fact that the absence of any expertise not available with the agency means, that much loss of revenue going to smaller or niche agencies. For others, it means regaining status as primary strategic counselors to top advertisers, a position they found yielding to management consultants and investment bankers, of late. If this were true, definitely the elements of the IMC programme would not be conducive to a commission system and a much more objective assessment has to be done to remunerate such activity. By insisting or persisting with a commission system, the client runs the risk of the agency advocating a strategy partial to media usage where it stands to maximize commission earnings, as against a more unbiased strategy that looks into the needs of the client instead of focusing on the agency's earnings.

## **PAYMENT BY RESULTS (PBR)**

PBR is an incentive based agency evaluation and remuneration system that links agency remuneration to mutually agreed performance standards. It is used to describe a service relationship in which some part of any associated remuneration is contingent on results or other performance assessment measured against predetermined criteria. It has strong parallels to the Management by Objectives (MBO) approach in terms of principles, implementation, mutual objective setting and measurement criteria.

It was born out of the dissatisfaction expressed by agencies and clients over the current remuneration practices. Clients were concerned that the present remuneration practices (commissions) discourage agencies to use non-traditional media and Direct Marketing (DM) in a bid to increase their billings and margins. The fee system does not encourage innovation and creativity since the agency already knows whatever the outcome the reward is certain. Agencies, however, have always felt that existing remuneration practices do not adequately compensate them for successful campaign that vastly impact company sales and profitability, especially when it is extended around the globe with suitable adjustments. There was no incentive for success.

It was first reported in the 1980s and is now finding favour with many clients who would like to be more objective and demand accountability from their agencies. P&G, Bell and Labatt were some of the pioneers who have tried out PBR with their agencies and been immensely successful. While it encourages performance from both agency and client, it also strengthens advertising product and service deliverables. Contrary to popular thinking, research in Canada and UK has proved that PBR users actually report incidence of higher remuneration to their agencies than reductions.

Some of the important benefits of PBR are:

- *Improved agency performance.* Agencies are motivated to achieve mutually set goals to earn the incentive promised on successful achievement
- *Improved client performance.* Clients are specific and focused in their briefings to the agency and work towards their marketing goals, giving better attention to agencies and helping them achieve their goals.
- *Goal congruence.* Both parties work towards common goals, instead of the ‘you versus me’ syndrome dominating. Partnering, rather than principal-supplier relationship exists.

PBR can take several forms with varying degrees of reward/risk built into the remuneration system. Essentially there are five forms of PBR.

- *Bonus.* It protects the current level of earnings and an incentive is built in for defined superior performance by the agency. There is no downside risk for both agency and client, but each participates in the rewards of superior performance or endures the opportunity cost of failure to meet established targets.
- *Cost Recovery.* All the agency costs are recovered, but margins are dependent on performance. This has the inherent problem of clients having to ascertain all agency costs, before agreeing to reimburse them. Similarly, agencies in their effort to eke out margins may allocate far lesser resources than what is required to do justice to the assignment.
- *Shared Risk and Reward.* The agency and the client put forward matching stakes into the PBR performance pool. The agency stands to lose all or part of its margin against the potential of an equal bonus reward. Here clients balk at the prospect of accelerated payments to the agency, especially when the agency to improve its margins, cuts staff and resources to barest minimum affecting performance and results.
- *Earn Back.* The agency revenue is reduced by some factor with the potential for the agency to earn back the revenue and profit through superior performance. Typically, these are used by fledgling agencies, which are hard up for business and yield to such demands of clients. It can be extremely risky for the agency and the client.
- *Combination.* This combines the Bonus and the ‘Earn Back’ approaches. Agency revenue is reduced by some factor with an attractive carrot dangling for the agency, subject to achievement of business objectives, agency performance and advertising objectives.

PBR is not for everyone. There needs to be a high level of transparency and trust by either party. There must be protection against plan changes like reduced spending or postponement of marketing activity, necessitating revisit of the PBR terms. The scope for PBR schemes is more with large advertisers since the potential for showing good performance is higher. It can be a do-or-die situation for an agency with a substantial downside risk. Measuring performance is vital to PBR success. Objective methods to measure agency performance, therefore, need to be identified before PBR schemes can be implemented. The quality and strength of the agency-client relationship can be severely tested in this system.

## **ADVERTISING BUDGETING AND REMUNERATION**

There is a very significant connect between budget setting techniques and remuneration methods adopted. Sophisticated methods of remuneration are more likely to be adopted by brands with large budgets, especially in FMCG, durables and automotive industries. Improved performance appears to be associated with advertisers using data orientated approaches to remuneration and budgets (Hooley and Lynch, 1985). The effort has always been to be as objective as possible to compute the efforts of advertising in corporate performance and link it to remuneration. Wherever more sophistication is introduced in remunerating agencies, almost always, it constitutes a part of the overall advertising budget setting process.

Budget setting, remuneration and accountability are inextricably linked. With marketing heads being more accountable for all advertising expenditures, clients and agencies are under pressure to demonstrate the effectiveness and value of advertising investments. The increased use of PBR is a direct reflection of this trend. Advertisers have roped in the agency as a partner in the marketing process right till the end. Sales have increased, budgets are bigger, while cuts in staff strength (notwithstanding, the quick turnover in marketing staff) has led to more accountability for advertising spends in the near term. In many cases clients had no other alternative but to shift the advertising accountability to the agency.

## **CONCLUSION**

Obviously, there is no clear cut answer to this knotty issue. Every advertiser must find their own solution to this problem, as to which method serves their needs best. Similarly agencies, need to know their strengths and weaknesses and their ability to deliver results.

Whichever system is chosen, it must be one that incorporates the following elements:

- It must provide adequate professional services to the client.
- It must fairly compensate the agency for its work.
- It must provide an incentive to both advertiser and the agency.
- It must be simple to operate.
- It must be reviewed periodically.

The tussle between the commission and the fee systems is not going to be over in a hurry. Agencies, almost always would prefer the commission system, whereas clients, by and large, would favour the fee system. Only fixing the fee would continue to remain a nightmare. An obvious compromise for this is PBR, which gives an opportunity to both client and agency to work together towards a common goal and each benefiting, the client in meeting its marketing goals and the agency in being rewarded, adequately and fairly, depending on performance.

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**NOTES**