An Exploratory Study into the Role of Agency Remuneration Within the Context of the Advertising Budget Setting Process

Helen Robinson
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abstract</td>
<td>ii</td>
</tr>
<tr>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td>Background</td>
<td>1</td>
</tr>
<tr>
<td>The Budget Setting Process</td>
<td>1</td>
</tr>
<tr>
<td>Agency Remuneration</td>
<td>2</td>
</tr>
<tr>
<td>Comparison between Agency Remuneration and Budget Setting Methods</td>
<td>3</td>
</tr>
<tr>
<td>Factors Associated with Budget Setting and Agency Remuneration Practice</td>
<td>3</td>
</tr>
<tr>
<td>Research Objectives</td>
<td>4</td>
</tr>
<tr>
<td>Research Method</td>
<td>5</td>
</tr>
<tr>
<td>Research Findings</td>
<td>5</td>
</tr>
<tr>
<td>The Budget Setting Process and Those Involved within that Process</td>
<td>5</td>
</tr>
<tr>
<td>The Extent to which UK Advertisers Use Sophisticated Methods of Budget Setting</td>
<td>6</td>
</tr>
<tr>
<td>Agency Remuneration in the Context of the Advertising Budget Process</td>
<td>6</td>
</tr>
<tr>
<td>The Relationship between Remuneration and Budget Setting Methods</td>
<td>7</td>
</tr>
<tr>
<td>The Role of Accountability in the Advertising Budget</td>
<td>8</td>
</tr>
<tr>
<td>Conclusions</td>
<td>9</td>
</tr>
<tr>
<td>Recommendations for Future Research</td>
<td>9</td>
</tr>
<tr>
<td>References</td>
<td>10</td>
</tr>
</tbody>
</table>
Abstract

This paper explores the role of agency remuneration within the context of the advertising budget setting decision process. Advertisers are increasingly under pressure to maximise and demonstrate the effectiveness of the advertising budget. Consequently, agencies are also becoming more responsible and accountable for client performance and the budget. Issues relating to setting advertising budgets, agency remuneration practice and the role of accountability are investigated amongst a sample of fourteen senior client and agency management in the top one hundred UK advertisers and agencies.

This study confirms previous research (Low and Mohr, 1999) that advertisers consider brand objectives, market history, forecast and advertising effects when setting their budgets. Findings indicate that advertisers tend to use a combination of data-based budget setting techniques and managerial judgement, although the degree of sophistication varies between clients. The research also suggests that budget-setting, remuneration and accountability are inextricably linked.

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Introduction

Over the past twenty years, interest in how advertising works and advertising budget setting has fuelled the debate surrounding the need to understand returns made on advertising investments and accountability, "specific measurable objectives related to product movement" (Lauterborn, 1992). In the early 1990s, recession, budgets were cut and advertisers came under increasing pressure to maximise and demonstrate the effectiveness of the advertising budget (Bennett, 1993). The proportion of the overall communications budget being spent on immediately measurable activities, such as sales promotion and direct mail, increased at the expense of the advertising budget during this recession (Lauterborn, 1992). Trends towards linking agency remuneration to advertising effectiveness, or payment by results (Lace, 1998, 1999), and the introduction of industry standards such as BS 5750 (Bennett, 1993) reflect this move towards greater accountability. Issues relating to setting advertising budgets and agency remuneration practice are the subject of considerable debate both academically and commercially. This study examines the role of agency remuneration within the context of the advertising budget-setting decision process.

Background

The literature focuses on the search for improved budget setting and agency remuneration practices. Research on the budget setting process is examined first, followed by agency remuneration.

The Budget Setting Process

The advertising budget can be considered as a corporate investment, one element among many that contributes to achievement of overall company objectives. The objective of setting the advertising budget is to grow brands or businesses through more efficient and effective spending (Dittus and Kopp, 1990). Although advertising budgets are often regarded as a current expense to defend existing sales, part of the budget comprises investment that builds brand equity, thus creating additional sales.

Advertising budget setting is a process, not a specific formula or technique (Broadbent and Jacobs, 1984; Piercy, 1985; Broadbent, 1989; Kotler, 1998). Broadbent (1989) suggests reviewing brand objectives, previous brand budgets, advertising effects, marketing history and forecasts before deciding the budget. Kotler (1998) also advises considering product lifecycle stage and substitutability, competition, market share and consumer base at this stage. Ray (1982) recognises six advertising budget setting approaches which he classifies as either principally judgement or data orientated. Judgement based methods include arbitrary, affordable and percentage of sales. Data orientated techniques comprise competitive parity, objective and task, experimentation, modelling and simulation. Within these approaches there are a variety of techniques that advertisers can use to help determine the advertising budget (Broadbent, 1989).
Several empirical studies into budget setting practice have been conducted over the last twenty years (Patti and Blasko, 1981; Hooley and Lynch, 1985, 1990; Piercy, 1986; Synodinos, Keown and Jacobs, 1989; Hung and West, 1991; and Low and Mohr, 1999). Patti and Blasco’s (1981) survey indicated an increasing professionalism in marketing, with advertisers favouring increased use of data-orientated budget setting techniques compared with earlier studies. Hooley and Lynch (1985) found comparable trends towards more sophisticated budget setting practices in the UK. When this study was repeated, significant changes in sophistication of budget setting practices were detected (Hooley and Lynch, 1990). Between 1985 and 1990, increases in data-based techniques, objective and task and experimentation were observed. Respondents reported using a combination of methods to aid budget setting decisions (Hooley and Lynch, 1985, 1990; Hung and West, 1991). Overall, research by Patti and Blasko (1981), Hooley and Lynch (1985, 1990) and Hung and West (1991) indicates increased usage of sophisticated techniques and less reliance on judgmental approaches among large advertisers.

The above findings are not supported by a more recent study by Low and Mohr (1999) who investigated the processes US brand managers use to set and allocate advertising and sales promotion expenditures. Despite increasing sophistication and use of marketing information, computer systems and reliance on quantitative marketing models, the tendency to base spending decisions on intuition and historical precedence still prevails. Previous years’ advertising budgets impacted on the decision making process and there was a reluctance among senior management to accept experimentation results.

**Agency Remuneration**

Advertising agencies traditionally acted on behalf of media owners, selling space to advertisers. Over the last twenty years, agency service structures have changed considerably. Media buying and planning, originally part of the ‘full service’ agency, split from the core agency and media independents were formed, taking a significant proportion of media handling (Jacobs, 1995). Lace (1998) found that only a third of advertisers have full service agreements with their agencies. The removal of media departments has forced core agencies, formerly paid on percentage of media billings, to re-evaluate their businesses and justify their income. Modern agencies aim to produce strategic and creative ideas that add value (Rainey, 1997).

Three basic approaches to paying advertising agencies emerge from the literature: commission, fee and payment-by-results (PBR). Much of the literature surrounding agency remuneration discusses the merits and drawbacks of various compensation methods, but empirical evidence on remuneration is limited. Low and Mohr (1999) report that agencies are generally remunerated by commission or fees, but do not expand on this point. The Association of National Advertisers regularly surveys advertiser compensation practice, and has detected trends towards results-based payment systems (Lauterborn, 1992; Lace, 1998).

The only major UK study into remuneration practice was conducted by Lace (1998), and was followed up by qualitative and quantitative research focusing specifically on PBR (Lace 1999). Fees dominate and account for over half of all agency agreements in both the UK and US (Lace, 1998; Lundin and Jones, 1998), with estimated costs as the most popular fee type, followed by flat and cost-plus fees (Lace, 1998). Only an estimated 4 per cent of advertisers pay the traditional 15 per cent commission rate, and commission appeared in one-third of agreements, most of which were based on fixed rate commission rather than sliding scales (Lace, 1998). Full service agreements are likely to be commission based, while agreements without full service were likely to be fee based (Lace, 1998). Over 20 per cent of all advertising agreements included an element of PBR with an additional 10 per cent of respondents expressing an interest in including PBR into their agreements in the future (Lace, 1999).
Overall, Lace (1998) observed a bias towards fees in remuneration practice with significant use of PBR as part of remuneration agreements. These findings reflect trends observed in the US (Lundin and Jones, 1998) and Europe (Jensen, 1994). This research suggests a move towards more sophisticated remuneration methods, similar to trends observed in the budget setting studies.

Comparison between Agency Remuneration and Budget Setting Methods

There appear to be several similarities between agency remuneration and budget setting methods. Ray's (1992) description of budget setting approaches as being judgement or data orientated can be applied to remuneration methods.

The commission system is an arbitrary one. Successful brands and companies tend to generate larger budgets, whilst failure often results in reduced ‘adspend’, thus reducing agency income (Best, 1981). This compares with the percentage of sales technique, which usually produces large budgets for successful, big brands. However, large budgets may not be necessary for larger brands and, similarly, smaller or declining brands may actually require and increase in adspend, which this method does not recognise (Broadbent, 1989).

The majority of fees are judgement orientated, although some have a data-based element. Fees based on a commission equivalent are judgement based. Resource-based fees are calculated using cost data, but resource allocation is estimated and does not consider the added value produced (Mishon, 1998) and, therefore, is relatively subjective. In addition, neither commission nor fee-based approaches relate to profit (Low and Mohr, 1999), the ultimate measure of advertising effectiveness. Fixed-cost working is the most data-orientated of the resource fee-based remuneration methods because it is based on an average of accumulated actual costs for various items over time.

At the other end of the spectrum, the most sophisticated data-based PBR remuneration agreements rely on independent research. Techniques such as modelling and scanner data analysis can be used as performance measures on which payments are based (Lace, 1999).

Factors Associated with Budget Setting and Agency Remuneration Practice

Similarities between the factors influencing budget setting technique and agency remuneration methods used can be detected. Sophisticated methods of remuneration and budget setting are more likely to be adopted by brands with large budgets within the fast-moving consumer goods (fmcg), consumer durables and automotive industries (Hooley and Lynch, 1985, 1990; Lace, 1999). Improved performance appears to be associated with advertisers using data-orientated approaches to budget setting and remuneration (Hooley and Lynch, 1985, 1990; Lace, 1999). Political influences appear to play a role in the overall budget setting decision process (Piercy, 1985, 1986, 1987), although their role in agency remuneration is not discussed in depth.

Hooley and Lynch (1990) predicted that advances in consumer sophistication and evaluation technology, such as EPOS scanning and people meters, would encourage innovative organisations to find better solutions to communication cost effectiveness. Root and Naples (1998) confirm that modelling and analysis using scanner data is being employed to aid budget allocation decisions, particularly by packaged goods companies. Modelling, using scanner data, can also be used to measure PBR (Lace, 1999).
Accountability appears to be a major influence on budget setting and remuneration agreements. The 1990s witnessed trends towards increased effectiveness of marketing budgets (Bennett, 1993), and increased usage of sophisticated budget setting techniques (Hooley and Lynch, 1990; Hung and West, 1991) and remuneration methods (Lace, 1998, 1999). Lauterborn (1992) proposes that: “accountability is going to determine budgets and compensation and we will all be the better for it”.

Overall, the empirical research suggests that advertisers are using several approaches to aid decisions on advertising budgets and employing more data orientated techniques. Although a decline in judgement based approaches can be observed, there is still a strong tradition of judgement-based budget decision making, and this approach is still used in many instances. However, technique usage must be put into the context of the budget setting process, and the organisational and economic environment. Trends towards more data-orientated methods of agency remuneration are also detected, although many agreements are still based on arbitrary methods.

Several areas identified within the budget setting literature are of interest for further research. This study focuses on the role of agency remuneration within the advertising budget, as there is growing interest and little academic exploration in this area. Previous research (Patti and Blasko, 1981; Hooley and Lynch, 1985, 1990; Hung and West, 1991) suggests that advertisers are using more sophisticated methods of budget setting. However, Low and Mohr’s (1999) study questions these findings. This research follows on from Low and Mohr’s qualitative study, using a similar methodology, to investigate the sophistication of the advertising budget. Lace (1998, 1999) indicates that the budget size is related to method of agency remuneration and that issues of accountability are relevant to both budget setting and agency remuneration (Lauterborn, 1992). To develop these themes, the research also attempts to further examine the relationship between budgets and agency remuneration.

**Research Objectives**

The overall aim of the study is to examine the role of agency remuneration within the context of the advertising budget setting decision process. Using Low and Mohr’s (1999), Lace’s (1998, 1999) research findings and Lauterborn’s (1992) views regarding accountability, specific objectives have been identified to achieve the overall research aim which are to:

- study the budget setting process and those involved in that process
- examine the extent to which UK advertisers use sophisticated methods of budget setting
- deepen our understanding of the role of accountability in the advertising budget
- understand the importance of agency remuneration in the context of the advertising budget setting decision process
- explore any possible relationship between remuneration and budget setting methods.
Research Method

Qualitative research was used, in the form of semi-structured interviews with senior client and agency management. Qualitative interviews were used for a number of reasons:

- the research is exploratory
- qualitative research encourages deeper understanding of the issues surrounding budget setting
- Broadbent (1992) and Hooley (1992) have recommended qualitative research into the budget setting process
- it allows for comparison with Low and Mohr (1999).

Advertisers and agencies interviewed were within the top one hundred companies in terms of adspend and billings respectively. The sampling frame for advertisers and agencies was defined by trade publications Marketing (March 2000) and Campaign (February 2000) respectively. Snowball sampling was employed with three main sources of contacts: existing industry contacts, contacts made via WACL conference, 22nd May 2000, and contacts via ISBA (Incorporated Society of British Advertisers).

The sample included fourteen face-to-face interviews; seven client and seven agency respondents to ensure an equal balance between agency and client perspectives. Clients interviewed were from the automotive, FMCG, financial and utility industries.

Research Findings

The Budget Setting Process and Those Involved within that Process

The research confirms previous research (Low and Mohr, 1999) that:

- advertisers tend to review and set brand objectives
- forecast based on market history, prepare long term plans
- consider advertising effects, as recommended by Broadbent (1989).

“That might be over several years and the more immediate future they would look at a one year plan with specific objectives after that year. So the budget obviously, to a certain extent, will come from those objectives.” (Agency)

“We track share of voice on advertising… It’s usually related to market share.” (Client)

“I put in a marketing spend appropriate for that given all the market data I have and all the competitive information I have.” (Client)

However, the depth and extent to which these considerations influence the budget setting process is still unknown.

The research agrees with previous research (Piercy, 1986; Low and Mohr, 1999) that budget setting is an inherently political process involving negotiation, trading and justification.
“The marketing department put together a proposal for what they think they need in order to make their contribution to the business.” (Agency)

“There is a debate, the trade off, everyone's budgets end up being cut, and he hopes his is cut less than other peoples.” (Agency)

“Plans are finally submitted… the Chief Executive and the board will… vote for or against the whole investment programme at a board meeting.” (Client)

The majority of advertisers use the 'bottom-up/top-down' budget approval process, therefore, in general, marketing departments have some involvement and control in the budget setting process, although higher management finalise and approve budgets. The findings indicate that greater marketing departmental control over the budget process is associated with more sophisticated budget setting and remuneration methods. Furthermore, the research suggests that marketing orientated companies' initial budget proposals are more likely to be accurate and approved.

**The Extent to which UK Advertisers Use Sophisticated Methods of Budget Setting**

The research agrees with Low and Mohr (1999) that advertisers tend to use a combination of data-based budget setting techniques and management judgement, although the degree of sophistication varies. Clients interviewed in this study appeared to be more sophisticated than those in Low and Mohr's (1999) research. In general, one method appears to be used as the basis of the budget decision and is counterbalanced and or justified by using other techniques.

“After we have set our financial goals… we work backwards from that and we say what kind of advertising do we need to achieve those kind of awareness objectives… It's usually measured as… a percentage of turnover.” (Client)

“Each product's budget is established in its own right. Now the way that budget is established is we have a reasonably sophisticated econometric model… Inevitably and unfortunately, another starting point is how much money we spent last year.” (Client)

“Mostly we look at what we can afford… It's a kind of percentage of revenue, with a bit more discussion… There is almost a sort of, what did we spend last year, let's spend it this year.” (Client)

The combination of managerial judgement and analytical methods was also observed in Low and Mohr's (1999) study, and the research agrees that best practices for budget decision making should involve both quantitative, data-based techniques and managerial expertise and intuition.

**Agency Remuneration in the Context of the Advertising Budget Process**

Initially, this study indicates a trend towards more sophisticated methods of remuneration. However, many agreements observed are not based on objective data, but on judgement, thus suggesting a lack of sophistication among agency remuneration agreements in general. The level of sophistication among PBR agreements varies, and the majority of agreements were primarily judgement based, using subjective evaluation criteria.
“It varies. We’re in a transitional phase at the moment… there is a general direction away from commission towards fees… We will pay in most cases, we will pay a fixed monthly fee for a core team… Increasingly we are trying to put that (PBR) in.” (Client)

“Commission. We have a set rate on production and a sliding scale on media.” (Client)

“As with any appraisal, there are a series of areas that they were judged on … media, creative and client service. There was a link to performance… It was a success measure that didn’t have a volume attached to it.” (Client)

“A strong shift from commission to fee (resource based), normally with a performance related component to it.” (Agency)

The findings showed that advertisers using data-based budget setting techniques are more likely to use sophisticated remuneration agreement methods. Moreover, clients that are using more sophisticated PBR evaluation criteria felt that subjective agency evaluation does not constitute results, and that service should be included within the base fee. Exceptions to this view were found among those who did not believe in the ability to measure agencies on performance.

“How do you separate the advertising elements out of the other parts of the marketing mix.” (Client)

Furthermore, the findings strongly indicate a relationship between remuneration, budget setting methods and political influences. The more sophisticated advertisers in terms of remuneration and budget setting methods were more likely to have greater control over budgeting decisions.

In general, the findings agree with Lace (1999) that clients using bonus payment structured PBR agreements should plan the highest payment within their budgets and any unused bonuses would probably be redeployed into media spend.

“It has to be in their budget; if they don’t spend it… it probably goes on media.” (Agency)

The Relationship between Remuneration and Budget Setting Methods

The findings suggest that agency remuneration structures are not a consideration within the budget setting process, because many advertisers appear to be using relatively unsophisticated remuneration methods. However, those using more sophisticated budget setting and remuneration methods did appear to consider agency payment methods within the budget setting process.

“I suppose in theory you could say if you were working the budget from setting your opening tasks and your objectives, you’re more likely to extend that thinking through to the way that you remunerate your agencies.” (Agency)

Trends towards IMC and globalisation of client and agency networks impacting on remuneration also emerged from the research. This study agrees with Lauterborn (1992) that where agencies are given responsibility for IMC that the remuneration agreement terms can help agencies to work with others. The impact of globalisation is not at present fully known.
**The Role of Accountability in the Advertising Budget**

The findings indicate that budget setting, remuneration and accountability are inextricably linked. Advertising budgets are becoming more accountable, and both advertisers and agencies are under pressure to maximise and demonstrate the effectiveness and value of advertising investments.

“Accountability is growing by the minute.” (Agency)

“There is clearly a move to make service agencies more accountable.” (Client)

Findings show that accountability has a strong influence on budgets and agency remuneration agreements, as predicted by Lauterborn (1992). The increased usage of PBR agreements reflects this trend, although an increased sense of client-agency partnerships was also attributed to increases in PBR usage. Several factors were identified which appear to have contributed to this demand for increased accountability.

“Accountability is one pillar within that partnership debate. I think PBR is just a by-product of that, a desire to reflect the partnership rather than a supplier and manufacturer relationship.” (Agency)

The research suggests that perceptions of marketing departments within client companies relate to the need for accountability. Furthermore, demand for accountability also emanates from marketers themselves, thus negating previous suggestions that they are forced by other parts of client business to become more responsible for budgets.

The findings also indicate that short-termism (fuelled by shareholder and stockmarket pressures to deliver financial results) and quick turnover of marketing staff, has led to a greater demand for measurable activity and accountability.

“Too many clients are driven by day-to-day, week-to-week considerations, rather than a … long term view of what the budget should be.” (Agency)

Retailer pressures, fuelled by consumerism, impacts on accountability as manufacturers are tempted to use promotional activity to deliver predictable results. The research also shows that adverse economic conditions, such as the early 1990s recession, impact on budgets and remuneration agreements.

“Particularly in the recession of the early 90s… as firms were squeezed, budgets were squeezed, advertising tended to be the first budget that went.” (Agency)

The findings suggest that agencies are becoming more accountable due to a reduction in size of client marketing departments, and that media fragmentation appears to be forcing both agencies and advertisers to allocate media budgets more carefully to demonstrate the effectiveness of media decisions.

“The account has got bigger… so the amount of advertising we have been doing has dramatically increased, but the numbers of those of us here to manage it has dropped by half… so what we have done, is that we have dramatically shifted the responsibility into the agencies.” (Client)

The availability of more sophisticated advertising effectiveness measurement tools may also have impacted on demand for accountability.
“Essentially the tools for measuring effectiveness of advertising have improved… there are more ways of measuring it.” (Agency)

Conclusions

The research confirms previous research (Low and Mohr, 1999) that advertisers consider brand objectives, market history, forecast and advertising effects. Findings show that advertisers tend to use a combination of data-based budget setting techniques and managerial judgement, although the degree of sophistication varies between clients. The findings agree with previous research (Piercy, 1986) that budget setting is inherently political, and there is a strong relationship between political influences, the budget setting process and agency remuneration.

Results indicate a lack of sophistication among agency remuneration agreements in general. However, advertisers using data-based budget setting techniques appear more likely to use sophisticated remuneration agreement methods. As many advertisers appear to be using relatively unsophisticated remuneration methods, the findings suggest that agency remuneration structures are not considered within the budget setting process. However, those using more sophisticated budget setting and remuneration methods did appear to consider agency payment methods within the budget setting process.

The research also shows that budget setting, remuneration and accountability are inextricably linked. Advertising budgets are becoming more accountable as advertisers and agencies are under pressure to maximise and demonstrate the effectiveness and value of advertising investments. Accountability appears to exert a strong influence on budgets and agency remuneration agreements.

Recommendations for Future Research

Qualitative research is the most appropriate methodology for exploratory studies of this nature. However, generalisations cannot be made from this research and therefore further quantitative research is recommended to provide conclusive support for the findings of this study. Supporting quantitative research is proposed in the following areas: spending patterns, sophistication of budget setting methods and agency remuneration practices, and political influences.

Further qualitative research amongst smaller and medium sized advertisers and agencies is also recommended.
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