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The current client-agency relationship is flawed, argues Tim Williams, founder of consultancy Ignition, and Ronald J Baker, founder of the think-tank

VeraSage Institute.

The current cost-based compensation model for advertising agencies is flawed for a simple reason: it misaligns the economic incentives on each side. The client pays whether the agency adds value or not and the agency is paid a fixed amount regardless of the value it creates. Clearly, this present model is not in the best interests of the client or the agency.

Even more perniciously, the existing compensation model focuses entirely on the wrong things: efforts, activities and costs. It does this at the expense of focusing on the right things: outputs, results and value.

Marketers are looking to their agencies for campaign integration, media neutrality, creative innovation, holistic communication and marketing plans, independent of any agency discipline. Agencies believe clients can add the most value by providing clear direction concerning strategy, timing, and objectives. Agencies also believe that more value would be created by much broader sharing of information, access to decision makers, and engaging the agency as an extension of the client team.

Overcoming resistances

Both parties cite significant obstacles to moving to a value-based relationship, including:

- Different definitions of value
- Lack of willingness to share risks-rewards
- Agencies' lack of control over business results
- Lack of information sharing
- Insufficiently defined metrics
- Lack of mutual trust to make value-based agreements work

To some extent, both sides are locked in a form of stalemate, thinking there is no better way to enhance value on each side. Each party largely believes that a penny more to one side comes only at the expense of the other side; a fatalistic zero-sum view of the world. Little wonder the status quo is characterised by a degree of mutual distrust, lack of communication, and under-investment in a more rewarding compensation model.

Moving to a new model

If value is like beauty; in the eye of the beholder, how are we to define it? What factors create it? How can agencies be paid if they cannot fully control how clients create it? What happens if value isn't created?

These questions require that new models be developed for true value-based relationships. We have come to believe that an effective approach to value-based compensation must include characteristics like shared risks and shared rewards; evaluation of both parties (not just the agency) that is linked to compensation; and the use of leading (not lagging) indicators as metrics of success.

Lagging versus leading indicators

Most measures of performance (sales, market share, stock price, etc) are lagging indicators that only tell us where we have been. Measures can only confirm the past. To peer into the future, we need measures that are tied to theories, what economists call leading indicators. The correct leading indicators will predict the lagging indicators.

All of the metrics gleaned from financial statements are lagging indicators, which have little predictive capability, unless your theory is the future will be an extrapolation of the past, a perilous assumption in today's fast-changing world.

For instance, the airlines focus on three leading indicators: on-time arrival; lost luggage; and customer complaints. Notice that all of these indicators define the success of the airline the same way the customer does. We measure these things because the customer cares about them, not simply because we can.

Control versus influence

Of course an agency cannot completely control business results. However, they have tremendous influence over various factors that create value. These influencers directly impact the leading indicators, such as: project management, collaboration and unconventional thinking. For the marketer, clear and consistent communication, direction and approval processes are examples of its influencers.

These influencers would be graded over a pre-defined period of time and compared to the goals established at the beginning of the relationship. The scores will influence agency compensation.

How will you know if each side is grading fairly, and not just abusing their power to negatively influence the compensation? This is an issue of trust, not pricing. Why be involved in a relationship without mutual trust, respect and honest communication? The beauty of the influencers on each side affecting compensation is the alignment of the incentives to do the right thing, and to relentlessly communicate.

What is the value to the client?

Once the indicators and influencers have been identified, the expected outcomes are benchmarked, and the financial impact of achieving the objectives is quantified. This quantification answers the question, "If we accomplished these goals, what would be the value to the client?". The answer to that question will form the basis for a value-based price.

Among other things, the price can be determined by the difficulty of the desired outcomes, ownership and use of intellectual property, the amount of risk-reward assumed by the agency, service guarantees, and other permutations of value propositions the agency could present to the marketer. The number of possible pricing points is only limited by the imagination on each side, bowing to the reality that value is subjective and there is never going to be a 'one best' model. This approach does provide a framework so each side can search for the price that is commensurate with the value being created.

Not final words

Incentives matter. A true value-based model aligns the economic incentives of both marketer and agency, putting each into a value-based mindset with the ultimate goal of creating ever-increasing value on each side. Rather than allocating resources to solve problems, thereby feeding failures and starving strengths, it pursues opportunities.

It's time for a new vision for marketer-agency relationships; a new way of thinking and operating that emphasises client value. A world in which these virtues are practiced as much as they are preached. A reality whose time is here.

Tim Williams is the founder of Ignition, a consultancy devoted to helping marketing organisations create and capture more value. He is the author of 'Take a Stand for Your Brand', ranked in the top ten books on brand building on Amazon.com. Tim welcomes your comments at twilliams@ignitiongroup.com.

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