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szabo MEDIA COLLECTION PROFESSIONALS

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Dear Friends:

For well over a century, advertising agencies have been an integral part of the media industry. While the relationship between agencies and media providers can sometimes be challenging, particularly in the area of payment liability, agencies have been and continue to be very valuable players in an ever-changing and increasingly complex business. In this issue's feature article, we dispel a few commonly-held beliefs about agencies—some of which were never true and some of which were true in the past but are no longer—and offer some tips on developing best practices for dealing with agencies in today's media environment.

The business and economic challenges facing media in the coming year were the subjects at the Media Financial Management's East Coast regional seminar in New York City. Szabo enjoyed hosting lunch at the September 15th event, "Media Outlook 2011." And speaking of looking forward, we'll celebrate the upcoming season at our annual Szabo Holiday Party, December 11th in Atlanta.

Best wishes for a wonderful fall,

Robin Szabo, President
Szabo Associates, Inc.

7 Common Myths about Advertising Agencies ...

Know the Facts and Develop Best Practices!

Advertising agencies have been around for a very long time. For those interested in business trivia, the first U.S. advertising agency was founded in 1850 in Philadelphia by Volney B. Palmer, whose sole service was placing ads produced by his clients in various newspapers.

Advertising agencies' overall reason to exist—to create, plan, and handle advertising—has largely remained the same over the past century and a half. Over the years, widely accepted ways of doing business developed between agencies and their customers and between agencies and media, and these practices remained largely unchanged through the 1970's.

The evolution of media over the past few decades, along with the economic realities in recent years, has compelled all parties—advertisers, agencies, and media—to rethink some of their traditional practices, particularly in the areas of compensation and payment liability. One tangential benefit of this reevaluation has been to dispel old myths about how agencies operate. By understanding how agencies do business in today's marketplace, media can better develop practices that protect their own interests while fostering a win-win relationship with these valuable industry players.

Myth #1: All advertising agencies that purchase media have adopted the "sequential liability" position.

In 1991, the American Association of Advertising Agencies, commonly referred to as the 4A's, recommended to its members that they adopt a sequential liability position. As defined by the 4A's, the position asserts that the agency shall be solely liable for payment of all media invoices if the agency has been paid for those invoices by the advertiser, and that prior to payment to the agency, the advertiser shall be solely liable.

Founded in 1917, this venerable organization now has about 1200 members, which produce approximately 80% of the total advertising volume placed by agencies nationwide. According to the 4A's website, virtually all of the multinational agencies are members; however, more than 60% of its membership bills less than $10 million per year. Agencies must meet certain criteria with regard to structure, services, standards, and practices to be considered for membership. Because the 4A's boasts an impressive and influential membership roster and has been a worthy and vocal advocate for agencies for so many decades, media have paid close attention to its positions and recommendations to its members regarding issues such as payment liability.

Many 4A's members, particularly the large national and multinational agencies, have adopted the sequential liability position. That said, there are more than 15,000 U.S. advertising agencies routinely purchasing media that have not done so.

—continued on page 2

7 Common Myths—

—continued from page 1

These agencies accept media providers' terms and conditions. Most media providers today have adopted a joint and several liability position, which holds all parties—the advertiser, agency, and buying service (if applicable)—liable until media receives payment.

Myth #2: Advertising agencies need more time than direct accounts to pay for media purchases.
Agencies bill on estimate, either on credit with 30-day terms or cash-in-advance, at the time the media order is placed. Unless the agency has agreed with the advertiser to extend its payment terms, most agency invoices should have been paid by the time the agency receives media invoices. Generally, it is the advertiser who requests longer payment terms from the agency.

Myth #3: An advertising agency's sole compensation is the standard 15% agency commission, received when the agency purchases media.
Media commissions once were the predominant method of agency compensation. The method was based on the idea that the agency, as a result of its efforts on behalf of the advertiser, would profit as the advertiser's business grew. The reverse would also be true, with agency revenues stagnating or dropping if the advertiser's business failed to grow and media budgets shrank. A second basis for the method was the assumption that the advertiser would maintain a certain advertising to sales ratio. Since the efforts required to service clients were not always commensurate to the size of media buys, the commission method often resulted in big advertisers with fat media budgets paying disproportionately high payments to agencies, thereby subsidizing small advertisers, which paid disproportionately low payments.

As media costs began to soar in the late 1980's, particularly for television, advertisers paying huge commissions to agencies began to revisit their agency compensation arrangements. Also, by that time, many national agencies had become parts of publicly traded holding companies, making predictable revenues more important. For these reasons, a shift began in the early 1990's to a fee-based model, which is based on hourly rates, project fees, or monthly retainers, alone or in combination.

There has been much discussion and debate in recent years about "value-based compensation," which links the agency's compensation entirely to the value (as defined by both parties) that the agency provides the advertiser. The model has met resistance because it relies totally on results, putting the agencies in the position of "betting it all" on an outcome that is difficult to define or measure and that may or may not be attributable to advertising.

"Performance incentives," on the other hand, have gained ground among advertisers as a way to motivate and reward agencies. Unlike its value-based cousin, the performance incentive model usually adds the incentive bonus to a fee- or commission-based structure.

According to a 2010 survey of major marketers by the Association of National Advertisers, traditional commissions now account for only 3% of compensation plans. Approximately 75% of agency compensation agreements use the fee-based model, and less than 1% use the value-based model. The ANA survey also showed that 46% use performance incentives, a practice that is much more prevalent among large advertisers spending more than $30 million per year. A whopping 70% of large advertisers use performance incentives with at least one of their agencies, compared to only 8% of those spending under $30 million per year. ANA also reported that the two most widely used criteria for incentives are agency performance reviews and sales goals.

Myth #4: Since the advertising agency checks the creditworthiness of the advertiser, the media provider doesn't need to.
Whether your organization adheres strictly to a joint and several liability position or accepts a sequential liability position, determining the advertiser's creditworthiness can save you a lot of grief if nonpayment occurs. If you hold a joint and several position, you want to have the option of pursuing any and all parties involved until your invoice is paid. If you have agreed to an agency's sequential liability position, and the agency has not paid you because it has not been paid by the advertiser, your best recourse may be to pursue the advertiser for payment. In this scenario, your chances of getting payment directly from the advertiser are severely diminished if the advertiser has gone bankrupt or is facing deep financial distress. If you hold a joint and several liability position and the agency, having received payment from the advertiser, goes out of business, you may still be able to seek payment from the advertiser since the advertiser received a benefit from the media buy. In any case, the additional protections afforded by evaluating the creditworthiness of both the agency and advertiser are well worth the extra effort.

Myth #5: Advertising agencies have a fiduciary responsibility to pay media providers when they are paid by the advertiser.
An agency is not a fiduciary, which by legal definition is "one often in a position of authority who obligates himself or herself to act on behalf of another and assumes a duty to act in good faith and with care, candor, and loyalty in fulfilling the obligation." In simple terms, the advertiser generally does not entrust funds to the agency to pay media on its behalf.

Agencies treat media money received by the advertiser as "general" commingled funds, not as segregated funds held in trust for the media provider. Agencies can do whatever they wish with the funds they receive from advertisers. They can also pledge as collateral any accounts receivable that are due them.

Myth #6: Advertising agencies provide advertisers with detailed billing, which includes the names of the media companies from which space/time was purchased and the individual amounts due each.

Most billing to advertisers is not detailed and may only reference a particular campaign and month. This practice makes it very difficult for a media property to look at an invoice received by the advertiser from the agency—which may include amounts due any number of unnamed media providers—and determine which portion is theirs. It also makes it difficult to determine the amount that the advertiser paid the agency for a specific buy, or to try to collect from the advertiser if an agency has gone out of business.

Myth #7: Advertising agencies are "agents for a disclosed principal."

In order to properly define the agency's role and to further reduce its exposure in the event of an advertiser's default, the 4A's has suggested to its member agencies that they include in their client agreements a clause that, for media and production purchases, the agency is functioning as an agent for a disclosed principal. By law, a person or entity acting as an agent for a disclosed principal is not liable for the contract debt of the disclosed principal.

As intimidatingly legal as this clause may appear, simply saying that you are an agent does not make you one. Without proper documented authority, an agency cannot bind its client, the advertiser, to any agreement.

Best Practices.

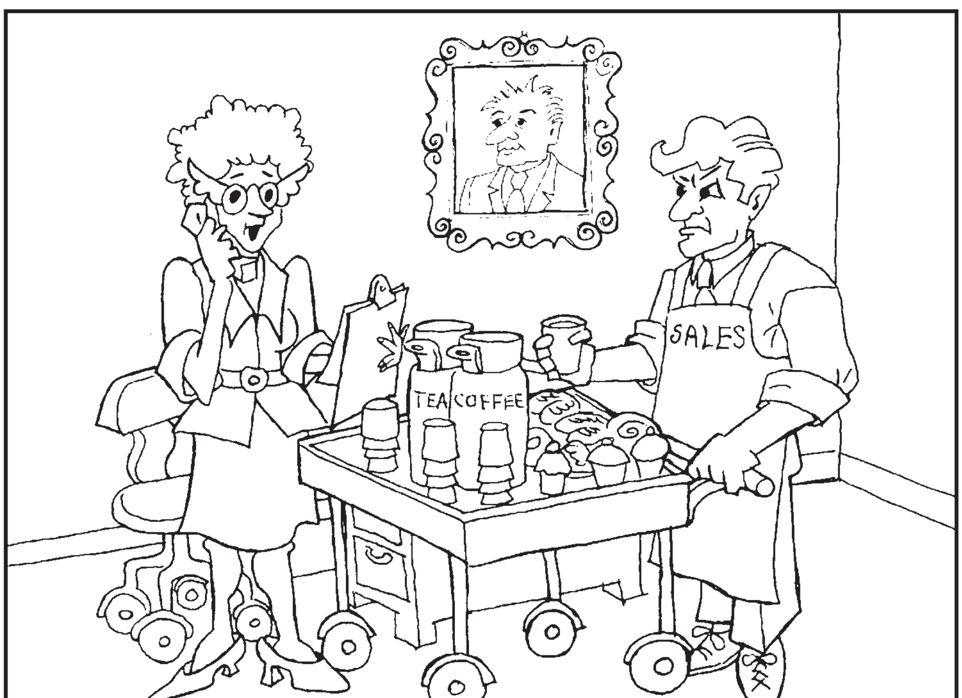
Now, after all of this "myth-busting," how can media use this information to improve their practices in dealing with agencies? Here are a few suggestions:

1. Include a joint and several liability clause on all correspondence with the agency. This position best protects your organization in the event of nonpayment by either the advertiser or agency.

2. Engage the advertiser as a participating player in the media buying process. This practice will significantly lower media's risks associated with advertiser creditworthiness and payment liability. Advertisers generally have preferred to remain insulated from the media buying process to avoid being considered a "principal." As such, the courts could hold them liable for the actions of the advertising agency acting as the agent on the principal's behalf. (Agencies, on the other hand, prefer to be regarded as an "agent" rather than an independent contractor.) Because of their reluctance, advertisers should be made aware of the benefits that derive from an active partnership with media.

Advertisers that allow media providers to become acquainted with their businesses and with their agency agreements reduce the likelihood that media will pursue them for payment if they have honored the agreement and the agency fails to pay media. Advertisers that are true players require detailed billing and "police" their agencies to make sure the media portion is paid on a timely basis, thereby avoiding the problem in the first place.

Agencies can also benefit from this cooperation. Since the agency is the party with which the advertiser contracted, the agency should be the primary source of information on the advertiser and should be willing to share results of its credit evaluation with the media provider. If the media provider approves the advertiser, who then fails to pay the agency, that agency is



"Sales wants to renegotiate the compensation agreement, Boss. He's thinking base plus commission, plus a fee for each service that diminishes his self-esteem, plus an incentive bonus for agreeing to put up with us for yet another year."

—continued on page 4

7 Common Myths—

—continued from page 3

more likely to get help from media to resolve the problem.

3. Get a signed "Agency of Record" from the advertiser. This practice addresses the confusion about the roles that the agency and advertiser play in the media buying process. The "Agency of Record" document, which you can develop in-house, states the authorities that have been granted to the agency to act on behalf of the advertiser in purchasing space or time, including the agency's authority to contract in the advertiser's name and to bind the advertiser to the agreement's terms and conditions. Additionally, the form should include a statement that, if the advertiser entrusts the agency with money to pay the media provider, the advertiser will remain liable if the agency fails to pay.

4. Enforce your 30-day payment terms. Agencies should have received their payment from advertisers in time to meet your payment terms. Additionally, agencies with fee-based agreements are paid their fees on a monthly basis, regardless of the volume of buying that takes place. Thus, fee-based agreements somewhat defang the old agency excuse, "We haven't been paid yet by the advertiser, so we can't pay you." On the downside, these agencies no longer have a vested interest in collecting the media portion of the buy from the advertiser, since they no longer bill the advertiser for the gross amount and remit to media the net amount. Both of these facts should compel media to insist on timely payment from agencies.

5. Stay abreast of new developments. The discussions and debate among advertisers, agencies, and media providers about compensation, payment terms, and liability issues are far from over. The rapidly changing media landscape and the financial pressures that all parties face, especially in these difficult economic times, guarantee that negotiations will continue and new business models will emerge in the years to come. By staying informed of advertisers' and agencies' efforts to protect their interests in these volatile times, media providers can best protect their own. ♦

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