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Graffiti/BBDO Sofia

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ABSTRACT

The advertising business in Bulgaria is in its early teenage years. However, 12 years after the fall of the communist regime the advertising industry in Bulgaria experiences a boom. The competitiveness of the market implies flexibility and correct cost allocation, pricing and capacity decisions.

There are different ways the client in a service industry such as the advertising to be charged, they are – on the bases of agency hours, agency commission over the budget, fixed commission, etc. The decisions for the cost allocation methods and the ways of charging are taken by the managing team of the agency together with and based on the data provided by the financial department. The decision for charging however, is influenced by the client's opinion and preferences.

I. Introduction

1.1. Company overview

Graffiti/BBDO Sofia is an affiliated institution of BBDO Worldwide, one of the leading advertising agencies, part of the Communication Group Omnicom/a consortium of advertising, PR and marketing communication agencies. The company has been founded in March 1994 in Sofia and has started with just one client – one of the biggest BBDO clients – Wrigley's. Later on the agency has acquired more clients both worldwide BBDO clients, as well as locally won accounts. Graffiti/BBDO is a full service agency, which provides development of advertising or more accurately communication strategies, which include creative, media planning and buying, PR & BTL activities, design and production of POS materials, following the competitor's activities, etc. The company is privately owned the founders are Romanian. They own Graffiti/BBDO Bucharest too. The Bulgarian company benefits from the affiliated institution BBDO Worldwide with base in New York, as well as from the Romanian Graffiti/BBDO, which has a little longer history, the agency in Sofia uses the know how as well receives some of its biggest clients – Pepsi Co, Wrigley directly from the mother company.

Today, 8 years after the opening of Graffiti/BBDO Sofia, the agency has around 15 full service clients, and more than 30 employees. The agency has survived the economic crises in Bulgaria in 1997, when actually there was no advertising at all for about half a year. A lot of agencies closed or actually bankrupted during this period. Graffiti/BBDO Sofia, not only survived but also kept its employees.

2. Organizational Structure

On the top of the agency is of course the CEO or as it is at BBDO the Managing Director. Then comes the administrative director, below are the directors of the other departments – the Client Service Director, the Creative Director, the Media Director, the production Director as well as the PR & BTL Director. Below are the departments themselves with the Account Director, Account Executives and Account Assistants in the CS dept, the copywriters and the art directors in the Creative dept, the media planners, media buyers and the researchers in the Media dept, etc as it is shown in Appendix 1 on page

1.3. Management Control and Decision Making.

There is no additional Accounting or Financial dept. in the organisational structure of the agency, however there is an outside accounting house that controls the

financial accounting. The managerial accounting on the other side can not be separated from the agency, thus it is kept together by the Managing Director as well as by the Administrative Director and sometimes by the Directors of the agency departments.

The advertising business in Bulgaria has started late. Its beginning is marked immediately after the fall of the communist regime in 1989. The Bulgarians still remember the first TV spots, the first billboards. However, as everything that comes late this business had a lot to catch up. Thus the last 12 years had marked really booming development of the advertising in Bulgaria. The market is really competitive. Hundreds of agencies are competing for the same big clients, year after year offering better and better conditions – discounts on media buying, decreasing agency commissions and other forms of remuneration. The Managerial Accounting especially in terms of Cost management became an issue. The Managers of the agencies didn't have neither the experience nor the knowledge to implement management audits. Thus a lot of mistakes followed. The strategy if it can be called strategy may be ironically defined as "Management by mistakes". Graffiti/BBDO Sofia did not gather some know how from the BBDO Worldwide in this aspect and respectfully had some hard times as well as the other agencies.

A lot of decisions had to be made, a lot of answers must have been given. During the first years of its existence Graffiti/BBDO was serving several clients, the tasks have been simpler and easier, with the development of the market the company has been constantly invited to participate in pitches and this started to take a lot of the time of the people as well as a lot as output financially in terms of materials, labour, overheads. Decisions had to be made on the following – to grow or no, to hire new personnel or no, what is the capacity of the agency, to hire part time employees, or outside sub-contractors, to stick on the existing clients and to provide them with excellent service, charging them more and keeping them for longer time..... These were the questions, so in order to take the decisions the managers of the company needed a lot of information, data on cost behaviour. An accounting system was needed, a score keeping was to be created.

3.Problem Definition

Cost allocation in a service company is far more complicated than in a product company. Cost drivers are different because the end product of the agency's activities is more or less intangible, thus hard to measure. Having in mind the advertising business it is even harder. A lot of managers think that if they spend some money on advertising the sales should definitely grow. Of course it is not the case, the good advertisement may increase awareness, inspire trial, build certain image however if the product itself is of poor quality, if the price is inadequate or the distribution is rare the sales will not grow for sure.

4. Possible solutions or *How to estimate the cost of services*

In the same time the work in an advertising agency is very diverse in its nature. The problem is cost allocation and the definition of cost drivers – the activities that affect costs is difficult to be defined. In other words the different departments in the agency can have different managerial accounting system – different way of charging the clients.

4.1 Cost Driver

For example if we take the media department – the activities that the department performs can be defined in three groups – media planning, media buying and research – competitors' monitoring, following the ratings of the media etc. The activity that really can bring profit is the media buying, because the agency media commission is calculated just on the media budget of the client when the budget is really spend, in most of the cases all the preliminary research and planning incurs just costs – in terms of fixed & variable costs – office rent, electricity & telephone bills, secretarial & other employees in the media department wages etc. The hard issue in this case is the fact that the time that the media department spends on media planning and buying for a client who spends \$50 000 a month is not less that the agency hours spend for a client that spends \$500 000 monthly. Thus the charging must be balanced and if for a client who spends \$50 000, the agency may afford to ask for 10% media agency commission, however for the bigger client the agency may ask for just 2-2,5% commission.

If we take the creative department for example it is even more harder to estimate the costs and the value of the activities. For the work of its creative department it is difficult to charge on the basis of commission, sometimes it is possible a client to be charged on the bases of agency hours, however not always real agency hours of course because the work on inventing a slogan or a birth of an idea for TV spot scenario is difficult to be measured in astronomic hours. Most of the agencies just provide the creative work for free for its full service clients. In this case the agency must calculate the work and the costs that the creative department incurs into the agency commission. However, it is not always the case.

In terms of production department it is easier. Here within the service company products are being produced – products such as P.O.S. materials, TV & radio spots, billboards, etc. In most of the advertising agencies these products are being produced by sub-contractors. In most of the cases the agency charges with agency commission on the production budget. This commission covers the costs incurred by the creative department in terms of design and the price for pre-printing of the d.t.p. specialists, as well as the costs made by the client service department – the

department that co-ordinates the different departments in the agency and communicates with the client.

Let's take a specific example:

Case I

Task: Production of 10 000 posters 50/70sm, paper 200 gr.

Activities performed by the agency:

1. Client service department takes the order from the client, prepares a creative brief for the creative department and controls the whole process – 5 hours
2. Creative department makes the design – 4 hours
3. Desk top publisher makes the pre-printing – 2 hours
4. Production manager – search for the best sub-contractor in terms of price and periods for completing the order, co-ordination of the work of the printing house, delivering the posters to the client – 7 hours.

Total: 18 agency hours

Costs of the posters is however calculated as follows:

1. Films – 50.00 lv
2. Colour probe – 100.00 lv
3. Paper + Print – 1,20 lv/poster = 12 000 lv.

Total cost for production of 10 000 posters 12 150lv

Agency commission – 10% or 1215 lv

In terms of agency hours the price for an agency hour is equal to less than \$80.

Case 2

Media planning and buying for \$250 000 – TV budget for 1 month for new brand of the Wrigley's chewing gums.

Activities performed by the agency:

1. Client service department takes the order from the client and prepares the media brief for the media department and co-ordinating the whole process of planning and buying – 5 hours
2. Media department – planning – 3 hours, buying – 2 hours, post evaluation of the campaign – 2 hours. Total – 7 media hours

Total agency hours – 12 hours

\$250 000 total net media budget

2,5% media agency commission - \$6450

The price for an agency hour in this case is around \$537.

4.2. Variable & Fixed Costs

Of course in both cases we didn't measure the fixed costs such as office rent, utilities, depreciation etc. We can calculate how much of these costs go to the above projects. For example if the rent per month for the agency's office is \$10 000. The daily rent /we take of course just the working days/ is around \$360 per day. One working day consists of 8 working hours, thus the Case 1 took 18 hours or 2 days and 2 hours of the agency. In other words we must allocate around \$750 more for office rent for the posters project; and \$540 for the Wrigley's media buying case. The same calculation may be made for the other expenses. For example if we take the labour. The labour may be considered as fixed cost if the payment is on fixed salary base. The labour may be considered also as a variable cost if it is paid on a project bases or on an hourly bases. Both cases are used in an advertising agency. There are permanent employees and part time employees. The first once are paid more as considered to be more experienced and loyal to the company.

The above stated examples show why the way of charging in an advertising agency is not always fair for the clients, the agency revenue, not always corresponds to the work done. Probably the most correct cost driver in the cases of cost accounting of an advertising agency are the agency hours.

4.4 Cost Centres, Cost Pools, Profit Pools and allocation of service departments costs

Each of the departments at Graffiti/BBDO may be considered to be a cost centre or as responsibility centre for which costs are accumulated. One department also may contain several cost centres.

“Cost pool is a group of individual costs that is allocated to cost objectives using a single cost driver”, /pg 445, Introduction to Management Accounting, Charles T. Horngren, 1993/ In this case different costs as building rent, utilities, janitorial services etc may be in the same cost pool, allocated in the basis of square footage and space occupied.

Profit centres on the other hand have responsibility for controlling revenues as well as costs/or expenses/- in other words profitability.

The issue with cost allocation is up-to date in an advertising agency because some departments exist only to support other departments as for example the Administrative and the Client Service Department. The costs that these

departments incur are totally reallocated. The ideal cost allocation system must focus on the causes of cost – the cost drivers.

5. Budgets and Control on Engagements

In a service organisation as an advertising agency instead of products, there are certain projects to be realised. Budgeting is formulated and a plan consisting of different job orders is prepared. Job orders are used for service costing as well as for planning and control services. If we assume that Graffiti/BBDO has budget for a PR consultancy of a client as follows:

- Revenue –	\$10 000
- Direct labour/for professional hours charges to engagements/ -	\$2 500

- Contribution to overhead and operating income –	\$7 500
- Overhead /all other costs/ -	\$6 500

- Operating income -	\$1 000

In this example:

budgeted overhead	\$ 6 500
Budgeted overhead rate = -----	= ----- = 260%
	budgeted direct labour \$ 2 500

In an advertising agency the overhead is applied most often on the bases of agency hours, which becomes cost driver.

5.1. Activity Based Costing

The Activity Based Costing System classifies costs as neither direct nor indirect. Sophisticated and costly systems identify many activities and cost drivers so that the most costs can be physically traced to products and services. The ABC as a system for cost allocation is one of the most appropriate systems for service companies such as Graffiti/BBDO Sofia. First because the profitability of the services is more accurately measured by this system. Second as global competition increases managerial decisions require better information on cost of services.

5.2. Overheads

Activity Based Costing tends to shift overheads to direct costs. Costs such as direct – support labour, telephone calls, photocopying, computer times etc. are applied by directly measuring their usage on each engagement. The remaining costs are allocated to cost pools based on their cause.

Let's take the PR consulting example of Graffiti/BBDO Sofia again. The case analysed from ABC point of view looks as follows:

Direct professional labour	\$5 000
Direct support labour	\$ 1 000
Fringe benefits for all direct labour*	\$ 2 400
Telephone calls	\$ 100
Photocopying	\$ 200
Computer time	\$ 700
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Total direct cost	\$ 9 400
Applied overheads **	\$10 340
Travel cost	\$ 1 400
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Total cost of engagement	\$ 21 140

*40% assumed rate multiplied by $\$5\,000 + \$1\,000 = \$2\,400$

**110% assumed rate multiplied by the total direct costs of $9\,400 = \$10\,340$

The Activities Based Costing approach also has a lower overhead application rate. For example in the above example the percentage of overheads from the total direct costs assumed at %110 of total direct costs instead of %260 of direct labour. The overhead costs are fewer because the costs are traced directly and because the application base is broader including all direct costs instead of just direct labour.

6. Can *Graffiti/BBDO Sofia* bear new clients or no?

6.1. Capacity Decisions

The decision making process needs relevant information. "The accountant's role in decision making is primarily that of a technical expert on cost analysis who help managers focus on relevant data, information that will lead to the best decision."/Introduction to Management Accounting, pg. 143, Charles T. Horngren, 1993/ Let's analyse the following example:

Graffiti/BBDO Sofia has an opportunity to increase its client's list with a new prosperous client. However, the company faces shortage of human resources. The managerial decision that was to be done was – to hire new personnel and handle the client or not to accept the account. The accounting calculation showed that if the company hires several new people in its creative department, where they were most needed, the revenues from the

new client will not cover their new salaries. Moreover, the new client had highly seasonal products which needed advertising just during the three summer months, thus after this period the hired people in the creative department will not be needed any more, so the company will suffer losses while paying their salaries. The simple accounting analysis advised the managing director of Graffiti/BBDO to refuse the new client. Hopefully the managing director advised by the HR manager accepted the new account and covered it financially by hiring part time employees/sub-contractors in the creative department. Of course the accountants give relevant data and analysis to the Executive managers, however the final managerial decisions need a lot more data than just financial in order to be taken. In the example shown if Graffiti/BBDO hires permanent employees the marginal costs for handling this new client will exceed the marginal revenue. Thus the project won't be profitable.

6.1 Pricing Decisions

One more reason for the difficulties in cost accounting in the service industry and especially in the advertising business is the fact that the pricing is discriminatory. For one and the same services different clients are charged differently. Especially in the period after the fall of the communist regime the first advertising agencies have been charging the Bulgarian companies very low and the multinational companies very high. Today 12 years later when the advertising market is almost regulated the competition rarely allows for such differentiation.

7. Conclusion

The problems with cost allocation, capacity decisions and pricing decisions at *Graffiti/BBDO Sofia* has been solved and are being solved by the managerial team together with the financial department of the agency. There are different ways in which the costs in the agency are allocated. Costs are allocated by activities, by department, by client, by agency hours etc. "Most often however, the way of charging is determined not just by the agency but by the clients also. And sometimes agencies win a pitch for a new client not because of better creative proposals or because of more effective media planning, but because of more flexible ways of charging, which is highly valued by the clients today"/interview with Sofia Peneva, Graffiti/BBDO Sofia – CEO/.

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