

Understanding and Negotiating Agency Overhead

In order to understand agency overhead and negotiate it effectively, it's important to understand some terminology, the background, the context ... and some maths!

TERMINOLOGY

Overhead:

Overhead is the term used to describe the charge a business may make to its clients to contribute to its indirect costs.

Indirect Costs:

Indirect costs (or overheads) are those which a business incurs regardless of the amount of work it does. These could include rent, salaries and insurance etc.

Direct Costs:

Direct costs for an agency are those which are incurred as a direct result of client activity. Direct costs vary according to the amount of work done and are easy to associate with a specific client or project. This is mainly the cost of time spent by staff working directly on a project.

Profit:

Like all other businesses, creative agencies need to make a profit in order to survive. Their total annual fees must exceed the combination of indirect and direct costs.

In order to cover their indirect costs, agencies charge an hourly rate that includes an agreed contribution to these costs (the overhead allocation). In effect, all clients of an agency share the task of covering the agencies indirect costs.

Agency Overhead:

Agency overhead is usually expressed as a percentage of direct staff costs, so clients contribute in proportion to the amount of agency time they use.

You'd expect then, that the percentage overhead applied would not vary from client to client. However, it does, and some agencies could treat overhead as an opportunity to apply additional mark up rather than simply cover costs. That makes it negotiable.

Utilisation Rates:

Agency staff are generally billed out at 100% utilisation. That means every hour per day they work is chargeable to the client. However, in some cases they believe that if a member of staff is carrying out administration work on behalf of the agency these are not billable hours so the agency seeks to recover these costs by apportioning this time to overhead. If the overhead rate is greater than 100%, then this activity is more expensive for the client than would be the case had it been billed as a direct cost.

BACKGROUND

So how did we get here?

Not so long ago, all creative agencies were paid a percentage of the total media spend (Media Commission). There was little or no relation between the fees paid and the time spent actually working on the campaign. A big TV campaign was very profitable for the agencies who produced the single advert used. Some of the resulting adverts are now considered classics (Flake, Guinness, VW and many others) .

This arrangement had advantages and disadvantages: while it provided the time and space in which creativity could thrive, it was considered wasteful. It occurred to some clients that they could be more profitable themselves, if the creativity was measured - and paid for - in units of time rather than as a percentage of their spend. They had a point.

In response to this effort to rationalise, save money and measure creativity in units of time, Agencies needed a mechanism to protect their profits. Simply billing by the hour to cover direct costs was going to leave them short. So agency overhead filled this gap.

Sadly, today, for many Client/Agency relationships this is a compromise that fails both parties. It has become a lose:lose scenario.

Underlying this issue is the inherent difficulty associated with measuring creativity in units time. The hour during which that great idea emerged is surely worth more than the 100 in which it didn't?

Great ideas have a habit of taking time to emerge. We can all think of campaigns that turned brands around and had a far greater impact than could be expected for the hourly fee applied to the moment at which the big idea emerged.

Looking ahead, there are a number of initiatives that may prompt a change to the way that creative services are paid for.

Marilyn Baxter's white paper called "Magic and Logic" (for ISBA) explores how clients and creative agencies can find a win, win scenario. (www.magicandlogic.co.uk)

A Payment By Results (PBR) arrangement would surely favour both Client and Creative Agency. But do Agencies have the courage of their creative convictions and are Clients prepared to accept that results depend on factors outside the control of their Creative Agency?

So Where Do You Start?

If you are negotiating the terms of a new Client/Agency relationship, you have a rare opportunity to engineer a transparent and fair agreement on the rate of Agency Overhead; what should and should not be included and the associated direct cost rates on which they are based. Don't waste it!

Whether you are negotiating a new arrangement of an existing one, the starting point for is the calculation of the figure that represents the total indirect costs an agency will incur over the year. As you'd expect, an agency Finance Director will use data that presents the best case for the agency. This might come from budgets or forecasts.

However, the best figure to use is the actual indirect costs from the previous year.

What Should be Included and Excluded?

Having agreed the basis on which the total annual overhead is calculated, the next task is to agree what should and should not be included in overhead, and passed on to you, the client.

Direct and related staff costs should be excluded.

Direct staff are those who work directly on a client's work in roles such as these:

- Account Management
- Production
- Planning
- Creative
- Media Buying
- Art Buying

Costs incurred by the agency relating to those 'direct' staff are considered direct staff costs and excluded from overhead. These include:

- Salary
- Employer's National Insurance
- Pension contributions
- Healthcare
- Car allowance
- Bonus

The above costs will be covered in the hourly rate as direct staff costs.

The cost of indirect staff could be included. These will include those who work in Finance, HR and IT for example.

Other costs may be included such as property costs, administration, some marketing, some travel and entertaining, professional and training costs. There are no hard and fast rules. Any unavoidable cost that the agency incurs to make it possible for them to function might reasonably be included.

However, there will be some costs that should not be passed on in any circumstances. They could include:

- Production write-offs
- Bad debts
- Client entertaining
- Travel
- New Business Development (Pitching)

and anything that is likely already to have been paid for via direct costs.

There are some grey areas of course. For example, the Head of Client Services may

spend 50% of his or her time supervising and developing an account management team. It would be reasonable to split these costs between overhead and direct staff costs.

Further, an apparently indirect cost could be very closely associated with a Client or project. The relocation cost for a key member of staff for example.

Some agencies try to claw back the cost of staff downtime by including this in the overhead or by reducing the number of hours forming the basis for the calculation. This is often referred to as utilisation. This can affect the overall cost to Clients considerably and should be identified and either negotiated or excluded.

Consider also, extraordinary items and costs incurred by Agencies in a network or group.

It's important to exclude from the calculation, any cost the Agency incurs that could be considered exceptional and skew the calculation. These might include an Agency writing off large amounts of bad debt; or surrendering a lease at a significant cost, for example. It's unlikely that an unexpected Agency windfall would be added to the mix so, while these represent significant costs to the Agency, they ought not be passed on to Clients.

Some Agencies are recharged for overheads by their network. Some of these central provisions should be included if they relate to the work done by the Agency for the Client. However, it's important to look out for network recharges that an Agency might seek to pass on, which relate to shared resources, human and otherwise, that do not relate in any way to the work done for you. A good example is your Agency's contribution to the cost of maintaining a Far East office when your Agency does no work for you in that region. In these circumstances you would be subsidising the cost of that for other Clients, so it would be reasonable to negotiate that out.

Similarly, if you pay for a central European team via direct fees, for example, you should not be expected to pay towards that via network overhead as well.

Having wrestled with the above, you should now be able to agree with your Agency, what percentage of their total indirect costs ought to be included as part of the overhead.

Once you have agreed that, they will calculate and propose a percentage for overhead against direct fees and you will be able to agree a ratio confident that the appropriate inclusions and exclusions have been incorporated.

CONTEXT

It's vital to recognise that overhead allocation is just one of the charges made by Agencies. Direct costs, profit margins and the number of hours workable per person per annum all vary too and can affect the final hourly rate more than the overhead allocation.

MATHS

Below you'll find a formula you can use to calculate and compare the impact of Agency overhead levied by various Agencies:

$$(Direct\ Staff\ Cost\ Per\ Annum + Overhead\ Allocation) \times Profit\ Mark-up / standard\ hours\ per\ annum = Cost\ Per\ Person\ Per\ Hour$$

EG:

$$£50,000 + £55,000 (110\% \text{ Overhead}) \times 20\% / 1,500 = £84 \text{ pp/hr}$$

Notes:

- Express the overhead as a percentage. This is usually between 85% and 130%
- Profit Mark-up should be expressed as a percentage and is usually between 8% and 20%.
- Standard hours are usually between 1,500 and 2,000 per annum.

Here are two further examples:

1. Average direct staff cost and LOW overhead allocation with average mark up and utilisation:

$$£75,000 + £63,750 (85\%) \times 14\% / 1,750 \text{ hrs} = £90 \text{ per hour}$$

2. Average direct staff cost and HIGH overhead allocation with average mark up and utilisation:

$$£75,000 + £97,500 (130\%) \times 14\% / 1,750 \text{ hrs} = £112.37 \text{ per hour}$$

As you can see, there are factors other than the overhead allocation that influence the end cost per person per hour. You may be attracted and reassured by low direct staff costs per hour, only to find that an agency covers this by applying low rates of utilisation. Similarly, the savings associated with a negotiated low overhead allocation could be negated by being applied to a higher direct staff cost.

You can be sure that those with whom you negotiate have their own best interests at heart and not yours. So it's important to realise that the overhead allocation is only one part of the equation.

SUMMARY

- Factor in all parts of the equation and don't be distracted by reductions in one area that are recouped in others. Consider the final cost per hour
- If you are negotiating with a new Agency, remember that this is a rare chance to exploit your advantage, especially if it is pre-contract
- Demand transparency in the calculation of overhead
- Recognise that your agency needs to cover costs and make a profit
- Agree the basis for the calculation of an agency's overhead. This should be factual data from the previous year
- Agree definitions of direct staff costs and indirect staff costs with inclusions and

exclusions. This should be stated in the initial pitch brief