Seventeenth in a Series of Position Papers Addressing Key Industry Issues

I. Objective

It is time to transform the marketing services industry's approach to agency compensation.

Client demands for cutting edge agency services have never been greater, however the compensation amounts that clients expect to pay to agencies is under relentless scrutiny. Agencies are facing intense client pressure on compensation including demands for arbitrary cuts in fees and extended payment terms. Agency executives indicate that marketing services firms are increasingly being treated like commodities and client pressure on agency compensation is worse than ever before.

In order to facilitate the transformation of agency compensation, the 4A's has developed an industry guidance doctrine that is based on four strategic pillars:

1) <u>Agency Principals should lead the transformation of agency compensation</u>

The lack of agency management commitment to transform pricing strategy and compensation discussions with clients will result in the continued deterioration of agency compensation arrangements and agency profitability.

Agency compensation will continue to deteriorate unless agency management gets involved in pricing strategy and client compensations discussions. 4A's urges agencies to evolve pricing as a core management competence.

2) <u>Agency Principals have an opportunity to reframe marketers' value orientation to highlight the scope of business benefits that marketers derive from superior marketing innovation and execution</u>

Agencies have the opportunity to reframe clients' definition of value by orienting agency compensation discussions on the scope of client business benefits (e.g., sales growth, market share gains, brand equity and brand valuation improvements, etc.) that an agency creates for a client's business rather than on the agency's costs and fees. Agency Principals are positioned best to lead the discussion of scope of client business benefits that an agency creates.

The foundation for all agency compensation discussions should be a value discussion. 4A's recommends that all compensation discussions frame agency value creation and scope of benefits as the pre-requisite for discussing agency services, compensation and proposals.

3) <u>Agencies should adopt a principles-based approach to compensation and terms</u>

In order to help agencies consistently negotiate appropriate arrangements with clients, the 4A's recommends that agency management actively develop and adhere to internal standards, benchmarks, threshold/minimums and policies to guide the agency when negotiating arrangements with clients.

4A's recommends that agencies establish internal agency standards on critical servicing, compensation, intellectual property and contracting principles prior to initiating negotiations with clients and prospects.

Inculcating agency principles and standards provides a foundation to guide an agency's negotiations with clients. Each agency's principles and standards need to be routinely affirmed in communications that are disseminated to, and endorsed by, agency heads and key client service directors in addition to finance staff and legal counsel.

Agency management should also develop negotiating expertise, pricing data, benefits-based value metrics and benchmarks that facilitate enterprise compliance with the agency's principles-based approach to agency compensation.

4) <u>Client marketing and Agency account management should be included in all agency compensation discussions</u>

Most large advertisers now have expert and experienced procurement departments that are skilled in negotiating lower prices for marketing services. Agency compensation discussions often segregate agency finance and client procurement in negotiations that decouple the value of the agencies services and the benefits of superior marketing from the discussions of scope of work and the level of agency remuneration.

In many instances the client's marketing and procurement functions are not aligned on the goals, objectives and metrics of success for their agencies. Negotiating with client procurement in isolation will, more often than not, lead to a discussion that is primarily focused on cost savings.

Agency compensation should not be negotiated in silos. Compensation discussions should include all key stakeholders i.e. client marketing and client procurement along with Agency account management and agency finance.

Your agency should develop a team-based approach to articulating your agency's value proposition, discussing alignment of economic interests and negotiating equitable agency compensation arrangements.

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II. Background

The proliferation of communications and content possibilities has increased the complexity of the business and challenged agencies to add new talent, invest in data, build infrastructure and redefine creativity. Concurrently, clients are mandating that agencies do more with less. The pressure from clients is being led by procurement but client marketing is also now pushing for reductions in all expense areas because CMOs are under pressure to improve ROI and reducing cost is a predictable way of improving ROI.

Agency financial executives have expressed concern about the lack of systematic support from their agency operating management and holding company colleagues who seem to be primarily focused on defending existing client assignments and gaining new client revenue streams even at terms that are sub-optimal.

Lack of agency management and agency client service director involvement in, and commitment to, agency compensation negotiations is viewed as a significant industry problem. Agency CFOs have commented:

- "Agency senior management and client service ARE the problem and sometimes give away more than necessary in exchange for what they hope will be a long-term relationship."
- "Due to the oversupply of agencies and low barriers to entry in this industry, we continue to kill each other on pricing. Our industry's problem is our inability to demonstrate value on a regular basis or to remind the client about this value on a regular basis. Somehow, this gets lost in the negotiation process with procurement."
- "Internally, when agency finance and account management are not aligned in their objectives it is a problem."
- "It is critical to keep agency leadership and client service directly involved in the negotiating process with procurement. Negotiations cannot be left only to finance."

When agencies negotiate compensation and terms with sophisticated clients more often than not the client will involve professional buyers in the negotiation and contracting process. Client professional buyers may have titles that read procurement or sourcing or supply chain management. Whatever their title, it is likely that these professional buyers are well schooled in the strategies and tactics of negotiating.

Client procurement takes the view that they have a corporate responsibility to their shareholders to conduct in-depth, due-diligence vendor reviews, bids and audits. The supply chain management mindset is to negotiate everything, simply because they can.

Given that agencies are increasingly dealing with professional buyers, agencies must become adept at anticipating procurement's agenda. Agencies must plan for the processes and methods that sourcing will use to standardize and commoditize you as a vendor. Your agency must prepare how, if and when the agency will respond to procurement demands and power moves.

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III. Considerations: Process and Principles

Client focus on quantifiable improvements to marketing ROI has exacerbated the attack on agency compensation. This focus on reducing agency compensation has created an economic paradigm that often defines value in terms of lowest cost rather than optimal benefits, which will over time diminish the industry's ability to attract and retain talent and thwart efforts at alignment of agency-client economic interests to the ultimate detriment of clients.

Fortunately, the 4A's and ANA collaborated to map a process that can help abate the trend toward defining value based solely on lowest cost. The ANA and 4A's recommend a four-step compensation process that includes:

1) Goals and objectives—The Scope of Benefit
2) Scope of services and scope of work
3) Compensation framework
4) Compensation particulars.

Agency client service directors should insist that all agency compensation discussions and marketing expenditure proposals begin with a management-to-management dialogue on the client's business goals and marketing expectations.

Transparent discussion on the scope of expected benefits is critical to helping the client and agency frame the business-building, value-added expectations and metrics for any marketing investment, including the potential amount to be paid to the agency.

Agency management should embrace the ANA-4A's "Rules of Engagement-Compensation Dialogue Process" guidance that is incorporated in the ANA/AAAA Compensation Guide

In advance of any specific client negotiation, every agency's management team should develop principles and business standards that are strategically constructed to reflect the agency's values, beliefs and core requirements. The declaration of the agency's principles should be constructed to persevere over time, transcend short-term fads and operational pressures, yet allow for client-specific opportunity assessment or opportunistic investments.

The types of policies, metrics and standards that can be prudently documented in comprehensive agency policy guidelines include, but are not limited to, the following:

- Compensation principles, expectations, preferences and requirements
- Strategies and parameters for aligning agency and client economic interests including reward-risk and term-of-engagement expectations
- An agency point of view on performance-incentive compensation, i.e., can establishing performance based compensation agreements help to align client and agency interests and demonstrate the agency's commitment to achieving agreed upon results
- Critical contract terms including two-way performance evaluation, ownership of ideas and contract verification/audit guidelines
- Data that the agency will disclose upon request as well as confidential or proprietary information that the agency will not disclose

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- Client transparency of business results information and marketing program expectations and metrics that the agency requires in order to be able to fairly assess the opportunity and formulate proposed terms
- The agency negotiating plan, including the expected roles of key agency and client participants
- Billing, credit and payment policies
- New business policies
- Policies and practices for dealing with competitive conflicts.

Developing agency principles and policies is the easiest part of the process. The more challenging aspects of inculcating a principles-based approach to agency compensation and terms involves senior management's commitment and adherence to these principles, persistent education of agency managers on the rationale for and nuances associated with the agency's principles, and illustrating the practical consistent application of those principles to a real world negotiating environment.

IV. Best Practice Guidance: 4A's Agency Compensation Transformation Doctrine

The 4A's believes that the roadmap for agency compensation transformation entails industry adoption of a "Transformation Doctrine" that is built on four foundational strategic pillars.

1) Agency Principals Should Lead the Transformation of Agency Compensation

The important dimensions that agency management can bring to the negotiating table include:

- Agency management should aggressively lead the dialogue on aligning the economic interests of the agency and the advertiser.
- Agency management must articulate the way that the agency's operations work, the cultural dynamics of the organization and any process requirements, thresholds or core relationship attributes that foster successful sustaining alliances.
- Agency management must calibrate the staffing plan and service standards needed to accommodate the agreed upon scope of work.

Agency compensation will continue to deteriorate unless agency management gets involved in pricing strategy and client compensations discussions. 4A's urges agencies to evolve pricing as a core management competence.

Agency management should deploy some of their proven problem solving skills and innovative thinking to break the gridlock of formulaic compensation structures.

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2) Agencies Have an Opportunity to Reframe Marketers Value Orientation

The foundation for all agency compensation discussions should be a value discussion. If your agency expects value to be defined based on the scope of benefits (rather than based on lowest cost) then the discussion should be focused on brand equity, business growth and marketing innovation rather than on agency time and costs.

The foundation for all agency compensation discussions should be a value discussion. 4A's recommends that all compensation discussions frame agency value creation and scope of benefits as the pre-requisite for discussing agency services, compensation and proposals.

Industry thought leaders have the opportunity to communicate the business building value of advertising in marketer discussion forums and industry events. Concurrently, agency leaders have the responsibility to articulate the distinctive value-added services that their organization provides and to document the business rationale for the client's investment in marketing and marketing services.

3) Agencies Should Adopt a Principles-Based Approach to Compensation

Agencies have a responsibility to shareholders, employees and to other clients to maintain the integrity of the firm's business operations and to negotiate arrangements that over time ensure fair and reasonable contribution to the well being of all agency stakeholders.

4A's recommends that agencies establish internal agency standards on critical servicing, compensation, intellectual property and contracting principles prior to initiating negotiations with clients and prospects.

Adoption of a principles-based approach will help frame core attributes and minimum thresholds that are needed to sustain successful relationships

Agency management should establish the principles by which the agency will operate, set the standards of what constitutes acceptable risk and rewards, and be the ultimate arbiter of what constitutes a fair and reasonable agreement.

4) Client and Agency Management Should be Included in All Compensation Discussions

It is essential to have agency account management and client marketing participate in compensation discussions.

Agency compensation should not be negotiated in silos. Compensation discussions should include all key stakeholders i.e. Client marketing and client procurement along with Agency account management and agency finance.

Agency compensation discussions are too important to be delegated solely to agency finance managers, client procurement groups or attorneys that do not possess the requisite skill sets and client-specific business acumen to adequately frame the dimensions of success or have conflicting personal priorities and objectives.

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V. Agency Compensation Transformation Doctrine–Strategic Pillars Summary

There is an opportunity to transform the industry's approach to agency compensation. The foundation for change will require senior agency management commitment and leadership.

Clients are under pressure year in and year out to reduce marketing expenditures. Marketplace realities strongly suggest that the context for the agency business model of the future must reframe value in terms of both efficiency and effectiveness. Furthermore, given the dynamics of buyers and sellers of marketing services, in order to sustain the transformation of agency compensation the agency go-to-market offering must be built on consistent adherence to sound principles.

A journey of a thousand miles begins with a few simple steps—it is time to begin the journey of transforming agency compensation. The 4A's Agency Compensation Transformation Doctrine features four strategic pillars that can help the industry begin to move in a positive direction.

Approved by the 4A's Board of Directors, September 2010.

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Postscript:

In order to illustrate the types of information that an agency might include within a comprehensive compensation and contract principles policy, the 4A's has developed a sample that illustrates the types of considerations requiring internal agency alignment on business principles.

Agency Compensation, Contract and Negotiating Principles; Policy Considerations Requiring Internal Agency Alignment

Basic Compensation

- Compensation Framework & Preferences
  Principle example:* Agency preference is a fixed fee (no cost or labor reconciliation) with a performance incentive overlay.
- Minimum compensation thresholds
  Principle example:* The services and compensation arrangement must guarantee a minimum level of agency gross income of _______ per annum— along with a minimum one year agreement.
- Target/desired compensation attributes
  Principle example:*
  (1) Base fee that covers agency costs plus an acceptable profit tied to an agreed upon scope of services.
  (2) A "Change Order and/or Scope Modification" process for accommodating changes in compensation corresponding to changes in scope.
  (3) Adequate level of client authorized compensation and services to allow agency to accomplish marketing plan objectives.
  (4) Sufficient scope/compensation latitude to allow the agency to staff with premier talent and experiment with and test innovative new programs.
  (4) A multi-year agreement—preferably 3 years.
  (5) A performance compensation arrangement that provides for meaningful upside rewards tied to achievement of business results and marketing goals that are aligned with the clients performance thresholds.
- Reimbursable Expenses
  Principle example:* Travel, Research, Media time/space, Production, Talent, Prints/Shipping, Legal, etc.

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- For labor or cost-based arrangements—agency policies related to:
  - Disclosure of confidential information
    Principle example*: Requiring an NDA from client and any third party intermediary that protects agency CI and prohibits use of agency CI outside of the engagement or in data bases. Confidential Information (CI) should be defined—Definition might include agency compensation amounts, labor cost components and rates, etc.
  - Disclosure of agency employee compensation information
    Principle example:* Agency policy is not to disclose individual salaries
  - Direct labor definition.
    Principle example:* Direct labor is the portion of total labor expense attributable by contract or by time allocation to the client's business. Direct labor value is to be calculated at a fully loaded rate or in cost plus agreements calculated to include all W-2 and 1099 plus payroll taxes and benefit plan expenses.
  - Time allocations—dedicated staff
    Principle example:* Agency members that work on only one client and work agreed upon hours will be billed at 100%
  - Time allocations—non-dedicated (shared) staff
    Principle example:* Staff not dedicated to one client will be billed at established hourly rates based on the number of hours worked on the client's business.
  - Overhead definition and basis (Actual, Multi-Year Average, Negotiated Rate)
    Principle example:* Agency overhead is comprised of all agency operating expenses except client direct labor and reimbursed direct client costs. Overhead is allocated to clients proportionately based on each client's direct labor. Overhead rates are based on a three year rolling average.
  - Overhead disclosure
    Principle example:* Disclosure of agency cost information only relevant to the development and administration of cost-based compensation arrangements. Agency does not disclose detailed overhead components and does not permit the audit of overhead.
- Profit definition, expectations and rationale
  Principle example:* In order to satisfy agency stakeholders (employees, owners, lenders, etc.) and to fund investments in new/expanded/improved services the agency needs to be consistently growing and profitable. Target operating profitability (before income taxes and financing costs) is 20%. Any profit margin less than 16% requires corporate approval.
- Mutual transparency on source and use of benchmarks
  Principle example:* Client (or client intermediary) benchmarks must disclose the source of the information, time frames, census, ranges and other material information to substantiate the relevance/comparability of the information. Client or intermediary benchmarks should be challenged by the agency if the integrity of the information is not documented by the client or can not be independently verified.

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- Bid transparency.
  Principle example:* There is an issue with client procurement not being transparent with agencies (and in some instances, with their own marketing groups). In cases where there are competitive bids or auctions insist on disclosure, in advance, of all bidders, bid criteria + weighting [price and non-price criteria] and understand who will make the decision. To ensure a transparent and fair bidding process recommend a post bid feedback process that includes disclosure of bid details among all bidder participants.

Scope of Services, Scope of Work, Level of Services

- Use of Scope templates
  Principle example:* Agency policy should cover scope of services to be provided, deliverables (detailed project tasks with timelines) and level of services. SOW information must be documented in the agency's scope tracking software system.
- Appropriate level of detail
  Principle example:* SOW information should be constructed by brand, complexity, service or media type, etc. The SOW should differentiate high priority and low priority task as well high complexity and low complexity work. The SOW process is very important. In order to minimize "misunderstandings" SOW information should be comprehensive and specific.
- SOW preparation
  Principle example:* Client service department has responsibility for overseeing the development the SOW in conjunction with project management, creative, media and other functional departments. The SOW should include assumptions relative to rework; timeliness of client review/approval and other factors that impact scope efficiency, effectiveness and/or timing. Client service must obtain written prioritization and authorization of the SOW plan from the client.
- Scope tracking process and responsibilities:
  Principle example:* Authorizations are required to "start work". Timeline tracking, monitoring scope changes and additions must be updated monthly. Client change order approvals and supplemental budget/fee authorizations must be documented in writing.

Performance Compensation (Payment by Results)

- Agency philosophy on alignment of economic interests
  Principle example:* Every client compensation negotiation should include a robust dialog on the client's business goals and marketing objectives. Executive level client and agency management should discuss strategies for aligning the agency's and client economic interests.
- Required client transparency of goals, budgets and metrics
  Principle example:* In order to evolve a material performance compensation discussion the client must be willing to share detailed goals, budgets and metrics information including key assumptions and data sources. The client must also agree to provide the agency with consistent, timely access to key information.

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- Reward-Risk parameters
  Principle example:* The agency's policy is that the base compensation arrangement prior to any performance compensation should be fair and profitable. In those circumstances where the agency (General Manager or Client Services Director level decision) decides to put profit at risk the ratio of target + maximum reward to agency risk ratio should be in the range of 2:1 and 4:1 respectively.
- Performance criteria
  Principle example:* The agency prefers that incentive/performance criteria include a combination of (1) Client business results (2) Marketing program results and (3) Agency performance evaluation scores. The agency performance criteria must be consistent with the performance criteria that are established for key client management.
- Weighting of criteria
  Principle example:* Weighting of performance criteria will/can vary based on the nature of the assignment. However criteria should be established and communicated in writing at the beginning of the performance period.
- Calibrating metrics and payouts
  Principle example:* Payouts should be structured with a graduated performance attainment and payment schedule. All or nothing structures should be avoided. If multiple client brands or business units are involved it is advisable to have separate payout schedules for each assignment. While client expectations of its agencies are likely high, "Meets Expectations" ratings should not be tied to overly aggressive stretch targets.
- Assessment of client ability to perform.
  Principle example:* Prior to entering a performance agreement, agency management should assess the client ability to consistently execute successful programs and to equitably steward incentives [Have previous client performance arrangements generated meaningful performance compensation to agency partners?]. The tenure and stability of the agency-client relationship should be considered. Performance compensation criteria should be clear and not subject to unilateral interpretation i.e. minimize the potential of a client to arbitrarily reduce or avoid paying performance compensation.
- Client budget provision and pay out timing.
  Principle example:* The client must agree to budget an appropriate amount to fund the agency performance payment. In the case of achievement above goal/budget client must establish a funding/authorization procedure that assures that the agency will be paid. Agency and client must assess each organizations revenue/expense recognition obligations.
- Agency audit-verification rights.
  Principle example:* The agency-client agreement should provide the agency with a mechanism for verifying performance attainment and pay out calculations.

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Intellectual Property (Ownership and Usage Rights/Limitations)

- New Business Ideas & Work Product
  Principle example:* The agency policy is that there should be written agreement between the parties that specifies that agency ideas and work product developed in conjunction with a new business pitch shall remain the property of the agency until the agency is hired to execute the work or there is agreement on a fair and reasonable payment to the agency covering assignment of rights. Transfer of ownership should be tied to payment of good funds from the client.
- Pre-existing agency I.P.
  Principle example:* The client agency agreement should protect agency ownership and usage rights related to all pre-existing agency intellectual property including software and software tools
- Use of agency developed materials
  Principle example:* The client-agency contract should include provisions that establish the agency's economic interests (if any) or subject the clients usage rights to agreement on supplemental compensation to the agency in circumstance involving: (1) non-advertising use of agency work (2) post termination use of agency developed materials (3) use by franchisees or affiliates and (4) for specialist or regional firms use in alternative markets, use in alternative media or use among alternative target audiences.
- Assignment of Rights
  Principle example:* The client-agency contract should limit assignment of rights to executions that are developed by and produced by the agency and paid for by the client.

Contract Terms & Conditions

- Vendor liability
  Principle example:* The agency business model is to operate as agent for the client as a disclosed principal. The agency contracts with vendors for all client related purchases should specify sequential liability.
- Credit, billing and payment policies
  Principle example:* Clients funds must be received by agency in time for agency to meet all third party payment obligations. Agency fees are billed at the beginning of each month and payable mid-month. For clients that require longer payment processing cycles billing should be accelerated.
- Term and termination
  Principle example:* Fixed term agreements require payment in full prior to termination. For evergreen arrangements the ninety day notice provision should included a minimum compensation provision [generally at the average monthly rate for the preceding twelve months].

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- Other Terms and Conditions:
  Principle example:* The agencies principles and guidelines should also provide standards covering: (1) Confidential Information—what constitutes appropriate transparency, disclosure and use of client and agency CI, restrictions on third party access and use of agency CI, etc. (2) Audit and verification guidelines and policies i.e. what, how often, who can audit, language that disallows contingency audit arrangements, cost responsibilities, etc. (3) Reps, and Warrantees and (4) indemnification and insurance standards.

The Agency's Negotiating Plan + Philosophy

- The agency negotiating team: participants, roles and responsibilities
  Principle example:* For all major compensation and contract negotiations the agency negotiating team should include: the President or office head, the Client Services Director or Senior-most Account Director on the account, the senior Finance Director and an attorney
- Negotiation Preparation
  Principle example:* All senior agency managers who are involved in major compensation discussions with clients must participate in negotiating skills training. Prior to beginning a negotiation with a client the agency negotiating team must outline preparation requirements and rehearsal plans, information requirements and benchmarks.
  Principle example:* The agency team should develop a list of information that is required from the client—this list should include information about the client's business goals and marketing objectives. The agency should ask the client for marketing budget information including the amount budgeted for agency remuneration along with key assumptions.
  The agency team should develop a detailed scope of work and agency service and resource plan. The agency should prepare the rationale for the proposal and provide benchmarks that support the agency proposal
- Management Do's
  Principle example:* Unsuccessful negotiations often happen when agency management is not aligned for the negotiation. Good negotiation skills are not enough. The agency team must also be aligned on the goals and objectives of the negotiation.
  Principle example:* Prepare in advance for procurement power moves. Agree on desired outcomes in advance and define agency requirements and mandatory arrangements
- Management Don'ts
  Principle example:* Don't negotiate in silos. Don't negotiate with client procurement without client marketing involvement
- Strategies and policies for working with third-party intermediaries.
  Principle example:* In those circumstances where agency and client agree that it is prudent to involve a third party intermediary in a negotiation the agency should have a "preferred list" of reputable intermediaries and standards for the expected role and conduct of the intermediary.

Reminder: This sample compensation principles and negotiating considerations document is illustrative. The categories of information and policies that your agency will want to include when you develop and document your agency's compensation principles will need to be customized for your circumstances and business model.

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