AAAA Bulletin
American Association of Advertising Agencies

*To primary contacts, chief financial officers, client service directors, new business directors, presidents, relevant committees and foreign advertising associations.*

**Date: December 3, 2002**

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# "GUIDELINES FOR COMPENSATION AGREEMENTS"
## —New AAAA/ANA Position Paper—

Enclosed is your copy of a new position paper, *Guidelines for Effective Advertiser/Agency Compensation Agreements*.

Released by the American Association of Advertising Agencies and the Association of National Advertisers, Inc., the document outlines for the first time ever a set of jointly endorsed guidelines covering compensation agreements between agencies and clients.

*Guidelines for Effective Advertiser/Agency Compensation Agreements* is divided into two sections: "Guiding Principles" and "Best and Worst Practices." It was produced over the past year by a joint ANA/AAAA task force formed in 2001.

The "Guiding Principles" establish a dozen points that the joint task force agreed are found in the most effective compensation agreements. Among others, the guidelines state that the best compensation programs:

- Align advertiser and agency interests and priorities
- Match compensation with the resources required to do the work
- Establish agreement on key compensation definitions and terms up front
- Do not favor one solution/service over another
- Are finalized before agency resources are committed.

The "Best & Worst Practices" section of the position paper provides a wide selection of suggestions and recommendations covering the gamut of current compensation formats. These include fees (fixed, hourly and cost-plus); commission agreements; and incentive compensation deals.

Additional copies of *Guidelines for Effective Advertiser/Agency Compensation Agreements* can be ordered by using the attached order form or by calling AAAA Publications at 212-850-0777. There is no charge for the *Guidelines*.

*O. Burtch Drake*
*President-CEO*

The Chrysler Building
405 Lexington Avenue • New York, NY 10174-1801 • *www.aaaa.org*
(212) 682-2500 • Fax (212) 682-8391

# GUIDELINES FOR EFFECTIVE ADVERTISER/AGENCY COMPENSATION AGREEMENTS

A joint position paper from the
American Association of Advertising Agencies
and the Association of National Advertisers, Inc.

American Association of Advertising Agencies
www.aaaa.org

Association of National Advertisers, Inc.
www.ana.net

# GUIDELINES FOR EFFECTIVE ADVERTISER/AGENCY COMPENSATION AGREEMENTS

A joint position paper from the
American Association of Advertising Agencies
and the Association of National Advertisers, Inc.

***Adopted by the AAAA and ANA Boards of Directors, November 2002***

AAAA
American Association of Advertising Agencies
www.aaaa.org

ANA
Association of National Advertisers, Inc.
www.ana.net

This Position Paper was produced by a joint task force formed in 2001 by the American Association of Advertising Agencies and the Association of National Advertisers, Inc.

The purpose of the task force was to identify and recommend principles inherent in effective agency compensation arrangements and to showcase best practices in agency compensation.

Compensation amounts and methodologies are essential parts of every advertiser-agency relationship, and clarifying the issues involved in agency compensation has become increasingly important.

The ANA and AAAA acknowledge the complexity of today's diverse advertising agency compensation arrangements and the need for all compensation terms to be fully understood by all involved in the process. They also recognize that different advertiser and agency practices affect the structuring of compensation arrangements.

This document, while not recommending one compensation method above another, supports guiding principles and best practices to be considered when developing an effective compensation arrangement.

# GUIDING PRINCIPLES

*The Best Compensation Programs:*

- **Are simple to understand and easy to administer**

Advertisers hire agencies to help create and execute business building advertising ideas and marketing programs. All the supporting processes–including agency compensation–need to be geared towards that goal. Accordingly, it's imperative that a compensation program be simple and clear enough for all involved to understand and execute.

On the flip side, a complex and poorly understood program may cause too much attention and energy to be diverted to administration and conflict resolution. These efforts do not aid in the developing of great advertising or marketing ideas.

Too much time spent debating the compensation arrangement can impair results and hurt the relationship.

- **Align advertiser and agency interests and priorities**

If the agency and advertiser are to achieve superior results and have an outstanding working relationship, it is important that the compensation system be designed to align the advertiser's priorities and interests with the success of the agency.

Compensation arrangements should be carefully constructed so that the rewards provided by the program fully support the priorities and intent of the advertiser and are not in conflict with them. For example, if it is the advertiser's priority to build awareness of a new product, promote trial of a new product, or increase store traffic, the compensation program should be designed to encourage agency actions that promote those specific goals.

Both parties should feel like they are working toward a common goal.

- **Match compensation with the resources required to do the work**

A thorough understanding of the assignment is critical in order for the agency to allocate appropriate resources. A review of the advertiser's detailed scope of work and the agency's projected staffing should be a two-way conversation, with both the agency and the advertiser providing a point of view.

Advertisers should provide as a backdrop their relevant experiences from prior assignments or with other agencies. However, the agency remains the best ultimate judge of the resource pool.

Agency compensation should be reflective of the talent assigned. Once the staffing levels for both number of heads and degree of expertise are agreed upon, a compensation agreement should be the logical outflow.

Periodic staffing and performance reviews, preferably at least once within the first six months of an assignment, will fine tune staff time requirements and staffing mix.

- **Are fair to both advertiser and agency**

An advertiser should expect to pay and an agency should earn fair compensation, including a fair and competitive profit.

A frank, open and up-front discussion of both advertiser and agency compensation expectations, including profit expectations and value to be delivered, is important to avoiding contentious misunderstandings of what is needed from both sides.

A mutual understanding of the vernacular employed in individual compensation arrangements generally makes for longer, more enduring compensation agreements.

- **Establish clear goals and objectives up front**

The advertiser and agency should determine and prioritize critical short-term and longer-term objectives, and since no two marketing assignments are the same, there is a broad range of possible objectives that could come into consideration.

Once marketing program objectives are set, the agency and advertiser can hopefully establish clearly defined, measurable, appropriate goals. These goals should be a byproduct of both the advertiser's business plan and agreed upon marketing priorities.

The same rigorous planning process that is used to establish objectives and goals for marketing plan elements should be applied to the advertising agency compensation arrangement.

The objectives of the compensation plan should be carefully constructed early in the process. Once again, there is a range of considerations. These include compensation philosophy; scope of services; consistency, quality, depth and diversity of staff; cost; administrative expectations; and agency profitability considerations.

- **Establish agreement on key compensation definitions and terms up front**

Take the time to establish a joint understanding of important compensation terms and conditions as they apply to your particular compensation agreement.

Agency CFOs and their advertiser counterparts should employ the same words and phrases when discussing agency compensation arrangements (these include fixed fees, labor based arrangements, adjustable fees, hourly rates, full time equivalents, multipliers, markups, margins, direct costs, etc.). But the meaning of these words and phrases often vary among their users. Care should be exercised to assure that everyone is on the same page.

- **Do not favor one solution/service over another**

Strategies and solutions recommended by agencies should focus on achieving advertiser goals and objectives without regard to the impact of its recommendations on agency compensation. Accordingly, compensation arrangements should be designed so that an advertising agency is neither rewarded nor penalized when recommending a particular solution to the advertiser's brief.

- **Are finalized before agency resources are committed**

Time is forever being compressed and there is an urgency to get things done. Assuming there is concurrence on the need to match compensation and resources, it is equally important that this be accomplished before the work is begun.

To avoid misunderstanding and undue risk to either the agency or the advertiser, work should not commence until there is substantial concurrence on the terms of the agency agreement.

- **Involve senior management stewardship**

Senior managers who are responsible and accountable for the effectiveness of marketing communications should be accountable and responsible for establishing the objectives and operating mechanics of the agency compensation program.

As with many aspects of business, senior management support is critical to ensure successful implementation and execution. Developing and managing an effective agency compensation program is no exception.

- **Remain flexible to accommodate change**

It is important that compensation terms remain flexible enough to accommodate significant changes in scope of services, timing of services, mix of resources, new products being developed, new and foreign markets, and products with limited or erratic spending.

Work being done and expected to be done, should periodically be compared to the original scope of services and service requirements.

- **Can be adapted globally**

With continuing globalization, consideration needs to be given to compensation arrangements that are adaptable for global use.

A global compensation structure, whether fee or commission based, may need to be adjusted by region to allow for differences in regional cost structures or custom.

Foreign currency use and responsibility for currency exchange differences should be discussed and agreed upon as should the accommodating of additional currencies. Most commonly, foreign currency exchange gains and losses related to third party purchases tend to be at the advertiser's benefit or expense.

Local legal requirements must be fully explored, and local payment terms should be considered. Tax implications should be identified and local labor laws must be known and should be accommodated within the compensation structure.

True global contracts generally require agreement on centralized accounting and reporting requirements. If not centralized there should be adequate standardized reporting to ensure compliance with global contract terms. A proper and consistent communication and fee distribution system known and understood by all pertinent parties should be in place

- **Endure over time**

As a result of adopting the guiding principles listed above, both advertiser and agency can expect a compensation program that endures over time. It is inevitable that an advertiser's business plans will change, thus impacting the agency's scope of service. Budgets may increase or decrease and the communications mix may change. Regardless of these business changes, the objectives of the compensation program should not change. Embracing the guiding principles of simplicity, fairness, alignment, clarity, adaptability, and flexibility will ensure that the compensation program established will stand the test of time.

# BEST & WORST PRACTICES

The Task Force focused on best and worst practices in developing fee and commission agreements. It also addressed what to consider when developing incentive arrangements.

*Fees*

There are numerous ways to develop fees. The structures of fees vary but can generally be categorized as:

- Fixed fees
- Hourly rates
- Cost plus.

Best and Worst practices for fees will be discussed on an overall basis. Separate commentary will be addressed to cost-plus fee situations, which usually have more variables, are subject to more administration, and require greater stewardship than either fixed fees or hourly billing arrangements.

**Best Practices**

- When developing a fee, all the parties should have a clear understanding of the fee's components and definitions, if applicable. Upfront understanding reduces confusion and disputes.

  The advertiser/agency service contract should also indicate those out-of pocket costs that are billable versus those, if any, that may be non-billable.

- Required agency resources and fees should be based on a detailed, mutually agreed upon scope-of-work. The scope-of-work or services should include clearly identified deliverables, timeliness of deliverables, numbers of revisions included, and core team responsibilities.

- There should be a clear process for reviewing and adjusting fees –both upward and downward–based on changes in the scope of work and resulting change in agency resources required vs. the original work plan.

- The scope of work and needed staffing often change during the year and it is in everyone's interest to periodically review the current scope of work. These periodic reviews are particularly important for fixed fee accounts and for accounts that have a history of spiraling work and costs.

- Audit of third party expenditures made by an agency on an advertiser's behalf should be considered an available option, and any audits should be performed by a credible, qualified auditor, agreeable to both the advertiser and to the agency.

**The following Best Practices pertain primarily to cost plus fees:**

- A cost plus fee's components are generally broken into direct labor, overhead, and other direct costs (e.g., travel, entertainment, research) and profit. (Many advertiser and agency professionals opt to express overhead and profit as a multiplier on direct labor costs.)

- Actual overhead rates fluctuate. It is a best practice to develop a longer-term perspective on overhead and it is usually beneficial to agree to overhead rates that can be kept in place for multi-year periods. Fixing the overhead rates, or multipliers, in this way can simplify the compensation process.

- An advertiser's right to audit or verify agency costs should be discussed and agreed to up front. The data being verified should be relevant to the compensation agreement. Any audit should be performed by credible, qualified auditors, agreeable to both the advertiser and the agency.

- If verifying the accuracy of individual salary information is a priority, the Task Force suggests that verification be conducted on a confidential basis by a mutually agreed, independent auditor.

**Worst Practices**

- At times, access to individual salary amounts is requested. Advertiser's access and review of individual salary amounts is always inappropriate. Any verification necessary should be conducted on a confidential basis by a mutually agreed, independent auditor.

- Advertiser reporting requirements that are either extreme or lax should be avoided. Most companies have their own reporting requirements. However, customized reporting should only be required if it serves a meaningful business purpose. It is worthwhile for the advertiser and agency to decide together the level of data and the preferred reporting format and frequency. By working together, a lower cost solution that serves the desired purpose usually develops.

- While benchmarking can be a valuable and important activity, data that is obtained inappropriately or is restricted in its use should not be used. Additionally, it is important that benchmark results are valid, accurate and truly comparable.

- Other adverse tactics concerning fee arrangements include arbitrary definitions of an agency's allowable costs, and unreasonably capping labor rates (i.e., capping rates or using average rates for above-average staffing needs).

- If a cost plus or hourly billing fee arrangement is agreed to, providing for only one way fee adjustments is egregious. If the fee is subject to actualization, it should be subject to both upward and downward adjustment. There should be reasonable guidelines and interim checkpoints to allow for these adjustments.

*Commission Agreements*

The commission system is a type of compensation based on a percentage of standard gross media and/or mark-up on production spending. Although there are varied commission structures, the more common arrangements are:

- Standard commissions
- Reduced rate
- Sliding scale.

**Best Practices**

- The best commission structures guarantee a revenue floor to cover base staffing requirements. Commissions generally work well for larger brands where spending is significant.

- Commission revenues should reflect service requirements, allowing the agency to yield fair and competitive profits.

- It is a best practice to define upfront what costs are to be marked-up or subject to commissions. This information is generally specified in advertiser/agency service contracts.

  The advertiser/agency service contract should also indicate those out-of pocket costs that are billable versus those, if any, that may be non-billable.

- Audit of third party expenditures made by an agency on an advertiser's behalf should be considered an available option, and any audits should be performed by a credible, qualified auditor, agreeable to both the advertiser and to the agency.

**Worst Practices**

- It is a worst practice to set commission rates without identifying the resources needed to service the account.

- Commission based systems can be inappropriate, especially for lower-spending brands, certain specific media types, niche markets, new-product introductions and when the scope-of-work includes significant integrated marketing services that have little or no commissioned media.

*Incentive Compensation Arrangements*

Incentive or performance-based compensation arrangements are incorporated in an increasing number of compensation agreements, with the incentive based on achieving agreed upon goals. These goals may be qualitative, quantitative, or a mix of both.

### Best Practices

Championing incentive provisions requires a belief in the ability of the agency to deliver agreed-upon objectives and goals.

Traits common to successful incentive compensation arrangements include:

- Clear and measurable metrics
- Metrics that align with the advertiser's goals and objectives and that are based on reasonably achievable performance targets
- Advertisers budgeting for anticipated agency incentive amounts
- Advertiser's senior management's stewardship of its incentive plan's metrics and parameters
- Interim advertiser/agency performance reviews
- Timely year-end performance reviews and timely payment
- Accounting for incentives in the year earned.

### Worst Practices

Incentive compensation arrangements that frustrate participants and have lower incidence of success generally fall prey to one or more of the following traits:

- Establishing incentive criteria well into the year
- Incentive systems that are based on virtually unachievable performance goals and "all or nothing" structures, since both tend to fail more frequently
- Discounting incentive payments from amounts actually earned under the incentive plan's previously agreed metrics and parameters
- Trying to use incentive programs to fix faulty base compensation programs.

# SUMMARY

Advertising agency compensation arrangements vary based on the vagaries of individual assignments and the nature of each advertiser-agency relationship. Adhering to these Guiding Principles, and following the above Best Practices will lead to better, longer standing compensation arrangements and will enable advertisers and agencies to focus their energies to achieving the advertisers' goals.

# ANA/AAAA Compensation Task Force

Laura Caffrey
Executive Vice President, Chief of Staff
FCB Worldwide

Renee Cassidy
Chief Financial Officer
Euro RSCG MVBMS

Tom Finneran
Chief Financial Officer
Arnold McGrath Worldwide

Neal Grossman
Chief Financial Officer – North America
TBWA/Chiat/Day

Paul Haggerty
Manager, Advertising Resources
General Motors Corporation

Gary Lee
Chief Operating Officer
Ogilvy & Mather Worldwide

Todd Robinson
Associate Director, Corporate Marketing Finance
The Procter & Gamble Company

Sherry Ulsh
Senior Director, Marketing Finance & Analysis
Burger King Corporation

James Zambito
Executive Director/Agency Relations
Johnson & Johnson

AAAA:
William Nicholson
Executive Vice President

ANA:
Barbara Bacci Mirque
Senior Vice President