

INPUT TO POINT 5 OF DRAFT COMPAG GUIDE TO NEGOTIATING AGENCY OVERHEAD AS PREPARED BY KEITH RAEBURN

WHAT IS OVERHEAD?

In any business the overhead will be costs which are indirect costs. “Indirect” meaning costs incurred by the company which are not variable with the direct services provided by the company. Such costs would include, among others, property costs, administration costs and legal fees.

What is the overhead in an agency?

Agency overheads are very similar to other businesses. Typically they would fall under the following categories:

- Property related costs - i.e. office rent, rates, depreciation, repairs and maintenance
- Administration costs - photocopiers, telephony, stationery, IT costs, equipment depreciation
- Marketing and new business costs - PR, third party costs for pitch work, AAR fees
- Travel and entertaining
- Professional costs - legal fees, audit fees, insurance
- Staff costs - training, recruitment, salaries and national insurance for non client chargeable staff

Why is understanding agency overhead so important?

Agency overhead is a key component of any hourly rate set by an agency. This hourly rate could be based on competitive rates, but if it is based on first principles then it will be calculated as follows:

Hourly rate =

$$\frac{(\text{Direct staff cost} + \text{overhead allocation}) * \text{Profit mark-up}}{\text{Standard hours}} = \text{Cost per person}$$

So to be pedantic, we are not so interested in the total overhead of an agency but more in its relationship to direct staff costs and its impact on the hourly rate charged by an agency.

Agency overhead as a percentage of direct staff costs

Agency overhead is the total value of all the categories of overhead. But when taken in the context of an hourly rate or a fee calculation it is generally expressed as a percentage of direct staff costs as follows:

Direct staff cost	£100,000
Agency overhead	£80,000

Overhead % 80%

Therefore the first point to note is that the overhead % depends not just on the absolute total of overhead but also on the absolute value of direct staff costs. Therefore, for example, a pay increase for direct staff of 10% would have an impact on the overhead % as follows:

Direct staff cost	£110,000
Agency overhead	£80,000

Overhead % 73%

WHAT ARE DIRECT STAFF COSTS?

To define overheads we need to agree a definition of direct staff costs. A standard definition would be:

Direct staff - all staff who work directly on a client's business such as:

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

Staff costs - all amounts paid to staff and benefits to which they are entitled, plus direct costs of their employment, for example:

Salary + Employer's NI + pension + healthcare + car allowance

A Bonus may also be considered a direct staff cost - some clients might only accept contractual bonuses rather than discretionary ones.

Indirect staff

Indirect staff would be those not directly charged to clients or working directly on client business such as Finance, HR, Admin, IT staff.

Grey areas!

Direct staff with indirect responsibilities

Some direct staff may have indirect roles. For example Head of Client Service may spend 50% of time on the supervision and development of the account management team. In this case the staff costs should be split equally between overheads and direct staff.

Overheads directly attributable to direct staff

Some costs which might, on the face of it, be overheads may need to be reclassified as a direct staff cost. For example relocation costs for key personnel in a contract.

Watch out for!

An easy way to inflate overhead is to allocate a % of direct staff time to overhead. For example some agencies might say that they only achieve 80% utilisation of their staff and therefore the 20% un-utilised time should be treated as an indirect cost and added to overhead. This can have a massive impact on hourly rates as follows:

	100% utilisation	20% downtime
Chargeable hours	1800	1440
Total direct costs	£1,000,000	£1,000,000
Downtime reallocated to overhead		£200,000
Revised direct costs	£1,000,000	£800,000
Overhead costs	£1,000,000	£1,000,000
Restated for downtime		£1,200,000
Overhead ratio	100%	150%

Furthermore once the hourly rate is calculated the full impact of reducing standard hours is revealed, as shown in this example of an Account Manager

	No downtime	20% downtime	20% downtime
Staff cost	£50,000	£50,000	£50,000

Overhead	100%	150%	150%
Total cost	£100,000	£125,000	£125,000
Profit margin 15%	£17,650	£22,063	£22,063
Total charge out price	£117,650	£147,063	£147,063
Standard hours	1800	1800	1440
Hourly rate	£65.36	£81.70	£102.13

Clearly, from this example, if the agency uses standard hours to calculate the fee then the impact of transferring 20% of direct time to indirect time within overhead was to increase the hourly rate by 25%. However if the standard hours are reduced as well then the impact is magnified to 56%!

Basis for calculation

There are a number of sets of data which can be used to calculate overhead. An agency could use its annual budget, its latest forecast, last year's actuals or some other base. It is clearly important specify or agree which base should be used. An agency finance director will use whichever base presents the best business case for the agency. However we recommend that prior year actual data should be used since this is factual. We also recommend that overheads should be recalculated annually.

There is no law which says agency overheads should reduce year on year. As we have seen the overhead ratio is a function of both direct staff costs and actual overheads and therefore changes to both bases will impact the ratio. However any sharp change should be justified by the agency.

Extraordinary items

The overheads used should reflect a steady state. Any exceptional or extraordinary costs should be eliminated from the calculation as these will distort the calculation. Such costs would include accelerated amortisation of leasehold improvements when surrendering a lease, write back of a bad debt, severance costs.

Impact of additional revenues on overhead

This is a trick point! Given there is no mathematical relationship between revenues and overheads in the ratio calculation there may well be no impact whatsoever on overheads. However, if staffing levels increase or decrease due to client changes and additional overheads are incurred, clearly the overhead ratio will change.

Agency networks and groups

If an agency is part of a network or group it is very likely that some network overhead will be recharged to the agency. The types of costs allocated could be as follows:

- Regional costs - the cost of a regional head quarter
- Head quarter costs - global office recharge
- Group costs - the costs of a holding company recharged to the agency network and then sub-divided across agencies.

It may be very reasonable for such costs to be allocated. For example the holding company costs may reflect the central treasury unit, legal costs and company secretarial services which under other circumstances would be incurred at a local level anyway.

The key issue is to ensure that only costs which relate to your business are allocated to your business. Therefore if you are a national client with no activity in other European markets you might question why you receive a share of the European headquarter's cost.

Equally if you pay for a central European team via fees then you may not want to pay for an allocation of the central overhead as well.

HOW TO NEGOTIATE THE RATIO OF OVERHEAD TO DIRECT STAFF COSTS

The overhead ratio is only of any interest in a time based fee remuneration arrangement.

The key to negotiation is to specify the definitions that will underpin the calculation. Therefore the which costs are deemed to be overhead costs and which costs are direct costs.

Non staff related direct costs

It is important to note that not all direct costs are staff related. Examples of other direct costs which should not be included in overhead are as follows:

- Production write-offs - where an agency makes a production error or is forced to write off an overspend on production these costs are by definition specific to a client. Therefore they cannot be absorbed into the total agency overhead.
- Bad debts - again these are clearly linked to a client (or ex client!)

- Client entertaining - it is inappropriate to recharge these costs as overhead - they are a discretionary expenditure
- Direct travel - where a client pays for travel costs it would clearly be a double count to also pay for other client related travel through an allocation of overhead.
- New business - the out of pocket costs relating to new business can be significant, especially if an agency studio is recharging artwork at a third party arm's length rate. Some clients will seek to put a cap on the amount which can be included in overhead.
- DDS or other IT costs which accrue on billings or revenues - given that the charge for the use of the DDS system is via a usage fee based on billings it is more appropriate for this to be recharged in line with billings rather than included in overhead. This might also apply to Barb and other research costs.

Agency studios

Many creative agencies have in-house studios. These may be separate profit centres, or third party implants. Either way common practice is to charge these services via a rate card rather than via an hourly rate built from staff costs plus overhead and margin.

It is vital that all costs associated with the studio are excluded from agency overhead since these costs are recovered through the price list rather than via direct time in fees.

This approach would also hold for any other services packaged and sold as separate profit streams, such as research, strategic planning, and innovations groups.

Fee negotiations

As always it is best to define at the outset of a relationship exactly how the client wants to remunerate the agency. This would be via the initial pitch brief. The definition of which costs are acceptable within overhead and direct staff costs plus the calculation mechanism should clearly stated.

One way of evaluating proposals is to issue a template for each agency to complete based on the client's criteria.

Some clients require complete transparency of overheads with full audit rights over the general ledger to ensure the calculation is accurate. Clearly not all agencies will accept this level of access.

Other clients are less stringent and only ask for the key components of overhead to be valued by being expressed as a % of total overheads. This would still follow the template that the client would have issued. In this way any unusual costs may be highlighted and additional questions asked.