



Carrot vs. Stick: Incentive Compensation

McBRIDE & ASSOCIATES
Marketing Communications Management Solutions

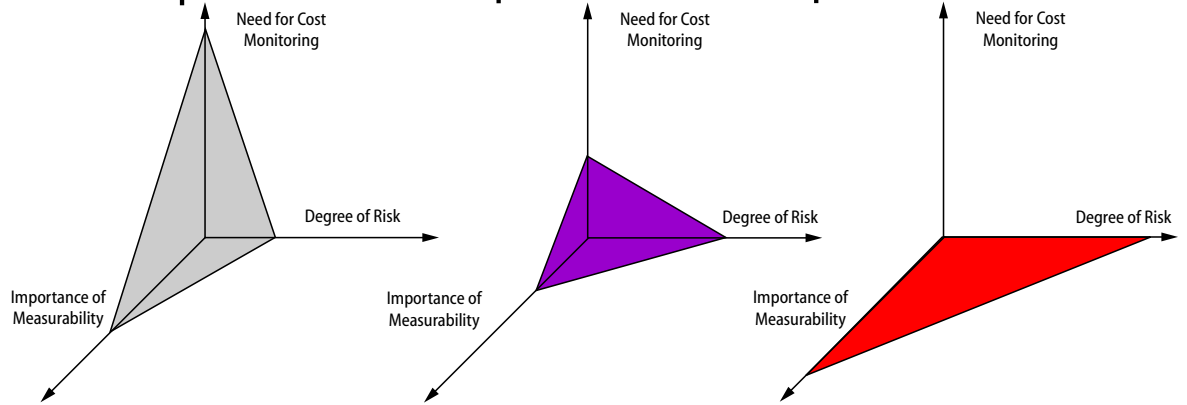
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AGENCY COMPENSATION METHODS

Agency compensation can be based on: commissions, fees and/or incentives. In most instances incentives are overlaid on either fees or commissions. The chart below isolates the individual characteristics of each method of compensation, in order to highlight the inherent differences.

	Fees (Behavior based)	Commissions (Media based)	Incentives (Outcome based)
Need for Cost Monitoring	High Depends on accuracy of Agency's cost accounting	Low Shown on all invoices	Zero Not a factor
Degree of Risk	Low Guaranteed cost/income levels for both parties	Medium Fluctuates with media spend; over/under payments likely	High Costs/income unpredictable for both parties; competitive and environmental factors affect outcome
Importance of Measurability	Medium Subjective: Agency performance evaluation	Low Media dependent: advertising to sales ratio; share of voice, etc.	High Objective: Demonstrated effects of advertising

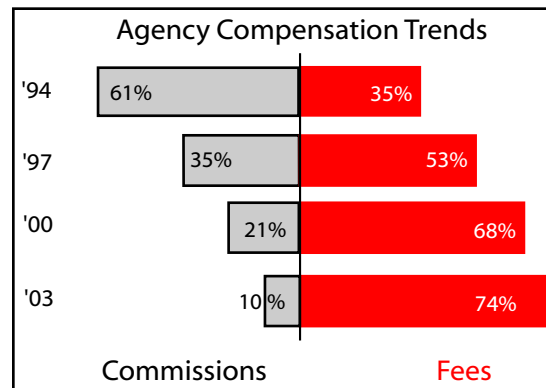


FEES REPLACE COMMISSIONS

Since 1994 there has been a steady shift to fees and away from media commissions based on the results of the Association of National Advertisers' Triennial surveys of "Trends in Agency Compensation".

Based on the A.N.A.'s 2003 Survey of 112 companies, 74% utilized some sort of labor-based fee arrangement to compensate their agencies.

The table below shows how the proportion of commissions to fees has reversed within the past ten years.



We believe that there are three reasons for the increased reliance on fees:

1. The hyper-inflation in media costs (particularly network TV) during the nineties forced advertisers to increase their spending just to maintain comparable levels of media impressions and share of voice.

2. To offset some of these increased media expenses, advertisers →

arbitrarily reduced their agencies' commissions from the traditional 15%, often, to levels below 10%.

3. When commissions became less lucrative for the agencies, they eagerly advocated labor-based fees instead; something many of them had railed against previously.

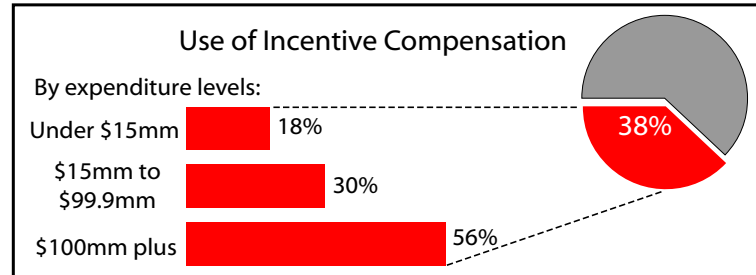
It was this confluence of events and goals that lead to the shift.

INCENTIVE TRENDS

The 2003 A.N.A. Survey reported little change from the 2000 survey in the overall percentage of advertisers using incentives. But it did report a decline in the percentage of incentive usage in the \$100mm plus category from 64% to 56%.

This change can probably be attributed to significant changes in the respondents from 2000 to 2003.

The overall number of companies participating in the survey went down from 136 in 2000 to 112 in 2003. But the actual number of participants in the \$100mm plus category went up from 33 in 2000 to 47 in 2003. So the lower incidence of incentive usage in this segment between 2000 and 2003 could be accounted for entirely by the new participants included in this segment in 2003.



INCENTIVE RESULTS

Only 68% of incentive users said that they resulted in any "improved performance" by their agency. Nonetheless 95% of those same advertisers said that they "will continue to use" incentives. This disparity could be explained in two different ways:

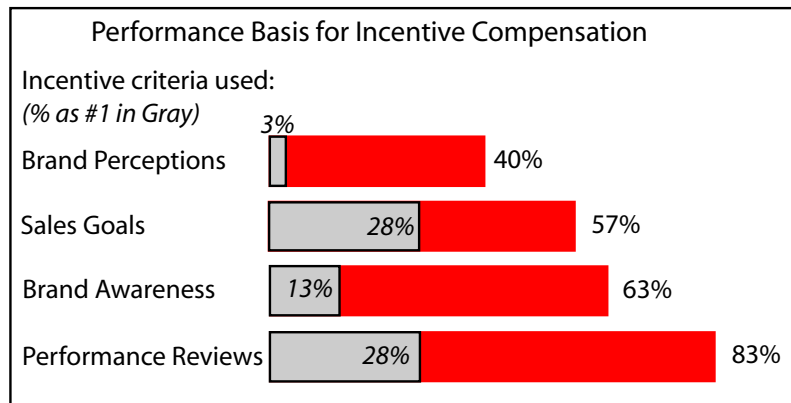
1. It could be a tacit acknowledgment that the criteria may be flawed;
2. Or the incentives could be more of a stick than a carrot.

We have published a 10 page booklet that discusses the results of the 2004 A.N.A. survey of *Trends in Agency Compensation* in more detail. It can be downloaded from our web site at www.mcb-associates. Look in the IDEAS section.

INCENTIVE CRITERIA

Among the sample of 43 advertisers using incentives, 80% used multiple criteria. The leading measures were agency performance reviews (subjective) and brand awareness (objective). These are both areas that the agency can influence more easily than sales.

The most objective measures of an Agency's effectiveness — changes in Brand Perceptions and/or Awareness — were considered by more advertisers in this survey than the last one. But still only 5 out of 32 companies reporting used it as their number one criteria.



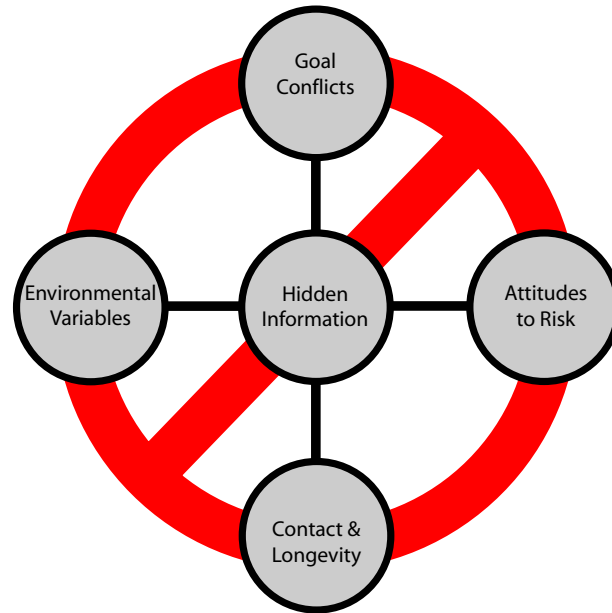
INCENTIVE GUIDELINES

When structuring a performance related incentive program for an Agency, here are three points to keep in mind:

1. Set and agree on the goals jointly;
2. Those goals should be attainable, meaningful and — preferably — objectively measurable;
3. The primary goal should be based on some sort of advertising induced effect.

COMPENSATION ISSUES

The diagram below highlights the factors that come into play when structuring and managing an incentive compensation agreement with an advertising agency.



Goal Conflicts

In an ideal world there would be a perfect concordance between the goals of the advertiser and the agency, similar to what exists between the pilot of an aircraft and the passengers on board. Because both parties are equally interested in arriving safely at their destination, the pilot/passenger relationship creates a self-enforcing contract based on strong mutual interests. →

(continued) Unfortunately this concordance of goals doesn't exist in the advertiser /agency relationship in spite of lots of talk about being "business partners". That's because an advertiser wants maximum effort for minimum compensation, while an agency strives for the exact opposite. Quick solutions benefit the agency under all scenarios except those based on actual direct labor.

Environmental Variables

Competitor's actions, downturns in the economy, interest rate changes, shortages of critical parts or ingredients, even bad weather conditions are just some of the uncontrolled variables that can undermine the best marketing plans. The negative effects of these non-communications issues must →

(continued) issues must be factored into any final assessment. And of course the most critical variable is the extent to which an advertiser can accurately track and measure the impact of advertising in a cost-effective manner.

Contact & Longevity

The length of the relationship and the depth and frequency of contact influences how successful an incentive agreement is likely to be. In those instances where there has been a long history of working together and the top managers in both companies communicate regularly, the relationship →

(continued) becomes institutionalized. This usually increases the degree of candor and honesty in conversations about the two most sensitive aspects of any incentive agreement: what's fair base pay versus bonus pay, and how will the achievement levels be determined?

Attitudes to Risk

Risk adverse marketers shift the uncertainties in their business plans to their employees by making a large portion of their compensation variable, as either performance bonuses and/or stock.

Not surprisingly this makes these same managers much more aggressive in trying to push this risk down into their vendors' contracts. Public agencies, where salaries represent about 50% of direct operating costs, often pay 25-50% bonuses to their high income employees based on the profit delivery of the agency and their →

(continued) business unit. And those agencies with a history of meeting their goals, often position these bonus payments as a (nearly) guaranteed part of the base package when recruiting. So to the extent outcome based agreements put the agency's or business unit's profits more at risk, it represents a form of double jeopardy for the senior agency decision makers. Although incentive pay may not result in bigger and better ideas from the agency, it will align the management's personal financial interests more closely with those of a large incentive-based client.

Hidden Information

Both parties in the advertiser/agency relationship usually reserve certain information about their actual operating costs and profits from one another. Even when both companies are publicly held, their costs and profits by business unit and product line are seldom revealed. Privately held companies are usually even more →

(continued) guarded about their costs and profits, if for no other reason to keep this information away from their own employees. And yet the equitableness of an incentive based agreement depends to a large extent on both parties willingness to share more of this information than they would otherwise.

DEALING WITH DUALITIES

NOTE: A duality is an issue that cannot easily be resolved, because contradictory aspects of the issue are inevitably present and are simultaneously desirable and undesirable.

The organizational cultures of advertisers and agencies differ considerably. These differences in shared beliefs can be broken down into four dualities:

- certainty versus uncertainty
- controllable versus uncontrollable
- individualism versus collectivism
- equality versus inequality.

When confronted with dualities individuals and organizations cope with the tension in the possibility of two opposing “truths” by forming basic assumptions that one side of the duality is “more true” (appropriate or desirable) than the other in their situation.

The most easily understood duality effecting the advertiser/agency relationship can be seen in the way each side views certainty versus uncertainty.

Most Advertisers’ organizations can be characterized as high certainty cultures that thrive on predictability and order. Their activities are highly structured and standardized with many written rules. They usually emphasize specialization, attention to detail, and stability (low turnover, clear career paths).

In contrast Agencies are more likely to have high uncertainty cultures, with much less structuring of activities, few written rules, with an emphasis on generalization, creativity and flexibility, where career paths are vague and the resulting staff turnover is viewed as inevitable and beneficial.

The chart on the following page shows how the four dualities come into play when considering and structuring an Agency Incentive agreement.

INCENTIVE DUALITIES

	Certainty	versus	Uncertainty
Primary aim of incentive plan	To identify and reinforce Agency behaviors that will lead to desired outcomes		To link highly valued rewards to desired outcomes and let the Agency figure out the instrumental behavior
Performance measures	Tactical, operational		Strategic
Security	Nurture feelings of security about the relationship, and reward steady progress		Discourage feeling of entitlement and reward only defined achievement levels
	Controllability	versus	Uncontrollability
Expected effect of motivation on results	Large (Agency has control over results and if motivated, can exercise it in the "right" direction)		Limited (Agency's desire to achieve results is not sufficient condition for success)
Causes of success or failure	Internally controllable by the Agency's own actions		External or environmental factors largely control the outcome
	Individualism	versus	Collectivism
Type of Agency the plan seeks to attract and retain	Aggressive, enterprising, risk-takers, solo performers ("every <i>man</i> for himself")		Stable, secure, willing to support employees in risky recommendations
Beneficiaries of goal attainment	Key individuals within the Agency		Agency as a whole
	Equality	versus	Inequality
Incentive planning and decision making	Done jointly by Advertiser and Agency		Advertiser driven and controlled
Goal setting process and performance monitors	Facilitated by small power distances — frequent interactions at all levels		Hindered by large power distances — isolated from top management
Performance measures	Absolute, objective		Relative, subjective
Role of Incentives	Small		Large

UNCOVERING DUALITIES

To assist Advertisers and their Agencies to better understand the dualities that influence their relationship, we have constructed a brief questionnaire that can be administered either online or via E-mail. The questionnaire consists of 40 closed-end multiple choice questions that can all be answered in about 10 minutes.

Here are some of the 40 questions used to assess the beliefs and behavior of advertisers and agencies considering an incentive compensation agreement.

(NOTE: These examples are all written from the advertiser's point-of-view.)

Please pick a number from the scale to show how much you agree or disagree with each statement and enter it in the space to the right of the item. Use the Neutral response when you have full knowledge but no clear opinion. But if your knowledge is incomplete respond with "Don't Know".

1 = Strongly Agree; 2 = Agree; 3 = Neutral;
4 = Disagree; 5 = Strongly Disagree; 6 = Don't Know

Advertising is a business expense that needs to be carefully managed..... _____

Everyone's compensation should be tied to the achievement of defined goals..... _____

We have to be more accountable for financial results than our agency counterparts..... _____

Please pick a number from the scale to show how often these statements would characterize the experience or behavior of your company.

1 = Always >95%; 2 = Often >70%; 3 = Sometimes 30-70%;
4 = Seldom <30%; 5 = Never <5%; 6 = Don't Know

When we cut our advertising spending our sales decline _____

Our advertising goals are realistic and communications based _____

Our company encourages and rewards risk-takers _____

COMPENSATION AUDITS

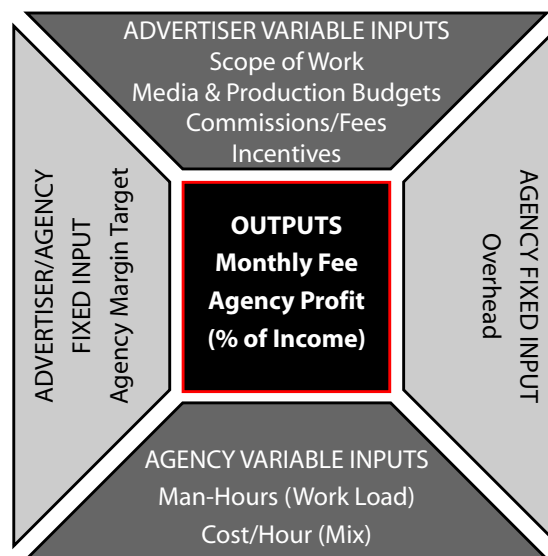
All agency compensation agreements ought to be reassessed periodically to insure that the terms are equitable for both parties. And Incentives and/or Labor-based agreements need to be reviewed annually.

When we conduct Compensation Audits for our clients, we build individualized models to reflect each unique situation. The diagram below depicts some of the inputs that we use to build these models. Incentives are usually added as a portion of the profit target.

A virtually infinite number of variable and fixed inputs can be combined to generate various potential costs to the Advertiser. At the same time the Agency can see what their income and profit margin would be under each scenario. Because these are interactive models all the participants in the negotiations can ask to see, what happens if...

In the end, when the parties agree on a compensation plan and an income target for the Agency, the underlying assumptions are clear to both sides. And everyone also understands how sensitive the Agency's margins are to variances in different areas.

Compensation Model Inputs and Outputs



Finally, and perhaps most important, this process provides benchmarks for both parties to use in accessing their actual results, and to make future projections more accurate.

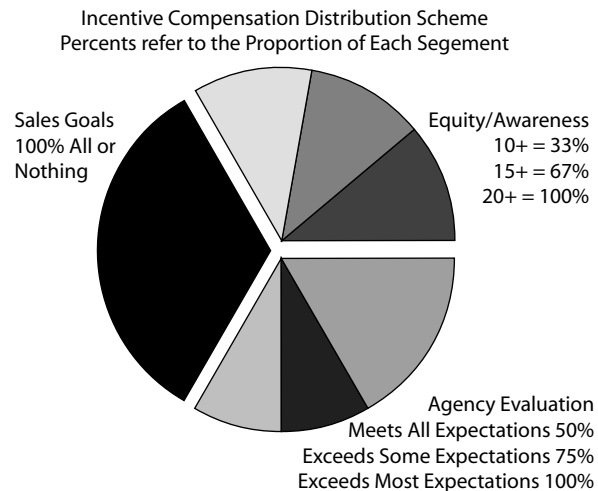
INCENTIVE COMPENSATION OPTIONS

Incentive Compensation can be structured to emphasize whatever is most important to the Advertiser. We favor agreements that are based on more than one criteria and include some measure of actual advertising effectiveness: such as improvements in Brand Equity or Awareness.

The overall role of the incentive portion of the agency's compensation should determine the stringency of the qualifying criteria. Still incentives should

(continued) not be an alternative to fair pay, but rather a true reward for above average performance.

Cash awards with no strings attached is what agencies prefer. However stock, or warrants to buy stock at a fixed price, may be used as currency for Incentives. But the Agency should be free to sell any stock award, immediately, if they wish. The example below shows how three equally divided criteria, can have differing levels of qualification.



WHAT WE DO

McBride & Associates was formed in 1991 to enable companies to improve the accountability and productivity of their marketing communications relationships. We do this by providing counsel in the evaluation, selection, compensation and management of advertising agencies as well as all other marketing communications resources.

We are distinguished from our competitors by the breadth and depth of our experiences in both advertising and agency management capacities. This paper focuses on our Incentive Compensation tools and techniques for Advertising Agencies. Visit our web site to obtain information regarding other services: www.mcb-associates.com.

OUR WORK OUR CLIENTS

Since 1991 our firm has been assisting in marketers to evaluate, select compensate and manage the full spectrum of marketing resources. Our assignments have involved:

- Mass-media agencies
- Direct marketing
- Sales promotion
- Hispanic marketing
- Public Relations
- Media Buying
- In-store merchandising
- Event marketing
- Relationship marketing
- Exhibit management
- Fulfilment services
- Enterprise marketing management tools

Some of the advertisers we have worked for include:

- Apple Computer (2)
- Bank of America
- Baskin-Robbins (3)
- Hasbro, Inc.
- Hewlett-Packard (5)
- Intel Corporation (2)
- Nvidia Corporation
- Pacific Bell (5)
- Plantronics, Inc. (2)
- Qualcomm (5)
- SBC/Pacific Bell (5)
- Siebel Systems
- sgi (Silicon Graphics, Inc.)
- 3Com Corporation
- Universal Studios Hollywood
- Verizon Wireless
- Visa (3)

Figures in brackets represent the number of assignments.

ABOUT US

Jack McBride's marketing career began with five years at Quaker Oats in Product Management. Later during 15 years with DDB, he directed many memorable advertising programs for such clients as General Mills and McDonald's.



From 1987 to 1991, McBride was the Vice -President Advertising for the E & J Gallo Winery. Since 1991 he has consulted for many of the leading advertisers in the West.

If you would like to learn more about any of the topics in this paper or about how we manage agency compensation audits covering all sorts of marketing communications resources contact Jack McBride via E-mail jack@mcb-associates.com or call 209-577-1464.