WHY AGENCY COMPENSATION IS
BROKEN

(And, what core issues are being ignored)

Ad Age: "Fix Agency Compensation"

IN THE FOURTH QUARTER OF 2012, *AD AGE* WROTE A COVER STORY ENTITLED, "2017 THE NEXT FIVE YEARS: HOW DO WE GET FROM HERE TO THERE"

This futuristic article has specific recommendations on what should be on marketers' 5-year plan. While it included many items that you might expect like data-driven TV, proliferation of mobile marketing and a greater focus on measurement, Ad Age also suggested that it is high time to "fix agency compensation."

You might be asking yourself; I did not know it was broken? Or, are asking how an item like agency compensation made it to this list of notable marketing activities for the next 5 years.

It seems like everyone ~ both clients and agencies alike ~ love to complain passionately about agency compensation. At the same time, most marketing and procurement pros do not understand the core problems and issues that are at the root of their discontent, nor do they know how to go about fixing them. As one Procurement Manager stated, "It is a specialized area with many moving parts for even a seasoned procurement professional to fully understand."

As a former agency CEO of two top-ten agencies, and now a consultant specializing in agency compensation, I see the problem magnifying and the level of trust in the client/agency relationship deteriorating even further. While both agencies and clients can improve, the onus needs to be put on the agencies themselves if they want better and more long-term relationships.

7 CORE ISSUES

1. Lack Of Agency Transparency
2. Intentionally Inflating Overhead Costs
3. No Clear Understanding Of What Is To Be Done
4. Paying Based On Time Encourages Inefficiency & Waste
5. Agency Performance Is Not Tied To Agency Profits
6. Frightened Of Metrics
7. Agency Bonuses Don't Work

7 Core Issues & Solutions

#1 Lack Of Agency Transparency

It's time for agencies to stop fighting, manipulating & in some cases falsifying salary and cost data.

In the good old days when compensation was based on commission, transparency was not an issue. Agencies simply purchased the media, marked it up 15% (17.65% for production) and passed through all net costs directly to the client with supporting attachments. But, with the influx of fees and more specifically, the wildly popular cost-plus contracts, agencies were forced to supply reliable cost information. Agencies resented this request, while procurement kept pushing and asking for specific cost data. Agencies, feeling this encroachment into their business practices, began manipulating the information or even worse providing inaccurate cost data to overstate costs. I have seen this first hand and continue to see it used by many leading agencies today. **SOLUTION**: It is time for agencies to stop fighting, manipulating and in some cases falsifying salary and cost data. Instead, they need to begin a truly open book policy if they want (need) to pass on all legitimate costs to their clients. This open book policy can, and should, remain confidential. It should not include named salary information, but should be "audit worthy" so that the agency is contractually obligated to provide full transparency.

#2 Intentionally Inflating Overhead Costs

Time is a measuring stick, but it should not be unlimited or an open checkbook for agencies.

Over 80% of today's agency compensation arrangements are cost-plus, meaning agency salary and overhead costs (rates) are calculated before adding an agency guaranteed profit margin. Agencies determine this overhead rate by including all agency costs, but salaries. These overhead costs can run the gamut between 80¢ and a $1.50 "on top" of every dollar spent on labor (salary) for people working on the client's business. That is a lot of money and a wide variation that is primarily driven by the size of the agency, the location of the agency, and whether the agency is part of a holding group. Historically, this has been an area where agencies "hide" profits by inflating costs. Further, certain overhead items should not be passed on to clients. We have seen agencies try to include items like new business expenses, senior management perks and club memberships and even in-house activities that provide no real value to the clients, which therefore, should not be part of the overhead rate. **SOLUTION**: If clients are to pay for overhead costs (which they will one way or another), a specific list of overhead costs needs to be provided. The agency should go one step further and both document and specify what is NOT included so that there is no question as to whether or not the agency has the right to pass on specific costs. This can generate further discussion as to what the client is willing to pay for, and puts the responsibility on the agency to defend the specifics within the overhead rate.

#3 No Clear Understanding Of What Is To Be Done

Too many times when agencies are hired, promises are made with the best intentions. But, the promises are about staffing, process, and creative work. However, why the agency is being hired and what is expected of them in terms of measurable business results are overlooked, or not clearly articulated by the client. **SOLUTION:** The client needs to be clear by spelling out, in quantitative terms, what results are expected and within what specified time frame. This explanation needs to outline what success and failure looks like for both the client and agency. These business objectives must be both "fair and shared" meaning that client and agency alike are judged by the same metrics. The agency can then decide, before committing to the client, if the business results being asked for (or which are required) are realistic and achievable. And, to walk away if they do not believe they can do what the client is asking them to achieve.

7 Core Issues & Solutions

#4 Paying Based On Time Encourages Inefficiency & Waste

Like lawyers, accountants and architects, agencies have knowledge to sell, however, they bill it as "time". The longer it takes to complete a task, the higher the costs. The more people doubled up (multiple creative and account teams) on the client's business to explore and create recommendations also increases costs. And, if the agency goes beyond the assignment to generate multiple ideas or to make unnecessary changes to a piece of creative, the costs increase as well. Recently, one of our clients explained to us that they requested a simple one-sentence copy change. The agency went back and redid the entire print ad because they felt that the client's request changed the core idea. The client felt otherwise and saw this as an inefficient and wasteful use of agency resources (which they were paying for). Our data shows that agencies overstaff by as much as 28% for the requested client assignments. **SOLUTION**: While time is the measuring stick for each assignment, it should not be unlimited or considered an open checkbook where, at the agency's discretion, extra time is added because they cannot crack the assignment or are purposely driving up the fees. Clients and agencies need to develop, debate and agree on a detailed Scope of Work (SOW) for the year. Based on this SOW, the agency and client should then agree on a fixed dollar amount for each SOW assignment. This fixed amount needs to take into account the complexity, estimated rework rate, and creative rounds to complete the assignment from start to finish. This fixed dollar amount will set clear parameters and encourage the agency to provide the solution without being wasteful or inefficient. It has another benefit as well, and something agencies love to complain about all the time. Namely, the constant tracking of hours and FTEs assigned to specific accounts.

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#5 Agency Performance Is Not Tied To Agency Profits

No one hires an agency to maintain the status quo. In most cases, you hire an agency to sell stuff. This is why David Ogilvy used the phase, "We Sell or Else." So, if that is what agencies are hired to do, why is it not fair to pay the agency their entire profit margin when those goals are achieved, but not when they fall short? But, the majority of clients today are guaranteeing agency profits of between 15 and 20 percent regardless if the agency recommendations are successful or not. This "no risk profit guarantee" allows for agencies to take on assignments even when they don't believe the results expected are needed, realistic and/or achievable. They simply go on to recommend work for which they are not accountable for in the marketplace, but still get their profits. It seems easier to fire the agency, than it is to say to the agency, "I want you to be as accountable as I am and be my partner by earning all your profits." **SOLUTION**: Stop the agency revolving door and give the agency clear performance targets by tying those targets to agency profit mark-ups. This makes the agency earn their keep and justifies (or not) their continued representation.

#6 Frightened Of Metrics

We hear from both clients and agencies way too often, "How can the agency be judged and rewarded when they do not have full control?" Guess what? The world is not perfect and no one has full control over achieving or not achieving specific brand targets. Agencies are part of a team, where each member contributes in their own unique way towards success. This "I can't be held accountable attitude" is simply a non-starter and is used by agencies to continue in a world where their recommendations are not tied to anything tangible. And, clients who are afraid of approaching their agencies are leaving money on the table because they are not disciplined enough to be clear and fair as it relates to agency performance. **SOLUTION**: The way to avoid fear is by approaching it head-on. Tell the agency what is expected, what the brand needs and how they will earn their profits. Their point of view on the metrics and performance targets is extremely important and should not be a cliff metric where it is all or nothing. Most good agencies believe in themselves and know they can increase brand value. If the client has set the bar too high and the agencies' entire profits are tied to that goal, then this is when a valuable conversation and resolution should take place. The client should want a fully committed agency that understands the risks and rewards and puts all, not some, of their profits on the line ~ the same way clients do every single day.

Clients who are afraid of approaching their agencies are leaving money on the table.

7 Core Issues & Solutions

#7 Agency Bonuses Don't Work

Only 3% of all agency holding group revenues come from bonuses ~ too small to matter.

According to the Association of National Advertisers (ANA), 49% of U.S. marketers offer their agencies some type of bonus. Yet, only 3% of all agency holding group revenues come from these bonuses. Here, is what clients need to know ~ they don't work. Why? Because they are too small to change agency behavior and rarely filter down to the people who work directly on the client's business. The agency (or the agency CEO) never planned for this bonus income and view this extra money as simply a gift or a prize. Therefore, bonuses have no impact on the overall agency performance that it was meant to reward. As one agency CEO said to me, "It is typically too small to make a real difference, so I only bank on what is built into the agreement."

SOLUTION: Why should the client give away money when it has no impact on their business? Clients need to change their mindset away from "bonus" to "earned incentives." How? First, by paying agencies their profits only when goals are achieved. Second, by allowing the agency to have a real chance to exceed the normal 15-20% profit margins when they help the client generate real incremental brand revenue, which in-turn pays for the extra agency profit. Clients also need to encourage the agency to formalize these earned incentives and to direct them to the people who help achieve the stated brand goals and objectives. This puts money in the hands of the people who have the greatest potential to impact the client's business vs. senior agency management who occasionally show up at the annual planning meeting.

CONCLUSION: Agencies and clients love to use the phrase "our marketing partners." In most cases, this simply is not true, and over time, client/agency relationships are turning into the classic vendor description even though both parties do not want to admit it. Many of the seven problems outlined above have lessened the trust and confidence between the client and their agencies. The average agency tenure is down to three years compared with eight years 15 years ago. In the past, agency partnerships used to be about long-term friendships and club memberships. Today's fast moving and results-oriented business environment requires more purposeful relationships that are accountable, measurable and honest. Agency compensation, as *Ad Age* points out, is broken, but clients need to embrace new models and try new performance-driven processes without worrying about their agency's reaction. Agencies, on the other hand, need to be full-fledged partners and truly believe in what they can contribute to the brand and be judged accordingly. By fixing these seven areas, both parties can be full-fledged partners once again. In the process, clients will save money on base fees while justifying every dollar spent, and agencies will show why they deserve the fees they are demanding.

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