



Leading the Marketing Community



ANA/AAAA COMPENSATION GUIDE

UNDERSTANDING DIRECT LABOR, OVERHEAD AND THE COMPONENTS OF COST-PLUS AND LABOR-BASED ARRANGEMENTS

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Understanding Direct Labor, Overhead and the Components of Cost-Plus and Labor-Based Arrangements

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I. BACKGROUND

In 2002 the ANA and AAAA issued a joint position paper entitled *Guidelines for Effective Advertiser/Agency Compensation Agreements* ([Download 2002 Guidelines](#)). Its purpose was to identify and recommend principles inherent in effective agency compensation arrangements and to showcase best practices in agency compensation. This position paper helped encourage greater dialogue between advertisers and agencies on compensation in general as well as the specific elements of compensation.

Subsequently, advertisers identified overhead, one of the specific elements of cost-based compensation, as an area of interest. Advertisers expressed a desire to better understand and to bring greater standardization and comparability to discussions on overhead.

The complexities inherent in Cost-Plus Fee¹ and Labor-Based arrangements sometimes result in confusion and misunderstanding. Advertisers and agencies believed that there was an opportunity to provide an educational framework as a means of fostering more consistent and efficient implementation of these types of advertiser/agency compensation arrangements.

In 2005 the ANA and AAAA established a joint task force whose focus not only included overhead but related issues as well including Direct Labor, out-of-pocket costs, and Profit elements of Cost-Plus and Labor-Based Fee arrangements. The task force's goal was to establish guiding principles, definitions, and best practices to help provide education related to cost-based arrangements. The task force does not recommend one compensation method above another, and its scope did not include Commission, Fixed Fee, hourly arrangements, fixed rate/multiplier, hybrid, sales, or performance-based compensations methods.

ANA and AAAA strongly recommend that clients and agencies sit down together from time to time to ensure that there is a full and mutual understanding of compensation arrangements.

¹ Capitalized words are defined in Exhibit 1, the definitions section of the Guide.



II. COMPENSATION DIALOGUE PROCESS

Rules of Engagement

In survey after survey marketers and marketing service providers indicate a high degree of skepticism about foundational assumptions, economic parameters, and contractual terms that result from even the best-intended, good faith negotiations. It is no surprise that many marketers and agencies are frustrated with the compensation process.

There must be a better way and there is—a logical, bi-partisan process for evolving dialogue between advertiser and agency that can add credibility to compensation discussions, demystify compensation parameters, and restore confidence in working relationships between marketers and their agencies. The ANA and AAAA recommend a four-step process that includes:

- 1) Goals and objectives
- 2) Scope of services and scope of work
- 3) Compensation framework
- 4) Compensation particulars

We believe that diligent and good faith dialogue regarding these four steps will improve the effectiveness of client-agency relationships.

Step #1 Goals and Objectives

Prior to discussing the specific terms of compensation and prior to developing a well-defined Scope of Work (SOW), the marketer and the agency should have a comprehensive discussion of the goals and objectives of the marketer's business and marketing plans.

The discussion of goals and objectives should include, but not be limited to, a dialogue on the following:

- The client's business goals and marketing objectives both short term and longer term—What is the core deliverable expected from marketing initiatives?
For example: awareness, attitudinal shifts, trial, compliance, price elasticity, category growth, market share, cross merchandising, etc.
- The role and responsibilities of both client and marketing service providers in the marketer's business processes.
- Any special or unique issues or requirements: technical, category, regional, global, etc.
- The factors and considerations that the agency should understand about the advertiser's business or about the way the advertiser works in order to be an effective business partner.
- The marketer's processes for approving communications strategy recommendations and creative executions.

- The program development, measurement, and research assessment procedures that will be utilized.
- Agreement on performance expectations. How the marketer will define and measure success—for the marketer’s business? For marketing programs and components? For the agency?
- What client resources will be available to support the marketing program? For example, marketing budgets, sales and distribution efforts, channel or retail activities, etc. (i.e. other critical aspects of the four P’s: product, price, place, and promotion)?
- Critical path and time frame considerations.

Step #2 Scope of Services and Scope of Work

Once marketer and agency have a clear understanding of the business goals and objectives, the parties should discuss scope of services and scope of work.

What types of services will the agency provide for the marketer? Will the agency’s responsibilities include:

- Strategic planning
- Market research
- Creative development, execution for all (or selected) media and non-media venues
- Production, casting/talent, licensing, traffic, art buying
- Media planning, research, buying—for which media and in which markets?
- Internet/interactive, search, web site—strategy? Design? Programming?
- Public relations, public affairs
- Database, direct marketing, crm
- Sales promotion, channel marketing, in-store, sponsorships
- Experiential marketing, events, trade shows, exhibits.

What services are the sole responsibility of the agency? If responsibility is jointly handled by the agency, client, and/or other services providers, how will integration and transfers be managed?

What consumer segments, customers, media types, geographic markets, and other marketing considerations require definition so that the scope of agency services are mutually understood?

Once scope of services has been delineated, the advertiser and agency should estimate and agree on quantity and level of agency services, i.e., the scope of work. Quantity of services should align with core deliverables and service expectations and with the overall scope of service (i.e., include the number or range of initiatives, events, campaigns, executions, mailers, etc., including specifically defined deliverables that are expected during the performance period). Level of services should also include discussion related



to expected stewardship and administrative requirements, rework parameters, and alternative marketing planning and execution considerations.

Step #3 Compensation Framework

There is no singular compensation approach that fits every individual advertiser–agency relationship. A number of methodological compensation structures are available, such as Media Commissions (on marketing expenditures), Fixed Fees, sales-based royalties, Cost-Plus and Labor-Based arrangements. Any one of these methods can work effectively when the parties’ interests and priorities are aligned. Both marketer and agency should discuss their compensation-related goals and expectations prior to selecting either a method or a level of remuneration.

—Advertiser goals and expectations: All advertisers want superior creative/thinking/strategy, but further conversation on the price value relationship needs to occur. Do you want the most-senior/costly staffers working on the account, or are you willing to work with less senior/less costly talent in an effort to reduce cost? How does the advertiser prioritize revenue dynamics? Can some fluctuation in costs be tolerated in order to be economical? Do you value a predictable fee versus the lowest-possible fee? How much time is the client willing to spend in order to administer the compensation arrangement?

—Agency goals and expectations: What is the growth opportunity on the account? Can you minimize costs now in hopes for future growth, or is this relationship “mature” and must it be profitable on its current terms?

—Are the agency and the advertiser willing to take some risk in order to maximize the potential for mutually beneficial upside income?

Step #4 Compensation Particulars

Prior good faith discussion of goals and objectives, scope of services/work and compensation framework should help facilitate an effective, balanced, and mutually satisfactory dialogue on compensation particulars.

The specifics of each advertiser-agency agreement will vary depending upon a host of factors, including the magnitude of the programs, the level of investment, the design of the compensation arrangement, the sensitivity and predictability of underlying assumptions, and the duration of the agreement:



—In Cost-Plus or Labor-Based arrangements, there should be agreement on the definitions of cost as well as the determination of whether actual or estimated hours, labor, or multipliers will be utilized.²

—In performance-based arrangements, the measurement criteria, range of performance, and payment schedule will require calibration.

—For Media Commission or sales-based arrangements, rates and structures should be codified.

Summary

The proposed process for evolving a comprehensive dialogue on compensation is consistent with, and builds upon, the guiding principles that were endorsed by the ANA and AAAA in 2002. The guiding principles that underpin the best compensation programs include:

- Establish clear goals and objectives up front.
- Align advertiser and agency interests and priorities.
- Establish agreement on key compensation definitions and terms.
- Match compensation with the resources required to do the work.
- Are simple to understand and administer.
- Are fair and equitable for both advertiser and agency.

As business goals, priorities, expenditure levels, and scope of activities change, the marketer and agency will need to incorporate those changes into their future dialogue on compensation.

² Supplementary compensation process comments related to Cost-Plus or Labor-Based Fee arrangements.

For Cost-Plus Arrangements: If the marketer and agency agree to work on a Cost-Plus Fee arrangement, the components of the fee typically will include Direct Labor, Overhead, Direct Client Costs, and Profit. In this type of compensation arrangement, it is important that terminology and definitions be clearly established (reference Principle #2) and that the level of costs being contracted for are understood (reference Principle #3). Cost-Plus Fee arrangements typically also require agreement related to the actualization of costs at the completion of the project or contract period.

For Labor-Based (Fixed or Variable) Fee Arrangements: If the marketer and agency agree to work on a fee arrangement that is not Cost-Plus but is based on the level of agency labor, then the parties should agree on definitions (reference Principle #2), contracted costs (reference Principle #3), and they should designate which components of compensation will be fixed and which components will be actualized.



III. GUIDING PRINCIPLES PERTAINING TO LABOR-BASED AND COST-PLUS ARRANGEMENTS

In addition to the Guiding Principles that were developed in 2002, the AAAA and ANA believe the following principles will be helpful in constructing “best practice” Labor-Based and Cost-Plus compensation programs.

PRINCIPLE 1: NO UNIVERSAL COMPENSATION PRACTICE

There is no one universal or industry standard agency compensation or cost accounting methodology.

While the components of most agency compensation agreements include Direct Client Labor, Indirect Labor, Overhead, Direct Client Expense and Profit, the exact definition, expense classifications, and mechanics of agency systems vary from agency to agency.

For true Cost-Plus arrangements where costs are actualized, the agency will be able to provide a description of cost accounting definitions and methodology. The agency’s systems and procedures should be able to be reasonably customized to adhere to the terms of the specific services contracts.

PRINCIPLE 2: CLARIFY COMPENSATION DEFINITIONS

It is important for advertisers and agencies to understand the definitions, nuances, and stewardship aspects of the various forms of fee arrangements such as Fixed Fee, Labor-Based Fee, and Cost-Plus Fee.

Advertisers and agencies should have a consensus understanding of expense categories, definitions, and classifications of cost-based compensation components prior to discussing agency compensation. Refer to frequently referenced compensation definitions in Exhibit 1.

PRINCIPLE 3: ASSESSING COMPENSATION PROPOSALS—APPROPRIATE VIEW OF COST COMPONENTS

In Labor-Based or Cost-Plus arrangements, the level of an agency's compensation is a function of Direct Labor Expenses, Overhead cost, reimbursement agreements pertaining to Direct Client Cost, Profit considerations and any agency performance compensation elements.

Advertisers should exercise due diligence to understand the costs that are being contracted. It is important for advertisers to understand the components of cost in order to evaluate proposals competently. Therefore, when assessing Labor-Based or Cost-Plus compensation proposals, it is reasonable for advertisers to request appropriate levels of detail (Reference Exhibit 2).

However, it is also important to understand that the cost components of an agency's compensation are interrelated and should be ultimately negotiated and agreed upon in aggregate within the context of the specific services contract.

PRINCIPLE 4: ALL REASONABLE AND CUSTOMARY RECURRING AGENCY OPERATING EXPENSES SHOULD BE INCLUDED IN AGENCY COST

The foundation of cost-based compensation arrangements is predicated on the advertiser paying for its share of an agency's costs (as agreed between the two parties) related to the cost of providing services to its clients.

When an advertiser and an agency agree to a cost-based compensation methodology, the advertiser is, in effect, agreeing to reimburse the agency for its cost and agreed-upon profit. Assuming that the agency's aggregate costs are reasonable (not extreme or excessive), appropriate, and not extraordinary, the advertiser should not arbitrarily or unilaterally omit legitimate, customary agency expenses from the cost component of the compensation arrangement.



PRINCIPLE 5: UTILIZATION OF BILLABLE HOURS

Dedicated Staff

When the agency service plan specifies dedicated staff, the agency will normally bill the advertiser 100 percent of each dedicated staff member's Direct Labor expense, Overhead and Profit factor. A dedicated staff individual works on only one agency client and works the agreed upon hours (FTE). A dedicated staff individual can expend hours on non-billable agency activities such as training, pro-bono projects, or agency business development activities.

Non-Dedicated or Shared Staff

For staff not dedicated to one client, the agency will normally bill the client, at established billing rates, the number of hours that the staff member works on the client's business. In practice non-dedicated or shared staff may be billed across all agency clients at less than, more than, or equal to 100 percent. Open channels of communication between advertiser and agency will provide understanding of the agency's practices with respect to staff utilization (i.e., utilization less than or more than 100 percent).

Ultimately, the determination of billing rates should be established in the advertiser-agency contract.

Staff time allocations should balance advertiser and agency needs for reasonable levels of staff productivity, including a positive, healthful working environment.



PRINCIPLE 6: NO INDUSTRY STANDARD OVERHEAD RATE

Different cost accounting definitions and methods can and do produce many different Overhead Rates. Prior to entering into Overhead Rate discussions, it is appropriate for advertiser and agency to align on suitable definitions and methodologies.

Agency Operating Expense levels vary in aggregate and by component (i.e., Client Direct Labor and Overhead) from year to year as well as by geographic location, marketing specialty, and by agency within each specialty.

Overhead Rates should be viewed in the context of the overall fee; for example, an agency with a lower level of Direct Client Labor (perhaps due to being more efficient or due to having lower employee compensation grades) may have a higher Overhead Rate, but lower overall Operating Expenses, than another agency with higher Direct Client Labor and a lower Overhead Rate.

To illustrate the dynamics related to Overhead Rates, a hypothetical example is provided below.

Assume that there are three agencies that happen to: (1) operate in the same building, (2) provide the same type, levels, and quality of service, (3) have similar clients, and (4) have the exact same total Operating Expenses. However each of these agencies have different Overhead Rates (ranging from 92 percent of Direct Labor to 150 percent of Direct Labor). How can this dynamic occur?

Let's look at the three-agency example in more depth and isolate a few dimensions of each agency's operating practices related to the composition of employee compensation elements and the categorization of selected expense items.

For example:

—Agency A's operating practices reflect average salary grades and average employee benefit programs. This agency's client agreements define Client Direct Labor as salary plus other W-2 and 1099 items plus Payroll-Related Expense.

—Agency B's operating practices reflect average salary grades and average employee benefit programs (same as agency A), but this agency's client agreements define Client Direct Labor as salary plus other W-2 and 1099 items. Agency B's client agreements categorize Payroll-Related Expense as a component of Overhead.

—Agency C's operating practices reflect below-average salary grades and above-average employee benefit programs. This agency's client agreements define Client Direct Labor as salary plus other W-2 and 1099 items with Payroll-Related Expense part of Overhead. Agency C's client agreements also specify that Client Direct Labor activity for selected staff functions (for example, client accounting and IT) are reclassified as Overhead.



The variations in the three agencies' operating practices are summarized in the table below:

AGENCY		A	B	C
Salary Grades/Payroll Expense		Average	Average	Below Average
Payroll-Related Expenses		Average	Average	Above Average
Expense Classifications - Payroll-Related Expense - Client Accounting/IT portion of Direct Labor		Direct Labor Direct Labor	Overhead Direct Labor	Overhead Overhead

The chart below provides the operating expense values and overhead rate calculations for agencies A, B, and C.

AGENCY		A	B	C
Payroll Expense		\$44,000	\$44,000	\$42,000
Payroll-Related Expense		8,000		
Staff Reclassification				(2,000) ³
Client Direct Labor (A)		\$52,000	\$44,000	\$40,000
Indirect labor		\$16,000	\$16,000	\$16,000
Space & Facilities		17,000	17,000	17,000
Professional Fees		5,000	5,000	5,000
Corporate Expenses		10,000	10,000	10,000
Payroll Related			8,000	10,000
Staff Reclassification				2,000 ³
Overhead (B)		\$48,000	\$56,000	\$60,000
Total Expense (C) (A+B)		\$100,000	\$100,000	\$100,000
Overhead Rate (B÷A)		92%	127%	150%

Given the variables and dynamics that can affect overhead rates, it's suggested that, consistent with best practice, overheads be viewed in aggregate, looked at as a range over time and that definition elements be clearly understood.

³ Client accounting and IT reclassified from Client Direct Labor to Overhead.



PRINCIPLE 7: PROFIT SHOULD BE ADDRESSED

In Cost-Plus agreements, where “plus” relates to agency Profit, the definition/determination of agency Profit should be discussed by the parties as part of the overall compensation agreement.

The method for determining the range of the agency’s target, actual, and/or potential Profit should be fair, competitive, and realistic.

PRINCIPLE 8: CONFIDENTIALITY AND DISCLOSURE

Specific advertiser/agency contract compensation, pricing, and terms are typically confidential. Nondisclosure agreements (NDAs) should be executed by the advertiser, agency, and any third parties who are provided access to agency confidential information. NDAs should acknowledge the confidentiality of advertiser and agency information, and restrict the access to, and use of, the information by the advertiser/agency, advertiser/agency employees, advertiser/agency auditor(s), advertiser’s/agency consultant(s), and any employees of the consultant.

Both advertiser and agency will respect the confidentiality of the other party. Requests for disclosure of agency cost information should be relevant to the development and administration of the compensation arrangement. The level of disclosure of agency expense items should be mutually agreed upon by the parties and documented in the contract.

Both advertiser and agency have the right to participate in any benchmarking studies sponsored by national nonprofit industry organizations, provided that reasonable precautions have been taken to ensure confidentiality.

PRINCIPLE 9: VERIFICATION OF COMPENSATION AGREEMENTS

True Cost-Plus Fee Agreements

When an advertiser and agency decide on an agreement calling for actualization of agency costs associated with servicing the client's business and agreed-upon scope of work activities, the agency should provide disclosure of actual Labor, Overhead, and Direct Client out-of-pocket costs which would enable a mutually agreed-upon independent CPA to confirm to the advertiser that the costs attributable to the client's business are properly presented.

Labor-Based Fixed Fee and Labor-Based Variable Fee Compensation Arrangements

These compensation methodologies, which do not involve the actualization of agency Overhead costs, do not normally entail verification of actual agency Overhead costs. However, if the advertiser/agency agreement specifies verification of Labor and/or Overhead, the parties should agree upon an independent CPA to perform the verification.

The advertiser/agency agreement should also specify the level of disclosure of estimated or actual agency costs as well as the conditions, timing, methodology, and cost responsibility associated with any verification of agency charges.

For all three compensation methodologies listed above: If verification of billable pass-through-costs is a priority, the advertiser/agency agreement should specify either a mutually agreed-upon independent CPA or the advertiser's internal audit staff to perform the verification.

PRINCIPLE 10: RELATIONSHIP EFFECTIVENESS AND EFFICIENCY

Agencies and advertisers should work together in partnership to explore mutually beneficial efficiency improvements and work to improve the effectiveness of marketing communications.

IV. ANA/AAAA LABOR-BASED AND COST-PLUS BEST PRACTICES

In the course of the ANA/AAAA Task Force discussions on Cost-Plus and Labor-Based compensation arrangements, a number of suggested best practices evolved. The following best practice suggestions should help advertisers and agencies foster a comprehensive, effective and efficient approach for developing and administering Cost-Plus and/or Labor-Based compensation agreements.

1. Labor-Based and Cost-Plus Fee compensation systems are inherently more complicated than commission, Fixed Fee or hourly compensation arrangements. Advertiser and agency should agree up front on budgeting, billing, stewardship, reporting, and/or verification expectations.
2. Agency labor expense is affected by the agency's employee remuneration philosophy, culture, location, benefit offering, reward, and retention philosophies. The advertiser's decision to work with an agency should recognize the agency's human resource model.
3. Agency staffing levels are a function of scope of work and service levels. Advertiser and agency must have comparable expectations. Changes in cost-based or Labor-Based compensation levels should be calibrated in conjunction with appropriate and timely changes in staffing levels and scope of work/services.
4. The billing method for agency staff that are working directly on the client's business should be specified in the advertiser-agency agreement.
5. Requests for agency cost information should be relevant to the compensation arrangement. Advertiser and agency should agree on a Client Direct Labor and Overhead expense documentation process that is administratively efficient and yet sufficiently comprehensive to provide the advertiser with reassurance that costs are fair, reasonable, and customary. Requests for proprietary information such as individual salaries is always inappropriate. Best practices for verification of costs are provided in Principle #9.
6. Overhead levels should be looked at in aggregate and as part of the overall compensation agreement.
7. Overhead is customarily allocated to clients based on their proportional share of Client Direct Labor. Cost-Plus Fee compensation contracts should reflect advertiser and agency agreement on Overhead Allocation methodology.
8. Overhead Rates should be reevaluated periodically, for example every three years, unless major changes on either the advertiser or agency side necessitate an earlier reevaluation.
9. When developing Overhead Rates, no Profit should be included in agency Overhead.



10. Direct Client Costs such as travel, research, licenses, materials, etc., should be either billed to the client as pass-through items or otherwise reimbursed as part of the compensation arrangement.
11. Generally Accepted Accounting Principles (GAAP) expenditure and revenue recognition rules require timely resolution of any compensation agreement, contingencies, or adjustments.
12. Cost-based agency compensation arrangements should include all reasonable and customary expenses and should not entail selectively excluding expense categories, i.e., cherry picking.
13. Overly complicated compensation terms and practices can result in misunderstandings and become a distraction. Advertiser and agency should collectively strive for consistency and efficiency in the administration of Labor-Based or Cost-Plus Fee agreements.
14. Advertisers should optimize their marketing expenditures and agencies should make a fair and reasonable Profit. The parties should collectively strive to identify process and marketing expenditure efficiencies. Fruits of efficiency improvements should ideally be mutually beneficial.
15. If verifying compensation agreements is a priority, then verification should be based upon an agreed-upon scope of audit conducted on a confidential basis by a mutually agreed-upon auditor (reference Principle #9).
16. If benchmarking is a priority, benchmarking should be done using appropriately comparable companies with disclosure of methodology and sample size.
17. Reconciliations should recognize both upward and downward variations.



V. EXHIBITS

EXHIBIT 1: FREQUENTLY REFERENCED DEFINITIONS

1. Agency Expense Definitions

The expense definitions and examples which follow are illustrative and are not intended to be all encompassing.

Agency Operating Expenses

Total agency operating expenses are divided into two categories: Direct Labor (or Client Direct Labor) and Overhead. Agency operating expenses exclude costs reimbursed directly by advertisers. Agency operating expenses also exclude agency Profit Markup or margin.

Direct Labor aka Client Direct Labor Expense

The portion of Total Labor Expense attributable by contract and by time allocation to client(s) business.

Freelancers

The generic term “freelance” is applied to a broad range of staffing circumstances including:

- Temporary employees who are on the agency payroll (receive a W-2)*
- Part time employees who are on the agency payroll (receive a W-2)*
- Independent contractors (receive a 1099 from the agency)**
- Consultants/advisors (may receive a 1099 depending upon incorporation)

Any of these forms of “freelancers” may work on the agency premises or they may work off premises. However, more often than not, freelancers work on premises due to the collaborative nature of most work.

* Government regulations and tax codes have broad based and inclusive rules, which require most “freelancers” to be categorized as employees for income tax withholding and for payroll tax (FICA, FUI, SUI) purposes. Further, depending on how regular and recurring a temporary or part-time employee works for an agency, many agencies categorize these individuals as regular employees rather than as freelance.

** Requirements to qualify as an independent contractor are highly restrictive-for additional information refer to common law requirements that must be met in order for a freelancer to qualify as an independent contractor.

**Full Time Equivalent (FTE)**

Full time equivalent (FTE) is a term used to express a unit of Client Direct Labor. One FTE is equal to one full time employee working on the client's business. Full time equivalents will normally be comprised of both dedicated staff and non-dedicated or shared staff therefore aggregate full time equivalents represent the equivalent number of full time staff, calculated on an agreed upon basis (customarily calculated using either a % time or a standard annual hours basis). Assuming a percent of time methodology, two people working 50% of their client billable time on the same client's business is equal to one FTE.

Operating Expense Principles

While all agency expenses should be recognized and reported in accordance with GAAP (Generally Accepted Accounting Principles), line item expense classifications will vary from one agency to another agency.

Overhead

Overhead is comprised of all Agency Operating Expenses except: (1) Client Direct Labor (Indirect Labor costs are included in Overhead) and (2) reimbursed Direct Client Costs. Overhead expenses do not include Profit.

Overhead Allocation

While there is no official industry, audit, tax or regulatory cost accounting method related to how agencies allocate Overhead to individual client activities, the predominant approach is to allocate Overhead to clients proportionately based upon the amount of each client's Direct Labor expense.

Overhead Rate

The customary method for calculating an agency overhead rate is to divide Overhead (as defined above) by aggregate Client Direct Labor (as defined above).

➤ Indirect Labor

The portion of Total Labor Expense not assigned by contract and by time allocation to Direct Labor (aka Client Direct Labor) including non-client time of non-dedicated or shared staff (Reference Principle # 5).

➤ **Professional Fees and Corporate Expenses**

- Insurance
Property, casualty, advertising liability, key man (i.e., life insurance on key agency individuals), etc.
- Non-Billable New Business
Labor (not included in Direct/Indirect Labor expense above), Presentations, Travel and Entertainment, Research and outside services (i.e., Freelance creative, consultants). This line item contains all non-reimbursed new business expenses, including expenses for pitching new client prospects.
- Other Operating Expenses
Publicity, donations, bad debts,* training, moving, employee welfare, business tax and personal property tax (i.e., taxes included in equipment lease payments), non-income tax, etc.

* Bad debts are “a sum of money owed that is unlikely to be repaid.” For agencies, bad debts represent billings not paid by advertisers, usually bankruptcy related. Bad debts are not related to intra agency billings and typically represent a very small portion of agency Overhead barring a major client bankruptcy. Bad debts are an anticipated and budgeted cost of doing business in most industries.

- Parent/Holding Company Service Costs
May include accounting, HR, IT, tax, treasury, payroll processing, benefits, insurance, etc.

Parent/Holding company service expenses should either be included under this line item or under the appropriate categorization within Overhead.

- Presentation Costs (i.e., creative presentations)
Excludes new business presentations.

Presentation expenses may also show up under other reimbursement arrangements (i.e., Direct Client Costs) depending on individual advertiser/agency contract.

- Professional Fees
CPA, legal, employee recruitment, training and relocation, consultants, tax advisors, etc.
- Research and Media Measurement
Media and statistical research fees (i.e., CMR, Nielsen, competitive spend tracking and measurement), etc.



Research expenses can sit in one of several places (Overhead and Billable Direct Client Costs) depending on individual advertiser/agency contract.

- Subscriptions/Memberships and Dues

Subscriptions (i.e., *Ad Age*, *Adweek*, Media services)

Memberships and Dues (i.e., AAAA, Art Directors Guild, AMA, Better Business Bureau – any kind of business associations/organizations that help service an agency’s client base)

- Travel and Entertainment

Non-billable industry and corporate activities.

Travel expenses may also show up under other reimbursement arrangements (i.e., Direct Client Costs) depending on individual advertiser/agency contract.

➤ **Space and Facilities**

- Communications and Delivery

Telephone, fax, postage, express mail, messenger, etc.

These costs may be included under Direct Client expense, Overhead or both expense categories depending on individual advertiser/agency contract.

- Depreciation and Amortization

Expense recognition associated with the write down over the useful life of furniture, fixtures, refitting space, etc. – all assets of improving and equipping office space.

- Information Systems

Computer costs including hardware, software and outside service bureau (i.e., outsourcing IT needs, outsourcing information processing), etc.

This line item may exclude salaries and payroll related cost of information systems staff.

This line item may include depreciation and amortization of owned IT office equipment if it is not already included under Depreciation and Amortization or Office Equipment lines.

These costs may be included under Direct Client expense, Overhead or both expense categories depending on individual advertiser/agency contract.



- Office Equipment and Office Supplies
Cost of non-owned (leased) office machines, copying equipment, all office supplies, etc.

This line item may include depreciation and amortization of owned office equipment if it is not already included under Depreciation and Amortization line.

- Rent
Rent, occupancy tax, rent escalation, wage and porter (i.e., security checkpoint, building services), utilities and repairs and maintenance, etc.

Payroll Expense (W-2 and 1099)

Base salary, overtime, bonus, car allowance, restricted stock amortization, benefits gross up and any other taxable compensation. Treatment of payroll expense items should be discussed between advertiser and agency during Direct Labor compensation and contract discussions.

Payroll Related Expense

Payroll taxes (F.I.C.A., federal and state unemployment insurance), group benefit plans (medical, dental, group life, disability, workers compensation), and retirement plan expenses (qualified pension, defined contribution, profit sharing and 401k plans).

Total Labor Expense

The agency's W-2 and 1099 Payroll Expense plus Payroll Related Expense for full time, part time and freelance. Mix of full time, part time and freelance employees will vary by individual advertiser/agency relationship and should be discussed by both parties.

Total labor expense is composed of both Direct Labor (Client Direct Labor) and Indirect Labor.



2. Compensation Methodology Definitions

Cost-Plus Fee

Cost-Plus fee components are generally broken into Direct Labor, Overhead, Direct Client Costs (e.g. travel, entertainment, research) and Profit. The cost components of Cost-Plus agreements reflect the agency's estimated cost for Direct Labor, Overhead and Direct Client Costs however, upon completion of the project or contract period costs are reconciled and adjusted to actual costs.

Advertisers and agencies should understand that true cost-plus agreements are typically more complicated to administer than other forms of compensation agreements.

Fixed Fee

The agency's compensation is negotiated for a specific scope of work and time period which does not vary.

Labor-Based Fixed Fee

An agency compensation method based upon the amount of estimated agency labor/time. The time components of labor-based fees are based upon: 1) estimated hours, or 2) estimated percent of staff time or 3) some combination of hours and percent of time. The labor rate component of labor-based fees can be based upon: 1) negotiated rates, 2) budgeted rates or 3) cost based rates. The Overhead multiplier and Profit components reflect estimated or negotiated rates. A labor-based fixed fee is not actualized at the end of the project or year.

Labor-Based Variable Fee

An agency compensation method initially based upon estimated agency labor however upon completion of the project or year labor values are adjusted to reflect actual labor time. Labor rate component of labor-based variable fees may reflect estimated/negotiated rates or be adjusted to reflect actual agency labor expense. The Overhead multiplier and Profit multiplier reflect the originally estimated or negotiated relationship to actualized Direct Labor values.

Mark-up

If no agency commission is included on outside purchases (such as talent, production, research, etc.) the agency adds an amount to the net outside purchase so that the agency receives an agreed upon percentage of the expenditure as a commission. (For example, 17.65% markup is equivalent to a 15% commission.)

Media Commission

Agency is paid a percentage of the advertiser's industry gross or net media billing.



3. Other Definitions

Direct Client Costs

Out of pocket costs that are directly attributable to specific clients.

Direct client costs include travel, research, creative materials, storage, postage and delivery, licenses, outside services, legal fees and other client related expenses that can be readily captured and that are directly attributable to a specific client. Direct Client Costs are generally directly billable to the advertiser without markup however they may alternatively be assigned to the client's Overhead depending upon the specifics of the advertiser-agency agreement.

Non Operating and Non recurring

Includes office closings, sale of assets/businesses, one time gains/losses, etc.

Profit

Profit represents the difference between agency client revenues (from Media Commissions, Mark-ups, Fees or other forms of client compensation) and Agency Operating Expenses.

There are two ways that agency profit is typically described: Cost Mark-up or Profit Margin. To illustrate the calculation of these the following values will be utilized:

\$100 Agency Client Revenue/(Client Commissions, Mark-ups, Fees, etc)

\$80 Agency Operating Expense. (Client Direct Labor plus Overhead)

\$20 Profit

- o **Cost Mark-up**

Agency Profit is sometimes looked at in relationship to Agency Operating Expenses i.e. a profit mark-up. Using the above referenced example the agency Profit (\$20) is divided by the agency's Operating Expense (\$80) yielding a mark-up of 25%.

- o **Profit Margin**

Profit Margin expresses agency profit as a percentage of agency client revenue. Using the above referenced example the agency's Profit (\$20) is divided by agency client revenue (\$100), yielding a Profit Margin of 20%.



EXHIBIT 2: ILLUSTRATIVE CALCULATION AND EXPENSE DETAIL WORKSHEET [1 OF 4]

Executive Summary

NOTE: It is important to recognize that there is no “one” standard or preferred agency compensation approach or cost accounting methodology. This illustrative worksheet attempts to diagram all components and categories incurred by the agency in the course of normal business. You will need to discuss and determine the appropriate figures for your unique agency / client situation. While costs may vary by marketing service or specialty group, agencies within these groups, across geographic locations and over time, this illustrative worksheet is intended to suggest a viable starting point for discussions.

Disclosure is subject to individual Advertiser/Agency agreements. XXXX = Frequently disclosed data fields

	\$\$\$
Direct Labor	
Base Salaries+Other W-2Payroll+ Freelancers	
Payroll Related Expenses	
Total Direct Labor (A)	XXXX
Overhead	
Indirect Labor	XXXX
Space & Facilities	XXXX
Professional Fees	XXXX
Corporate Expense	XXXX
Total Overhead (B)	XXXX
Direct Labor & Overhead (C) = (A+B) (Direct Labor and Overhead excludes those costs which are directly reimbursed by advertiser)	XXXX
Profit (D)	XXXX
Total Base Fee (E) = (A+B+D) or (C+D)	XXXX

(Performance Compensation if applicable (F) (Only if contract calls for an incentive to be earned in addition to the base fee. In essence performance compensation is an extension of base compensation arrangement.)	XXXX
(G) = Base Fee (E) + Performance Compensation (F)	XXXX
Direct Billable Client Costs (H)	XXXX
(I) = Base Fee + Performance Compensation (G) + Direct Billable Client Costs (H)	XXXX



EXHIBIT 2 (cont'd): DIRECT LABOR WORKSHEET ILLUSTRATION [2 of 4]

Disclosure is subject to individual Advertiser/Agency agreements. XXXX = Frequently disclosed data fields

	Hours**	\$\$\$
Direct Labor Expense*		
Account Management	XXXX	XXXX
Creative	XXXX	XXXX
Production	XXXX	XXXX
Media	XXXX	XXXX
Planning/Research	XXXX	XXXX
Specialty Groups as needed (Interactive, PR, IT, client accounting and other support functions specifically assigned to client)	XXXX	XXXX
Subtotal Base Salaries + Other W-2 Payroll Expenses + Freelancers	XXXX	XXXX
Payroll Related Expenses		XXXX
Total Direct Labor (A)		XXXX

*See Direct Labor definition in Exhibit 1, Sample Labor Planning Template in Exhibit 3 and Guiding Principle 5 - Utilization of Billable Hours.

**Client devoted hours supportable by contract or time allocation



EXHIBIT 2 (cont'd): CLIENT OVERHEAD ILLUSTRATION WORKSHEET (Client Share) [3 of 4]

Disclosure is subject to individual Advertiser/Agency agreements. XXXX = Frequently disclosed data fields

	% OH	\$\$\$
Overhead		
<u>Indirect Labor*</u>		
Account Management		
Creative		
Production		
Media		
Planning/Research		
Specialty Groups as needed (Interactive, PR, IT, client accounting and other support functions specifically assigned to client)		
Finance/Accounting		
IT/Systems		
Administrative and misc.		
General Management		
Subtotal Indirect Labor (W-2, 1099 & Payroll related expense)	XX%	XXXX
<u>Space & Facilities*</u>		
Rent		
Depreciation & Amortization		
Communications & Delivery		
Office Equipment & Office Supplies		
IT Systems		
Subtotal Space & Facilities	XX%	XXXX
<u>Professional Fees*</u>		
Research and Media Measurement		
Subscriptions/Memberships & Dues		
Professional Fees		
Non-Billable Travel & Presentations		
Subtotal Professional Fees	XX%	XXXX
<u>Corporate Expense*</u>		
Insurance		
Services/Costs provided at Parent/Holding Company		
Non-Billable New Business, including Labor, Travel & Ent, Research, & Presentation Costs		
Other Operating Expenses including Bad Debt provision		
Corporate Expenses Subtotal	XX%	XXXX
Total Overhead* (B) (Cume of Indirect Labor, Space/Facilities, Professional Fees, and Corporate Expense Subtotals. Client may request to understand individual cost components of overhead)	100%	XXXX

*See Definitions in Exhibit 1



EXHIBIT 2 (cont'd): DIRECT BILLABLE CLIENT COSTS ILLUSTRATION WORKSHEET [4 of 4]

XXXX = Disclosed data fields

	\$\$\$\$
Direct Billable Client Costs	
Research & Presentations (client-specific)	XXXX
Travel	XXXX
Creative Materials	XXXX
Other Pass thru's as defined by contract	XXXX
Total Direct Billable Client Costs	XXXX



EXHIBIT 3: SAMPLE LABOR PLANNING TEMPLATE

JOB TITLE	Dedicated Staff	Non-dedicated Staff	Estimated \$
	% Time	Hours	
MANAGING PARTNER	n/a	150	
ACCOUNT MANAGING DIRECTOR	n/a	300	
ACCOUNT SUPERVISOR	100%		
ACCOUNT EXECUTIVE	100%		
TRAFFIC SCHEDULER	n/a	50	
Total Account Management/ Account Support	200%	500	\$0
EXECUTIVE CREATIVE DIRECTOR	n/a	50	
ASSOC CREATIVE DIRECTOR	n/a	250	
SENIOR ART DIRECTOR	100%		
SENIOR COPYWRITER	100%		
ART DIRECTOR	n/a	800	
COPYWRITER	n/a	800	
Total Creative	200%	1,900	\$0
MANAGING DIRECTOR	n/a	50	
BRAND PLANNING DIRECTOR	n/a	100	
BRAND PLANNING SUPERVISOR	100%		
BRAND PLANNING EXEC / FIELD DIR	n/a	450	
Total Brand Planning	100%	600	\$0
PROJECT MANAGER	n/a	50	
PRINT PRODUCER	n/a	150	
ART BUYER	n/a	200	
PRODUCER	n/a	400	
ASST PRODUCER	n/a	800	
BROADCAST SUPPORT	n/a	-	
Total Production	0%	1,600	\$0
CLIENT FINANCE DIRECTOR	n/a	30	
TECHNOLOGY MANAGER	n/a	200	
CLIENT FINANCE MANAGER	n/a	450	
Total Finance & Technology	0%	680	\$0
TOTAL ESTIMATED FEE	500%	5,280	\$0



VI. SUMMARY

Strategy, design, and implementation of effective advertiser–agency compensation arrangements can, and do, have a profound effect on the consistency and effectiveness of marketing activity. The ANA-AAAA Cost-Plus and Labor-Based Fee compensation guide provides practical suggestions to help marketing partners align interests and efficiently steward collaborative and mutually beneficial business arrangements. The members of the ANA and AAAA would like to thank the members of the task force who contributed to the processes, principles, and best practices that are incorporated in this Guide.

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