

Best Practice Guidance

Agency Compensation: Market-Based Labor Rates



A Position Paper From the 4A's Finance Committee

Eighteenth in a series of position papers addressing key industry issues

4A's Board Approved.

I. Objective

Marketers and agencies have made significant progress in transforming the innovation, speed, measurement and performance of marketing activities. It is now time to transform the foundation of the predominant form of agency compensation, i.e., labor-based fees.

The purpose of this position paper is to suggest guidance to help the marketer and agency communities streamline the process for establishing and evaluating agency labor billing rates.

"4A's recommends that agency labor billing rates should be based on prevailing market rates set in the marketplace and reflecting the value, complexity and sophistication of services provided rather than being based on deconstructed agency cost and profit components."

II. Background

Labor-based fees are the predominant form of agency compensation in the marketing services industry. Transparent and comprehensive development of labor-based fee arrangements entails agency and client agreement on: (1) scope of benefits expected by the marketer (2) services to be provided by the agency (3) an agency staffing plan and (4) labor rates charged by the agency.

Prevailing agency labor rates charged to clients are derived based on a range of considerations including, but not limited to, agency reputation and pricing policy, services provided, market forces, industry rate card, budgets, opportunity cost, agency cost, negotiated rates, etc. While the process for establishing labor-based fee arrangements is inherently complex, the process is being made more complicated than is necessary by strategically flawed deconstruction of agency labor rates into agency internal cost and profit components. Deconstruction of labor rates into cost and profit components has the effect of linking all labor rates to cost, which is both inaccurate and inappropriate. The deconstruction of agency labor billing rates into cost and profit components is not in the best interests of marketers or agencies. We have reached the point where a costly ecosystem of consultants, software and flawed metrics has evolved into an unproductive industry reliance on cost-based agency labor rates that serves the consultant community well but does not contribute to value creation or improved client-agency relationships.

III. Considerations

Agency and advertiser relationships are best served by focusing on the scope of services and deliverables to be provided by the agency, marketing activity performance and the value that the parties establish for agency services.

“The price of an agency’s labor should be based on the value provided by that labor rather than the agency’s internal cost structure.”

Cost-Based Labor Rates Are Suboptimal

Any form of cost-plus or cost-based construct in pricing can engender a culture of adding up costs rather than creating and articulating value. This is not ideal for clients or agencies.

The reasons that agency labor rates based on cost components are suboptimal for marketers include:

- A cost-plus construct in pricing labor is as likely to lead to overpricing as it is to underpricing; market worth does not follow a cost-plus model
- Cost-plus constructed rates can result in an economic incentive for agencies to “load” more senior (i.e., higher-paid) staff than may be required onto a client’s business. Equally, they can act to price senior talent off the business. A better system is one where the service provider has an economic incentive to assign the work to the level at which it is best accomplished and ensures that senior resource is available but leveraged across sufficient volume of business, which leads to more efficient service models
- Too much energy is wasted in discussion of the details behind the cost components and administration of complex cost-based compensation arrangements rather than focusing on the value of services provided. Administration of cost-based arrangements adds unnecessary cost and management distraction at both the agency and the client organizations at the same time both are being asked to be more efficient with their use of time. Ultimately, the client has to pay for time spent by the client and agency administering cost-based agency compensation models, e.g., reporting hours, handling reconciliations, dealing with auditors, etc.
- Moving away from agency cost components in agency services pricing frees up valuable resources and enables marketers to focus on marketing implementation.

The reasons that cost-based agency labor rates are suboptimal for agencies include:

- Agency cost-based arrangements can serve to weaken an agency’s focus on key indicators of performance and productivity, e.g., agency value delivery, talent model, operating methods, systems and knowledge because the agency focus is on cost components and billable hours rather than on KPIs
- Deconstruction of labor rates results in an inappropriate focus on surrogate cost-component information (salaries, benefit plans, overhead, etc.) that is complex, administratively burdensome and one-dimensional

- Disclosure of confidential salaries by title or individual, which results from labor-rate deconstruction, is inappropriate
- Cost-based agency compensation can adversely impact agency employee compensation strategies and levels of employee compensation, which is not conducive to an agency's effort to attract and motivate superior talent
- Agency costs and profitability should not be determined by agency clients, vendors or intermediaries
- The components of an agency's cost and profitability, including salary information and overhead, is proprietary information that is unique to the agency, as it would be with any other company. An agency's cost should be calibrated and managed solely by the management of the agency. Furthermore, agency profitability is derived from a broad range of dynamics that are not exclusively attributable to individual clients.

Market-Based Labor Rates Are Strategically Appropriate

In most instances, the best and healthiest model for agency pricing is an agency services marketplace whereby the rates charged are reflective of the value of the services and deliverables as well as the quality and reputation of the agency in question, not on the costs incurred by that agency.

Value-oriented, market-based hourly rates provide an unambiguous method of pricing labor:

- While cost-based rates may satisfy the needs of client negotiators, the focus on cost does not help client marketing ensure that they will get the service they want (seniority of resources, inspiration beyond what is called for in the SOW, etc.)
- Using value-oriented market-based billing rates helps increase the focus on the value for money of agency services on a "total price" basis without the distraction of debating overhead rates and profit margins
- It is easier and cheaper to verify compliance with a single-number rate-based pricing model than it is to ensure compliance with a cost-plus construct.

Marketers that want to understand the relative range of labor rates or benchmark the rates that they are paying can accomplish those objectives, without the deconstruction of cost components, by comparing agency billing rates charged or agency billing rate quotes.

All talent and all agencies are not equal. Leading agencies are able to attract, retain and grow better talent, consequently, the value premier agencies create should exceed industry norms. Agencies should be compensated based on the value of their talent and the value of their work product. As an analogy, a luxury car model doesn't command higher prices solely because their cost for steel is more than that of other suppliers... they price at a premium because their product is perceived to be better. Clients are not coming to agencies hoping for a commodity output. Clients want innovative, distinctive marketing. Pricing agency talent and services on a cost basis will lead toward commoditization, whereas market pricing, based on the value of agency talent and services, facilitates linkage between value provided and value received.

IV. Guidance Summary

Labor rates in other professional service industries (e.g., lawyers, accountants, consultants) are not normally deconstructed into cost and profit components. Market-based rate cards and negotiated labor rates are the predominant labor-rate mechanisms that are used in professional service industries.

Cost-based deconstruction of agency labor rates into components parts (i.e., Labor Cost, Overhead & Profit) is not effective, efficient or relevant for clients or agencies. Furthermore, contentious cost-based rate negotiations can lead to a loss of mutual trust and inflame unproductive bias (i.e., Marketer view: “They are charging for every hour ... too many people in the room” versus Agency view: “They are not paying for our most senior people ... don’t recognize scope creep”).

Agency and advertiser relationships are best served by focusing on performance expectations, deliverables to be provided by the agency and the value that the parties establish for agency services.

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Approved by the 4A’s Board of Directors, March 2015