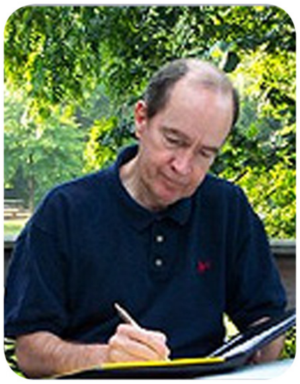

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Has Accounting Led Us Astray?

The World

Accounting was not my favorite subject in school. In fact, I didn't do well in it at all. I suspect that this was because, as I learned quite quickly, accountants like tidiness. It is at the core of their profession. And like many right-brainers I am basically an untidy person. Always have been. And probably always will be.

What I Did Learn

But there were some important principles I did pick up in accounting.

One was the importance of the accounting time period. Be it a month, a quarter or a year, our accounting professors stressed the importance of linking the cost of something together with the revenue (gross income) it generated within the same time period.

Without this linkage profitability (or lack thereof) for that period could be meaningless. And profitability is a basic measure of business success.

Another important principle came from a cost accounting class. While I had always thought of accounting as an exact science I learned, to my surprise, that in cost accounting the allocation of common costs (like overhead) are determined by formula.

A formula created by an imperfect human. And one that is always arbitrary. Thus it can be subject to all kinds of bias and can always be open to question.

Cost accounting is, in fact, not exact at all.

So, What Does This Have to Do With Agencies?

Very simply this. Over the past several decades these two accounting principles have dramatically influenced the business model that most agencies employ today. And while that business model is quite tidy, it may not be serving us as well as we think.

In fact, it might even be getting in the way as agencies face a new environment with mounting challenges.

Let's Look at Accounting Time Periods First

Advertising agencies are labor driven. Sure, this is intellectual labor, not pick and shovel labor. But it is labor just the same.

Just like a doctor, a lawyer, an architect, a consultant, or even an accountant, who are also laborers, the product of an advertising professional comes from her knowledge and her ability to apply that knowledge. The economic value and the worth to society comes from individual human work. Work that is often quite taxing mentally. And work that often has lasting value.

And each piece of intellectual content is unique and different from the last one. No two ideas or marketing solutions are quite the same. Everything is custom. And everything is new.

An advertising agency is a service business. This makes it quite different from a business that makes the same product over and over. Or, a business that sells products that are made by someone else.

Yet, regardless of the kind of business, accounting convention is to measure the revenue (gross income), the expense and the profit by time periods of individual months, quarters and years. All supported by tidy accounting.

Billing for agency work by the hour is simple and easy. And it links the cost of the labor directly with the income it generates all within the same time period.

But, linking when advertising agency work is done and when the revenue it generates is recognized may not be as easy, or as wise, as one might suspect.

The Messiness of the Commission System

Let's start from the beginning.

The advertising agency business was founded on the commission system. Whereby each time an ad created by the agency was published the agency received a commission. It didn't matter whether it was the first time the ad was run or the thousandth time. The commission was the same.

In order to create the ad, the agency would have to put in long hours of labor. Usually costing much more than it would receive in commission from the first time it ran. But in most cases the agency was banking on the ad running more than just once. And each subsequent time the ad ran, the agency received the same commission as it did the first time.

Uncertainty

When the ad was created nobody knew for sure just how many times it would run. Or, how much commission that ad would garner for the agency. If the ad was not effective in the marketplace, it probably would be run only once. But if it was effective, it could run many times. Possibly for years. Maybe even for decades. Just think of the Marlboro Man.

When you view it this way, you realize just how messy the commission system was from an accounting time period point of view.

An effective ad had annuity value. An ineffective one didn't. A fundamentally honest and fair business model. But not easy to account for.

The Time Period Disconnect

So under the commission system the time period in which the ad was created bore heavy labor costs with little gross income. Most likely resulting in a loss.

But then when the ad ran in subsequent time periods there was little if any labor cost but significant income. Which could lead to a distorted perception of profit for those time periods.

From an accounting standpoint this was a big mess. There was seldom any guarantee of how many times each ad would run in the future. An easy linkage between labor costs and income generation just did not exist.

So income and profit forecasting was difficult. Certainly not as simple as when the agency is billing for the time when the work is done.

Cash Drawer Management

Yet without sophisticated forecasting tools, agencies thrived during the commission system era. They did it by keenly understanding their expenses and spending rates and then shrewdly watching income, usually on a daily basis. Closely monitoring what cash went out. And what cash came in.

And then acting quickly if things appeared to be heading out of whack.

Now Let's Look at Cost Accounting

It makes sense to want to know if a client is profitable to the agency. Or a department. Or an individual. This kind of information can be tremendously helpful in the allocation of resources and the pricing of services. There is no disputing this.

And today, most agencies have cost accounting systems that can spit out this kind of information in mind-boggling detail. Most have extensive data on how people report their time and how labor costs and gross income compare for each period for every client, every department and every individual. All very tidy.

But Is It Misleading?

Undoubtedly staff time utilization studies and cost accounting profitability reports are helpful. Particularly if they are viewed strategically as trend or directional indicators over a considerable time span. From this 30,000 foot level they can help agency leadership better understand relationships and behavioral patterns. Thereby enabling them to lead the agency more effectively.

An important factor in strategically seeing through the fog of day-to-day agency operations.

Unfortunately however, granular time studies and cost accounting profitability reports are too often used tactically. And since their data is usually presented in very precise figures (often to the one hundredth of a percentage point) it becomes easy to be misled into elevating their accuracy to a level of truth they don't deserve.

Here's Why

First, staff utilization time studies and cost accounting profitability reports are based on information from lots of individual time sheets. It is kind of scary to realize that the entire structure of agency cost accounting rests on the accuracy and timeliness of the lowly time sheet.

And it is a dirty little secret how notoriously inaccurate agency time sheets can be. They are based on individual judgments and memories. Judgments and memories that may be generally accurate. But are not precisely accurate.

Now don't get me wrong. I believe that most agency people honestly try to be accurate and timely with their time sheets. But in many agencies the rules for what time is to be reported and how time is to be spent for clients and agency activities are fuzzy or poorly understood.

Thus two different people can report time for the same activity quite differently.

And the reality is that filling out a time sheet has low priority with most agency people. They enjoy their craft work. But time reporting is a nagging task. And often becomes little more than an after-the-fact best guess of what really happened.

A shaky foundation. But the only practical one available.

The Cost Accounting Formula

Second, once the time is gathered and entered into the system, the cost accounting formula comes into play. It provides the arbitrary determination of what constitutes overhead (or common costs) and how that overhead is allocated to clients, departments and individuals. There are dozens of different, but very legitimate, concepts that can be employed in the formula.

And each different formula can produce dramatically different results.

Usually, only the folks in accounting understand the formula being used. And the implications it has for the output of information.

This is probably a good thing.

Because any agency person who understands the formula is capable of improperly influencing information output by gaming the system.

Not a good thing.

With a Grain of Salt

So, while staff time utilization and client profitability information is helpful, it is not gospel. And trying to manage precisely through its metrics is a fool's errand.

Yet we see more and more agencies being managed – some might say micro-managed – against specific internal metrics. It is increasingly common for economic rewards and career promotions to rest largely on achievement of specific short-term gross income or profitability goals. Often these are written right into the individual's job description and expectations.

You have to question the wisdom of putting such emphasis on managing intelligent, talented, high-spirited people by specific numbers generated by accounting systems with such doubtful underpinnings.

That certainly does not appear to be in alignment with what the agency business is, or should be, all about.

The Wrong God

Have agencies come to worship the wrong god just because it is neat and tidy to do so? Do some internally generated numbers obscure rather than clarify the truth? Have sophisticated accounting practices beguiled agencies away from their true calling?

And if so, is there a path back?

The Reason for Being

Agencies exist for one, and only one, reason. That is to change consumer behavior for the benefit of the marketer, the consumer and society. That's it. Pretty obvious. And pretty simple.

That is the only reason marketers engage agencies. Their expectations are that the agency will change the behavior of their customers and prospects in the marketplace. That has economic value to them. And at the highest level, that is what they are prepared to pay the agency for.

Selling Stuff vs. Outcomes

Yet the sad truth is that today agencies are generally paid for the stuff they create and produce. Often the price of that stuff is denominated by the hours it takes to prepare it. Stuff that will likely help achieve the client's desired business outcome. But agencies are usually not paid for achieving the outcome itself.

Today's generally used agency business model is not set up to reward the agency directly for those market outcomes. And yet the current pay for labor business model is a polar opposite from how agencies began.

The commission system was essentially a pay for performance system. Its success relied on market outcomes. If the ad worked it continued to run and the agency was paid each time it did so. If the ad didn't work, it didn't continue to run and there were no residual payments. Some downside risks. But big upside potential.

Getting paid for agency work priced by the hour is a pay for labor system. The agency gets paid regardless of the market outcomes. No downside here. But no upside either.

Leadership vs. Management

There is an old saying that management is about doing things right. And that leadership is about doing the right things.

Most agencies are indeed well managed. They have highly sophisticated tools, like the accounting systems we've been discussing, to precisely manage their businesses. They are clearly doing things right.

The question is however, are agencies doing the right things?

Have agencies traded the inherent risk, but along with it potentially big rewards, in the pay for performance system for the siren song of downside protection offered by the pay for labor system? And in the process diminished their long-term potential by falling into a commodity vendor trap?

A New Era

While traditional agencies and traditional marketers have been talking about pay for performance systems for some time it still represents only a small portion of total agency compensation. Could it be that is because both clients and agencies are more concerned about protecting against downside risks than envisioning the upside potential?

Is that why we see so much hand-wringing and so little action on this front?

Yet all the while, new players in the advertising community (like Google, Yahoo, Microsoft, etc.) are quickly rewriting the rules. They are betting their futures on dominating the hundreds of billions of dollars of advertising spending. Bloomberg Businessweek reported that 2012 spending for search marketing was expected to exceed $17 billion and online display advertising would total $15 billion.

Search marketing alone has already become an overnight giant. And new technologies like Microsoft's Engagement Mapping promise to provide the same kind of precise market outcome feedback for other forms of emarketing.

And remember, pay per click is pure pay for performance. Pricing is based on outcomes, not hours of labor.

Interestingly, some of the very marketers who are telling their agencies that they will only compensate them on the pay for labor system are at the same time buying pay per click and other media on the pay for performance system.

And too frequently, these new media purchases are made independently of the client's primary agency.

Coming Full Circle

Could it be that the marketplace is returning to its origins? Are marketers again, albeit slowly, embracing the concept of pay for performance? And recognizing the benefits this offers them today? Just as it did in the past?

Is the paradigm shifting? Is the business model transforming? And if it is, will agencies be important players? If so, here are some things worth considering:

- **Embrace the Concept.** Pay for performance offers the best hope for agencies to escape the enervating downward pressure on hourly charges. But while the reward potential goes up significantly, so does the risk. And remember, if agencies are not comfortable accepting that risk, it is likely that new players will move into that void.

  Recognize too that a transition to pay for performance will not happen quickly or neatly. It took a couple of decades for the shift away from media commissions to hourly billing.

- **Refocus Agency Talent.** Many agency people feel their job is to create advertising which is paid for by the hour. The need for billable hours has been drummed into their heads. Often they don't see their higher responsibility. That is to change behaviors of consumers.

  If they are not focused on outcomes rather than projects they may never be able to soar individually. Nor will they likely be able to help their agency do so either.

- **Become an Evangelist.** Lots of marketers are stuck in old ways. Pay for performance can be scary. Perhaps they just feel safe where they are right now. Yet standing still is probably the most dangerous thing they can do. An evangelistic agency can help them see the new opportunities and increase their success.

  And folks that are traditionally minded on the client side may need to be flanked so the agency can engage with others within the client organization that are already sending money out the side door for newer forms of online advertising.

The Day Will Come

Unquestionably agencies face a bumpy road ahead. The huge transition in the marketplace is unprecedented. Old business models are decaying. New ones are emerging. Opportunities are skyrocketing. So are risks.

Transitioning from the current agency business model of pay for labor to pay for performance will be long, tedious and messy. But the agencies that navigate through this ambiguous time will emerge in a much brighter day.

A day in which success and compensation is measured by marketplace outcomes.

A day in which internal accounting micro-management reports can be forgotten.

A day in which staff time sheets can be discarded. Never to be seen again.

Ah, there will be dancing in the streets!