A MARKETER’S GUIDE TO

Basics In
Comparing Agency
Costs & Overhead
Basics In Comparing Agency Costs & Overhead
As consultants in client-agency relations, Jones Lundin Beals, Inc., is pleased to endorse industry initiatives such as this that work to clarify areas of agency compensation that are frequently abused in the process of establishing what should be a productive and rewarding relationship for both parties. The simple examples in this work illustrate clear, basic approaches to the reporting of overhead that should go a long way in helping advertising executives better understand this vital component of agencies’ costs in providing their services, and more clearly recognize the risks of benchmarking or otherwise generalizing from non-comparable data.

David Beals, President/CEO
Stanley H. Beals, Managing Director
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Introduction

The theory behind all agency compensation arrangements is for the advertiser and advertising/marketing services agency to reach agreement on a payment method and on an amount that allows the agency to recover its costs and earn a competitive profit.

Although there are many types of compensation arrangements, cost-based agency compensation arrangements are currently in vogue with many advertisers. In fact, some advertisers are familiar only with this type of compensation.

The focus of this book is on the cost component of that equation. The book takes a simple example of an agency cost model and demonstrates that the same set of numbers, presented in different ways, will lead to the same cost for the advertiser, even though hourly rates may vary and overhead rates as a percentage of direct labor will vary.

It also demonstrates how inconsistent “mixing and matching” may lead to less than full cost recovery for the agency.

This book addresses costs on a general basis. The negotiation of fees is clearly a one-on-one matter between the advertiser and its agency, as is the option to make the compensation arrangement cost-based. If it is going to be cost-based, there should be up-front agreement and understanding as to the components of direct labor, direct expenses, and overhead.

Used in conjunction with principles established in “Guidelines for Effective Advertiser/Agency Compensation Agreements,” this book provides a solid foundation when building cost-based fee agreements. “Guidelines for Effective Advertiser/Agency Compensation Agreements” is a joint position paper from the AAAA and the Association of National Advertisers, Inc., and can be downloaded from the “Publications” area of the AAAA Web site, www.aaaa.org.
The AAAA thanks the Task Force from the AAAA Large Agency Finance Committee for their efforts in putting this booklet together:

- Gary Lee, chartered accountant, executive vice president and chief operating officer, Ogilvy & Mather North America
- Joe Naporano, CPA, executive vice president and chief financial officer, Campbell-Ewald
- George Recine, CPA, executive vice president, director of Worldgroup Global Compensation and chief financial officer—North America, McCann-Erickson
- Rick Weber, chief financial officer—global business, Euro RSCG Worldwide
- Nina Werner, partner, chief financial officer, Deutsch Inc.

Finally, the AAAA extends its special thanks and appreciation to Stan and Dave Beals, of Jones Lundin Beals, Inc., consultants in client-agency relations for their review, input, and support of this project.
I. AGENCY COST COMPONENTS

Cost-based compensation arrangements, including the categorization of costs between direct and overhead cost categories, are frequently discussed but often misunderstood.

This book was written to assist advertisers and agencies in developing a common language and understanding of overhead rates, agency costs, and their application in cost-based, cost-plus, and labor-based fee development. For the purpose of this document all these methodologies will be referred to as cost-based.

The AAAA is not recommending an overhead calculation methodology, nor are we recommending a particular compensation methodology.

However, if an advertiser does wish to utilize a cost-based compensation methodology, we would like to clarify several important factors.

- If a component of an agency’s operating expense is not included in direct labor, and if it is not specifically allocable to an individual account (i.e., direct expense), then by definition it must be included in overhead and allocated proportionately to all accounts, in order to remain consistent with the “cost-based” assumption.

- The components of direct labor and overhead should be clearly and concisely stated in the contract and consistently applied in the fee calculation.

- Quoted overhead rates only have meaning when the composition of the rates is clearly defined and is applied consistently in the related contract. Therefore, applying overhead benchmarking techniques can only be done when definition and contract terms are aligned.
Agency Cost Components

For purposes of cost-based compensation methodology, total agency operating expenses are divided into two categories: direct labor and overhead. Agency operating expenses exclude costs reimbursed directly by advertisers. To focus the discussion on agency cost components that form the basis of the overhead to labor ratios presented in this book, we have excluded profit markup on total costs and direct expense.

**Direct Labor** is the cost of staff related to the direct servicing of advertiser business. Labor cost includes total employee compensation, plus social (including payroll) taxes, and the costs of retirement plans and employee benefit programs. Employee benefits, taxes, and all other wage followers are sometimes included in overhead and not in direct labor. Either presentation is correct as long as total agency costs remain the same.

**Overhead** is comprised of all other agency operating expenses except direct labor as defined above. Indirect staff costs are included in overhead. Indirect staff costs will also include the cost of non-advertiser time of direct staff if it is not included in direct labor. *(See the following examples.)*

The **Overhead Rate** is traditionally expressed as a percentage: Overhead divided by Direct Labor.

\[
\frac{\text{Overhead}}{\text{Direct Labor}} = \text{Overhead Rate}
\]

By definition any agency operating expense that is not defined as direct labor *(or a direct expense that is account specific)* is therefore included in overhead.

Changing the components of overhead and direct labor can change the overhead rate significantly. However, **the total cost to the agency, and chargeable to the advertiser, will not change.** The simple examples in this book will demonstrate how.
II. EXAMPLES

Let us imagine an extremely simple agency with the following assumptions:

- The agency has one client and one employee
- The employee works 1,600 hours on the advertiser’s business and 200 on agency administrative work, for a total of 1,800 hours
- The advertiser has agreed to cover the agency’s costs and provide a negotiated profit margin as well
- There are no un-reimbursed direct advertiser expenses.

For purposes of this book we will put aside the profit and discuss only the cost recovery. The term “billing rate,” in all examples will, therefore, not include a profit markup.

The agency costs structure is detailed below (note—these are hypothetical numbers used for illustrative purposes only).

<table>
<thead>
<tr>
<th>Total Agency Expenses:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Compensation</td>
</tr>
<tr>
<td>Benefits</td>
</tr>
<tr>
<td>Total Labor Cost</td>
</tr>
<tr>
<td>All Other Costs</td>
</tr>
<tr>
<td>Total Costs</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Compensation</td>
<td>$100,000</td>
</tr>
<tr>
<td>Benefits</td>
<td>20,000</td>
</tr>
<tr>
<td>Total Labor Cost</td>
<td>120,000</td>
</tr>
<tr>
<td>All Other Costs</td>
<td>122,000</td>
</tr>
<tr>
<td>Total Costs</td>
<td>$242,000</td>
</tr>
</tbody>
</table>

In a cost-based compensation system, the agency would realize a cost recovery of $242,000 (before profit markup).
Example I

Let us assume that the contract calls for:

- Developing the fee based on total advertiser hours, or 1,600 hours
- Treating benefits as part of direct labor.

The Direct Labor cost would be $75.00 per hour.

\[
\text{Direct Labor} \quad \frac{$120,000}{1,600} = \frac{$75.00}{\text{Hour}}
\]

Overhead is $122,000 so the overhead rate is 101.67%.

\[
\begin{align*}
\text{Total Cost} & \quad $242,000 \\
\text{Less Direct Labor} & \quad (120,000) \\
\text{Overhead} & \quad $122,000 \\
\text{OH Rate} & \quad 101.67\% \\
\text{(Overhead/Direct Labor)} & \\
\end{align*}
\]

Applying the overhead rate to direct labor results in a billing rate of $151.25. When this rate is applied to the 1,600 hours worked on the advertiser business, the result is a cost recovery of $242,000.

\[
\begin{align*}
\text{Direct Labor} & \quad $75.00 \\
\text{Plus Overhead (101.67\% x DL)} & \quad + 76.25 \\
\text{Billing Rate/ Hour} & \quad $151.25 \\
\text{Multiplied by Advertiser Hours} & \quad \times 1,600 \\
\text{Cost Recovery} & \quad $242,000 \\
\end{align*}
\]
**Example II**

In the second example, we keep the fee based on total advertiser hours (1,600 hours), but move benefits into overhead.

The direct labor cost would be $62.50 per hour.

\[
\text{Direct Labor} \quad \$100,000 \quad = \quad \frac{\$62.50}{1,600} \quad \text{(Labor Cost/ Hour)}
\]

Overhead is $142,000, so the overhead rate is 142.0%.

\[
\begin{align*}
\text{Total Cost} & \quad \$242,000 \\
\text{Less Direct Labor} & \quad (100,000) \\
\text{Overhead} & \quad \$142,000 \\
\text{OH Rate} & \quad 142.0\% \\
\text{(Overhead/Direct Labor)} & \quad \\
\end{align*}
\]

Applying the overhead rate to direct labor results again in a billing rate of $151.25. When this rate is applied to the 1,600 hours worked on the advertiser business, the result is still a cost recovery of $242,000.

\[
\begin{align*}
\text{Direct Labor} & \quad \$62.50 \\
\text{Plus Overhead (142.0\% x DL)} & \quad + \quad 88.75 \\
\text{Billing Rate/Hour} & \quad \$151.25 \\
\text{Multiplied by Advertiser hours} & \quad x \quad 1,600 \\
\text{Cost Recovery} & \quad \$242,000 \\
\end{align*}
\]
**Example III**

Example III assumes that the contract calls for:

- Developing the fee based on total hours worked, or 1,800 hours
- Treating benefits as part of direct labor.

Direct labor is now reduced to $66.67 per hour, as follows:

\[
\text{Labor Cost} \div \text{Total Hours} = \frac{\$120,000}{1,800} = \$66.67
\]

Then, indirect time should be reallocated to overhead based on this direct labor rate per hour, as follows:

\[
\text{Indirect Hours} \times \frac{\$66.67}{\text{Labor Cost/Hour}} = \text{Indirect Labor} = 200 \times \$66.67 = \$13,333
\]

\[
\text{Labor Cost} - \text{Indirect Labor} = \$120,000 - 13,333 = \$106,667
\]

Finally, overhead should be calculated, as follows:

\[
\text{Total Cost} - \text{Direct Labor} = \$242,000 - (106,667) = \$135,333
\]

\[
\text{OH Rate} = \frac{\$135,333}{\$106,667} = 126.87\%
\]

Overhead is therefore $135,333, or 126.87%.
Applying the overhead rate to direct labor results in the same billing rate of $151.25. Therefore, when this rate is applied to the 1,600 hours worked on the advertiser business, the cost recovery remains $242,000.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Labor/Hour</td>
<td>$66.67</td>
</tr>
<tr>
<td>Plus Overhead (126.87% x DL)</td>
<td>+ $84.58</td>
</tr>
<tr>
<td>Billing Rate/Hour</td>
<td>$151.25</td>
</tr>
<tr>
<td>Multiplied by Advertiser Hours</td>
<td>x 1,600</td>
</tr>
<tr>
<td>Cost Recovery</td>
<td>$242,000</td>
</tr>
</tbody>
</table>
Example IV

Finally, we retain the assumption that the contract calls for developing the fee based on total hours worked, or 1,800 hours, as in Example III, but benefits are treated as overhead.

Direct labor is now reduced to $55.56 per hour, as follows:

\[
\begin{align*}
\text{Labor Cost} & \quad \$100,000 \\
\text{Divided by Total Hours} & \quad 1,800 \\
\text{(Labor Cost/ Hour)} & \quad \$55.56
\end{align*}
\]

Then, indirect time should be reallocated to overhead based on this direct labor rate per hour, as follows:

\[
\begin{align*}
\text{Indirect Hours} & \quad 200 \\
\text{Multiplied by Labor Cost /Hour} & \quad \times \ $55.56 \\
\text{Indirect Labor} & \quad $11,111 \\
\text{Labor Cost} & \quad $100,000 \\
\text{Less Indirect Labor} & \quad (11,111) \\
\text{Direct Labor} & \quad $88,889
\end{align*}
\]

Finally, overhead should be calculated, as follows:

\[
\begin{align*}
\text{Total Cost} & \quad $242,000 \\
\text{Less Direct Labor} & \quad (88,889) \\
\text{Overhead} & \quad $153,111 \\
\text{OH Rate} & \quad 172.25\% \\
(\text{OH /DL}) & \quad
\end{align*}
\]

Overhead is therefore $153,111, or 172.25%.
Applying the overhead rate to direct labor results in the same billing rate of $151.25. Therefore, when this rate is applied to the 1,600 hours worked on the advertiser business, the cost recovery remains $242,000.

- Direct Labor/Hour $55.56
- Plus Overhead (172.25% x DL) + 95.69
- Billing Rate/Hour $151.25
- Multiplied by Advertiser Hours x 1,600
- Cost Recovery $242,000

See page 19 for a summary schedule of these examples.

As indicated in the pie charts below, the costs (the size of the pie) are of course the same using each methodology, even though the size of each slice (the direct labor and overhead portions) changes depending on the methodology.

Example I

101.67% Overhead Rate
Client Hours/Benefits in Direct Labor

Example II

142% Overhead Rate
Client Hours/Benefits in Overhead
Example III

126.87% Overhead Rate
Total Hours/Benefits in Direct Labor

Example IV

172.25% Overhead Rate
Total Hours/Benefits in Overhead
III. SUMMARY OF EXAMPLES

To recap, in each of the examples, compensation paid, direct hours worked and total cost recovery remain identical, but depending on how costs are presented, overhead varies between 101.67 percent and 172.25 percent.

<table>
<thead>
<tr>
<th>Direct Comp / Hour</th>
<th>Benefits in Direct</th>
<th>Benefits in Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,600 hour base</td>
<td>$75.00</td>
<td>$62.50</td>
</tr>
<tr>
<td>1,800 hour base</td>
<td>$66.67</td>
<td>$55.56</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Overhead Rate</th>
<th>Benefits in Direct</th>
<th>Benefits in Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,600 hour base</td>
<td>101.67%</td>
<td>142.0%</td>
</tr>
<tr>
<td>1,800 hour base</td>
<td>126.87%</td>
<td>172.25%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Overhead/Hour</th>
<th>Benefits in Direct</th>
<th>Benefits in Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,600 hour base</td>
<td>$76.25</td>
<td>$88.75</td>
</tr>
<tr>
<td>1,800 hour base</td>
<td>$84.58</td>
<td>$95.69</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Billing Rate @ Cost*</th>
<th>Benefits in Direct</th>
<th>Benefits in Overhead</th>
</tr>
</thead>
<tbody>
<tr>
<td>1,600 hour base</td>
<td>$151.25</td>
<td>$151.25</td>
</tr>
<tr>
<td>1,800 hour base</td>
<td>$151.25</td>
<td>$151.25</td>
</tr>
</tbody>
</table>

* Before profit markup
As demonstrated, changing the definition of just two components of agency costs can have a **significant impact on overhead rates**, with **no change in total costs (to the agency or advertiser)**.

Significant problems arise if an overhead rate is arbitrarily applied in a compensation methodology that does not uniformly and consistently apply the comparable definition of direct labor.

For example, let’s review what would occur if the same agency was requested by an advertiser to use an overhead rate of 101.67% (see *Example I*) but was also told to put benefits in overhead (see *Example II*, assuming a 1,600 hour base).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comp Cost Hourly Rate</td>
<td>$62.50</td>
</tr>
<tr>
<td>Overhead Rate (101.67%)</td>
<td>$63.54</td>
</tr>
<tr>
<td>Total Billing Rate</td>
<td>$126.04</td>
</tr>
</tbody>
</table>

Multiplied by

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hours on Advertiser</td>
<td>x 1,600</td>
</tr>
<tr>
<td>Total Cost Recovery</td>
<td>$201,664</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual Agency Cost</td>
<td>(242,000)</td>
</tr>
<tr>
<td>Loss</td>
<td>($40,336)</td>
</tr>
</tbody>
</table>

Therefore, full cost recovery, i.e., the underlying premise of the cost-based methodology, is not achieved and the agency suffers a loss as its costs are not recovered.
Variations in Overhead

Every company is different. Of course there are differences in overhead across agencies even when comparable measures and methodologies are applied.

- *Employee Compensation Strategy*—Agencies differ in the elements of employee compensation and benefits they provide their staff, which may cause overhead rates to vary. For example, if benefits are in overhead and an agency provides its staff with a different benefits package while paying somewhat lower salaries, that agency’s overhead will be higher—although total costs are comparable.

- *Geography*—Most costs vary considerably from region to region (e.g., rent) as well as from country to country.

- *Variations of Real Estate Market*—since rent is such a large component of overhead, the timing of when an agency’s lease commenced and expires and the conditions of the market at that time may well impact its overhead relative to other agencies in the same market.

- *Agency/Business Models*—Direct marketing, media or interactive agencies, or other agencies and businesses with a different business model or a larger share of “project” business will usually have higher overhead rates than agencies with large retainer or AOR assignments. This could be due to more indirect time; higher technology costs; subscription costs for proprietary databases; etc.

In each of these cases, of course, variations in overhead may or may not result in higher costs for the advertiser. However, it is important to understand the interplay between direct, indirect and total costs.
IV. CONCLUSION

This document provides a meaningful framework for explaining variations in overhead ratios when developing cost-based compensation arrangements and provides guidance when benchmarking.

An overhead rate quoted without context has no meaning. Benchmarking exercises and comparisons of overhead rates are meaningful only when all cost components are taken into consideration and treated in a consistent manner from agency to agency.

In a cost-based compensation agreement, it is incumbent on both advertiser and agency to understand, agree on and comply with a pricing methodology and contract terms consistently applied, enabling the agency to recover its cost and earn a competitive profit.
Books in “The Marketer’s Guide” series include:

- The AAAA Agency: What It Is and What It Can Do For You
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- Agency Compensation
- Basics in Comparing Agency Costs & Overhead
- Conducting an Agency Search
- Evaluating Agency Performance
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