Agency Overhead: The Rules of the Road

A User's Guide to Agency Overhead
Predominant Practices
Frequently Asked Questions (FAQs)

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Overview

There has been extensive discussion within the marketing services community related to agency overhead. Much of the agency overhead discussion is in response to client compensation consultants' and client procurement groups' efforts to deconstruct, benchmark and, in some instances, cap or limit the agency overhead component of cost-based compensation arrangements.

Members of the 4A's Finance committees believe that it is in the best interest of both the agency and client communities to provide information on agency overhead, including predominant industry cost-accounting practices.

Frequently Asked Questions

Agency management and financial executives are frequently asked questions relating to agency overhead by client procurement, compensation consultants, search consultants and other industry participants. This document provides rules of the road for agency overhead and references predominant industry practices.

The information is structured in a Frequently Asked Questions (FAQs) format, i.e., questions followed by answers that contain information and best practices.

FAQ #1, Overhead Multiplier

Question: Is there an industry-standard overhead ratio or direct-labor multiplier? How is the overhead multiplier calculated?

Answer: There is no industry-standard overhead ratio or multiplier.

The relationship of an agency's direct client-labor cost and the agency's other reasonable and customary operating expenses (indirect or overhead costs) are a function of that agency's business model, infrastructure, staffing philosophy, employee remuneration, benefit plan programs, location and other considerations. Because of the nuances that differentiate individual agency operations, overhead is not able to be benchmarked. This is why the 4A's has never fielded an overhead survey.

An agency overhead "multiplier" varies, depending upon the definition of the costs included within direct labor. In order to illustrate this dynamic, an illustration based on two predominantly used direct labor definitions approaches (and resultant overhead multiplier calculations) is provided below:

- Most agencies define Client Direct Labor as salary, bonus (W-2 & 1099), and all payroll taxes and group benefit plans
- Some compensation consultants want to define Client Direct Labor as base salary only.

The difference in Client Direct Labor definitions has a significant impact on the overhead multiplier when expressed as a percentage or ratio to Client Direct Labor.

The Illustration that follows uses identical agency cost amounts, i.e., costs for salary, bonus, payroll taxes, group benefits, indirect labor and all other operating costs. The differences between overhead multiplier calculations is based solely on where payroll taxes and group-benefit costs are categorized, i.e., for method #1, they are included in Client Direct Labor, while for method #2, they are included in overhead.

	Method #1	Method #2
Client Direct Labor		
Salary, Bonus (1099 & W-2)	$1.00	$1.00
Payroll Taxes and Group Benefits	.15	.00
Client Direct Labor	**$ 1.15**	**$1.00**
Overhead		
Indirect Labor		
All Other Operating Costs		
(e.g., Financing Costs and Income Taxes)		
Overhead	$1.15	$1.30
Labor & Overhead	**$2.30**	**2.30**
Overhead Rate Multiplier	1.00	1.30

An agency will have an overhead multiplier of either 1.30 or 1.00 on Client Direct Labor, depending upon the definition used for the expenses included in Client Direct Labor.

FAQ #2, Overhead Variability

Question: What are some of the factors that contribute to overhead variability?

***Answer*:**Some of the factors that contribute to variations in overhead ratios include:

- Agency Service Types
  Media service agencies have higher investments in proprietary research, data costs and booking/trafficking systems. This, combined with the fact that direct salaries in media are, on average, lower than in creative, often results in higher overhead rates for media service agencies.

  Data-based insights are highly valued by clients. Agency data and analytics capabilities are costly. It is expensive to acquire marketing, customer and consumer data. Agencies invest heavily in technology to process big data, and agencies pay premium wages to data scientists, mathematicians and data analysts to mine insights from big data. Agencies that have robust data and analytics capabilities have elevated overhead cost structures.

  Global agencies that invest in cross-border and cross-function coordination structures provide added infrastructure services for clients but add an element to overhead that does not exist with local service arrangements.

- Client Operating Preferences and Business Practices
  Most clients directly pay/reimburse the agency for agency research, travel and other direct client costs. However, some agency-client agreements may specify that some of these direct client costs are not directly reimbursed by the client. In such cases, those costs are then added to overhead for that client, resulting in a different overhead ratio.

  Clients that work with agencies on annual retainer relationships have a significant proportion of agency staff that is dedicated solely to their business, which yields efficiencies for both the client and the agency. Other clients that work with the agency on a project-to-project basis may have minimal dedicated agency staff. The latter, project–by-project, arrangements result in higher levels of indirect agency labor costs for the agency, due to lower staff utilization rates, which results in higher overhead.

- Location
  Employment practices, salaries, real estate occupancy costs vary from market to market, which can and do impact overhead costs and ratios.

- Period to Period
  Overhead rates do vary from year to year. While overhead ratio variation from year to year is often relatively small, a three-year average overhead rate will include annual variations of +/- 5% or more.

FAQ #3, Consultant Overhead Benchmarks

Question: Consultants claim that they have overhead benchmarks and endeavor to convince clients that overhead can and should be benchmarked. Are consultant overhead benchmarks accurate? Are consultant overhead benchmarks relevant?

Answer: Many compensation consultants base their business model on deconstructing agency labor billing rates into multiple cost-based components, i.e., salaries, benefits/taxes, occupancy and other agency overhead items plus agency profit. These consultants promote their benchmarks as proprietary information that can help a client manage and reduce agency costs and compensation. In point of fact, the deconstruction of agency labor billing rates into multiple cost-based components and consultant overhead benchmarking is unnecessarily complex and irrelevant.

Deficiencies in the accuracy, logic and relevance of agency overhead benchmarks are noted by many industry leading experts:

- The World Federation of Advertisers (WFA) in their 2014 Global Agency Remuneration Trends Report affirms that agency overhead is not a measure of agency efficiency.

  "Overhead is not an indicator of agency profitability or efficiency. A desire to improve the efficiency of agency costs should not lead you to assume that overhead is too high. It is not a universal benchmark and many factors can influence overhead as a percentage of total agency costs. For example, if staff costs rise relative to rent costs, overhead will go down. In contrast, as agency technology costs rise this should reduce labor costs and thus push up overhead as a proportion of overall costs. In different parts of the world, the ratio between people costs and rents or technology vary hugely. It is therefore important to dig into overhead with an open mind and not see it as an immediate lever for negotiation or savings. There may be a very good reason for the overhead to appear high in relation to salary costs."

- Compensation consultant Michael Farmer (Farmer & Company,) in his white paper #6 "The Myth of Overhead Benchmarks," notes:

  "*Benchmarking consultants claim that benchmarked overhead rates are in decline. Their declining benchmarked rates are then used by clients to force down agency fees. When fees decline, agencies downsize. The downsizing comes from reductions in Professional Services costs. As a result, the overhead rate for subsequent years goes up.*

  "Our work shows that the long-term trend is for agency overhead rates to rise with increases in agency productivity. Clients, though, believe that benchmarked rates are going down and so should agency fees, even though workloads are on the increase. If fees go down, overhead rates will rise. That's the real mathematical logic of the industry, in stark contrast to industry practice or the claims of the benchmarking consultants.

  "Clients beware! Agencies beware! There are overhead costs out there, and professional service costs as well, but there are no scientific overhead rate benchmarks. The sooner the parties realize this the sooner they will seek a more rational way of dealing with costs and fees."

Given variations in calculation methodology, differences in FTE/utilization approaches and, most importantly, because of the nuances that differentiate individual agency operations, overhead cannot be benchmarked accurately.

As an industry, we do not aggregate or publish overhead data because of variations in methodology and agency operations nuances. So where are the consultants getting their benchmarks?

It is likely the consultant is inappropriately using confidential data provided by agencies during new business pitches or during a negotiation process.

Agencies can protect themselves from inappropriate overhead benchmarking by following a few simple best practices:

- The use of agency confidential information, including overhead, should be covered under a confidentiality agreement that restricts not only the client but also the consultant performing the review from using agency data for any other purpose other than the agreed review.
- Overhead “benchmarks” should be challenged in terms of whether they represent actual overhead rates or negotiated overhead rates. The difference can be significant. Overhead is just one component of a compensation negotiation, and if the benchmarked data are aggregated after the negotiation versus actual data, then the benchmarks become even less relevant and are inappropriate for use.

Challenging a consultant as to the validity of the data and whether they have the right to use such data is appropriate.

FAQ #4, Overhead Full-Time Equivalent (FTE) Hours

Question: How do FTE hours affect overhead calculations? What are the industry norms for FTE calculations?

Answer: The concept of FTE is applicable to retainer arrangements that entail an annual scope of work and the commitment to reserve (allocate) an employee's time to a client. The FTE concept does not apply to short-term engagements or project work.

The basis for FTE hours varies from agency to agency. Allocation of hours impacts an agency's overhead calculation to the extent that time that is not assigned to client direct labor is allocated to indirect labor, which is a component of overhead.

Industry practices for FTE hours generally range from 1600 hours to 1800 hours, however, there is no industry standard for the allocation of costs associated with compensated absence time (vacation, holiday, sick), training time, pro bono time and new business time.

The ANA/4A's compensation guide notes:
"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."

The ANA/4A's compensation guide also referred to 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."

FAQ #5, Overhead Components and Allocation

Question: What is typically included in agency overhead, and how do agencies ordinarily allocate overhead?

Answer: For internal agency cost accounting purposes as well as for cost-plus client pricing arrangements, industry practice is to allocate their overhead expense pool in proportion to client direct labor costs.

The ANA/4A's compensation guide "Understanding Direct Labor, Overhead and the Components of Cost-Plus and Labor-Based Arrangements" provides a helpful definition and relevant framework for overhead:

- *"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.
- *"Direct Labor aka Client Direct Labor Expense*
  The portion of Total Labor Expense attributable by contract and by time allocation to client(s) business.
- *"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."

The ANA/4A's compensation guide also provides examples of the types of expenses that are included in agency overhead categories, for example, Parent/Holding Company service costs:

- *"Parent/Holding Company Service Costs*
  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."

In task force meetings with ANA, members of the 4A's Finance committees described Parent Company Service Fees as costs related to services that would ordinarily be borne by the Agency if it were a stand-alone company, including allocation of expenses suchas audit fees, tax preparation, legal services, membership dues,insurance costs and centralized services (e.g., accounting, IT, HR).

Typical costs included in parent company service fees include:

- Payroll, human resource + benefit processing administration
- Corporate insurance
- Tax research, planning and preparation (payroll, sales + use,state, federal, property tax)
- Real estate management
- Information technology management
- Consolidated purchasing management
- Professional fees

All companies have these charges.

- The parent company charges represent value received by operating units for services purchased centrally to leverage purchasing power.
- Parent company charges are cost efficient: If these services were purchased individually, costs would most likely increase.

Parent Company Service Fees do not include:

- Profit
- Restructuring or acquisition costs
- Goodwill amortization

FAQ # 6, Overhead Audit and Verification—Best-Practice Considerations

Question: Clients will occasionally ask to audit our agency overhead. The request is sometimes advanced by a client that is not charged based on actual overhead but rather charged based on either a fixed or negotiated overhead multiplier. What are industry best practices for responding to client requests to audit agency overhead?

Answer: Most agency-client MSA agreements limit the client's right to review agency overhead details or audit agency overhead costs.

The notable exception to agency limitations on client's right to verify agency overhead costs relates to true cost-plus arrangements where all costs are actualized at the end of the contract period and the client agrees in advance to pay based on actual cost.

If agency overhead is a fixed or negotiated multiplier, then audit or verification of actual overhead is unnecessary and inappropriate.

In those instances where agency compensation is based on actual overhead rather than a fixed or negotiated overhead multiplier, industry practice is to:

- Allow a mutually agreed-upon certified, independent accounting firm or "Big 4" auditor to attest to the accuracy of the agency's overhead calculation. In no case should agencies allow consultants, client internal auditors or "specialist audit firms" to undertake an overhead audit.
- The auditor must sign a non-disclosure agreement with the agency and agree to the scope of the verification.
- The auditor will not have access to individual employee payroll data or information related to the agency's other clients.
- The auditor is not permitted to disclose agency individual payroll records, overhead amounts or expense details to the client.
- The auditor is not permitted to use information for any benchmarking or database building.
- The client must agree that it will not accept disclosure of agency salary and overhead data.

An allowable auditor's verification of an agency's overhead, for cost-plus arrangements, will likely include a review of the agency's overhead calculation *and* could include attestation by the agency's CFO or internal audit staff as to the accuracy of the agency's overhead calculation.

FAQ # 7, Overhead Assignment—Incremental versus Full Absorption

Question: Most clients and consultants understand and accept the marketing service industry practice of allocating overhead and applying an overhead multiplier to client direct labor that covers all reasonable and customary agency overhead. However, from time to time, a client will endeavor to negotiate an overhead multiplier calculation that only includes incremental overheads that are directly associated with the client's business at the agency. How do most agencies respond to incremental overhead "activity-based" arrangement requests?

Answer: All for-profit service companies, including marketing services agencies as well as other professional service industries and manufacturing companies, must consider direct costs, indirect costs and profit components when they price their offerings. The mechanisms that organizations use to allocate indirect costs are customarily based on "prime costs," i.e., the direct-cost components that are directly attributable to the product/service output.

- Manufacturing companies account for direct prime costs such as the cost of ingredients, components, packaging materials, production direct labor and the production line. Manufacturing companies then allocate indirect costs of the facilities common space, equipment and staff support costs for things like delivery docks, raw material storage, quality control services and other essential production support services (engineering, mechanics, scheduling, purchasing, etc.).
- Accountants, lawyers, consultants and other professional service vendors allocate indirect costs based on client direct (prime) costs.
- Marketing services agencies' indirect costs, i.e., overhead are almost always allocated as a ratio of direct client labor (the exception relates to agency units that only work on one client's business).

Knowledgeable clients understand and embrace the economic imperative that cost-based agency pricing includes directly attributable client labor and out-of-pocket costs, indirect costs and a profit component.

Marketer due-diligence practices customarily seek reassurance that an agency's rates are competitive, and when cost-based compensation models are utilized, marketers seek reassurance that cost (direct and indirect) and profit components are reasonable and customary. Balanced and well-informed marketer due diligence is appropriate. Marketing services agencies should be prepared to articulate their value proposition and provide the marketer with relevant context for assessing the agency's pricing.

There is a minor element of the marketer community that endeavors to gain advantage by negotiating below-market rates. These organizations employ aggressive tactics, faulty benchmarks and illogical economic theories as tools in their negotiations. However, the majority of client-agency arrangements follow fair, balanced and consistent industry economic practice. Agencies that accommodate client requests for below-market rates risk deterioration of the agency's economic foundation which, over time, will adversely impact the agency's ability to retain talent, invest in their business and service clients.

FAQ #8, Overhead Lessons Learned

Question: There seems to be a disproportionate client and compensation consultant focus on agency overhead. There are also compensation consultants who claim to have an overhead database that they use to "benchmark" agency overhead—these benchmarking exercises sometimes seem arbitrary, inappropriate and divorced from the agency's labor billing rates. How can an agency provide education and context around agency overhead?

Answer: It is sometimes necessary to discuss agency overhead in an appropriate context, dispel misconceptions about overhead and describe relevant labor benchmarks:

Why This Topic Matters

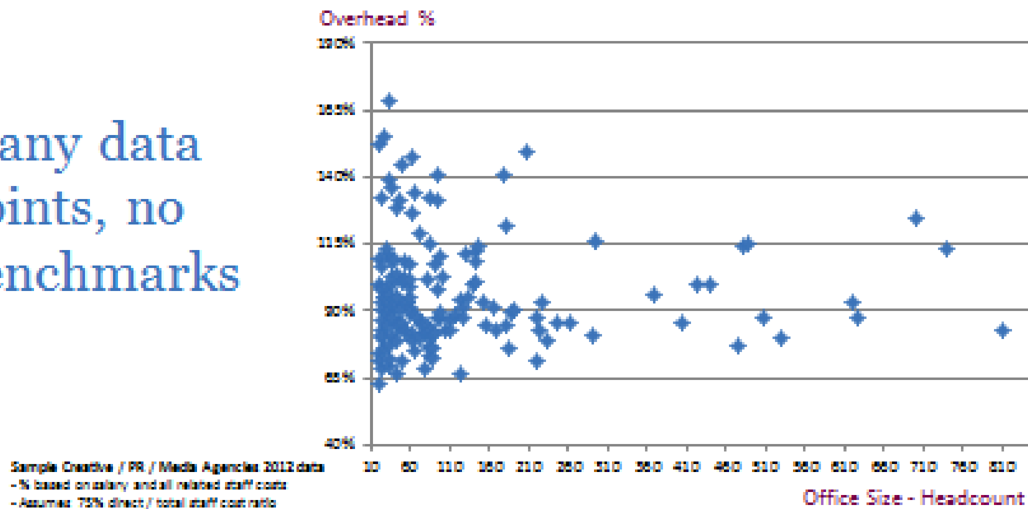
- Cost-based compensation agreements are the norm.
- Consultants create confusion about an agency's overhead rate.

Overhead and the Truth about Efficiency Metrics

Overhead Rates are Not Efficiency Metrics

- High overhead does not equate to inefficiency.
- Low overhead does not equate to efficiency.

There Are No Benchmarks of Standard Overhead Rates



There Is No Correlation Between Overhead Rates and Total Fees or Hourly Rates

- Agencies with lower overhead rates may well have higher overall costs, fees and hourly rates than agencies with higher overhead rates.
- Agencies with higher overhead rates may well have lower overall costs, fees and hourly rates than agencies with lower overhead rates.

Overhead, Fee and Hourly Rate Summary

Agency	Overhead Rate	Agency Cost (000)	Fee (000) 20% Profit	Hourly Rate (1,800 year)
Agency 1 (Baseline)	100%	350	438	$122
Agency 2 (10% increase)	92%	371	464	$129
Agency 3 (10% decrease)	109%	330	413	$115
Agency 4 (Productivity)	123%	335	419	$116
Agency 5 (Mumbai)	267%	220	275	$76

Overhead Myths and Misconceptions

- Agencies do not hide profit in overhead. By definition, an overhead calculation only contains expenses.
- Clients should pay the agency's actual overhead, including costs of the agency infrastructure (such as global network costs). Clients hire your agency because of your skills and infrastructure.
- Agreeing to a multi-year declining overhead rate is not logical. It does not equate to a price decrease or improvement in efficiency.
- A client request to pay only for "incremental overhead" is not consistent with the concept of overhead as a markup.

Benchmarks

If overhead can't be benchmarked, what can?

- Total fee relative to services provided
- Hourly billing rate by function
- Blended hourly billing rate across a team
- Total fee per head

Summary

- Agency overhead is not an indicator of efficiency or overall cost.
- There are no appropriate relevant agency overhead benchmarks.

FAQ #9, Additional Information on Agency Overhead

Question: Where can I access additional information about agency overhead?

Answer: The 4A's has compiled information and materials related to agency overhead. Titles and links to much of the available 4A's overhead information are provided below:

1) The Myth of Overhead as an Efficiency Metric
Rick Brook, SVP, Global Client Operations, WPP identifies myths about efficiency metrics—notably the invalid use of overhead as an efficiency metric. Rick suggests a hierarchy of metrics that are appropriate and should be used in compensation discussions.

The video recording of Rick Brook's 4A's Compensation Summit presentation is provided here:
Overhead & the Truth About Efficiency Metrics

Mr. Brook reprised his overhead presentation at an ANA Finance Conference; the slides from the ANA presentation and his overhead handout example are provided here:
Brook ANA Overhead Slides
Brook ANA Overhead Examples

2) 4A's Marketers Guide— Basics in Comparing Agency Costs and Overhead
Comparing Agency Costs and Overhead

3) 4A's Management Series: What is this Thing Called Overhead?
What is this Thing Called Overhead

4) The ANA/4A Compensation Guide—Understanding Overhead and Components of Cost-Plus and Labor-Based Arrangements
2006 Compensation Guide
Demystifying Advertiser "Hot Buttons"

5) 4A Position Paper—Myths in Agency Overhead
Myths in Agency Overhead

6) Mike Farmers—The Myth of Overhead Benchmarks White Paper
The Myth of Overhead Benchmarks

7) 4A position paper on Media Service Agency cost structures and the implications on overhead
Media Service Agency Cost Structures—Implications on Overhead

If you have questions pertaining to 4A's information on agency overhead, contact 4A's Management Services.