Aalto University
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# Agency Compensation Models in Search Engine Advertising - A Multiple Case Study

International Business

Master's thesis

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**Abstract of master's thesis**

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**Objectives**
The objective of this study was to investigate what agency compensation models are available for search engine advertising (SEA) in the Finnish market and explain the rationale and selection process for why certain models are being used. This is deemed highly important and current as SEA is now globally estimated to be the most popular form of digital marketing available for firms of all sizes, and these functions are suggested to be often outsourced to advertising agencies due to their high complexity. This study uses and tests agency theory as a theoretical lens to examine how the interests of an advertising client and its agency can be aligned to motivate the agency to work in the client's best interest. Agency theory was deemed a particularly useful framework to examine SEA compensation models as it has been often used for the similar objective of examining what compensation schemes are most suitable for various contexts and helping predict how various models affect managerial behaviour.

**Methodology**
The empirical research was conducted as a multiple case study. The primary, qualitative data for the study was gathered through themed interviews with key model selection influencing respondents from 8 search engine marketing, digital and media agencies operating in the Finnish market. The study is primarily deductive whereby a theoretical model is developed by combining both agency theory and related theoretical extensions. The model is then retrospectively tested in the empirical setting to evaluate its ability to predict and explain compensation model selection decisions for the SEA context.

**Key Findings**
The findings of this study revealed 7 different compensation models being used in the Finnish market with one of them, namely the New Commission, being completely new to extant literature. The findings revealed that no compensation models was considered ideal and that the model selection decision is driven by agencies and clients making tradeoffs between what desirable features they consider most important. The importance of each desirable feature is affected by a large number of moderating and boundary contextual factors that affect desirable feature valuation both in the beginning of the relationship as well as when the relationship progresses. Agency theory was found to be a sound predictor of the nature of compensation models in the beginning of the relationship but its predictive and explanatory capabilities reduced as the relationship progressed. This is due to the theories inability to explain the changes in feature evaluation over time or encompass the meaning of trust in the agency-client relationship.

**Keywords**
agency compensation models, search engine advertising, agency theory

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**Tavoitteet**
Tämän tutkimuksen tavoitteena oli selvittää, minkälaisia palkkiomalleja hakukone-, digi-, ja media toimistoilla on Suomen markkinoilla saatavilla hakusanamainontaa varten sekä selvittää miksi ja kuinka tietty palkkiomalli valitaan. Tämä on erittäin tärkeää ja ajankohtaista, koska hakukonemainonnan arvioidaan olevan tällä hetkellä maailmanlaajuisesti suosituin digitaalisen markkinoinnin muoto kaiken kokoisille yrityksille ja koska hakukonemainonta usein ulkoistetaan monimutkaisuutensa vuoksi. Tämä tutkimus käyttää ja testaa agenttiteoriaa teoreettisena näkökulmana selvittämään, kuinka mainostavan asiakkaan ja sen käyttämän toimiston intressit voidaan yhdenmukaistaa, jotta toimisto on motivoitunut toimimaan asiakkaansa eduksi. Agenttiteoriaa pidettiin hyödyllisenä viitekehyksenä tutkimaan hakukonemainonnan palkkiomalleja, koska sitä on usein käytetty vastaavanlaiseen tavoitteeseen eli selvittämään, mitkä palkkiomallit ovat soveliaimpia erilaisiin olosuhteisiin sekä ennustamaan, kuinka mallit vaikuttavat johtamiskäyttäytymiseen.

**Metodologia**
Tutkimuksen empiirinen osuus toteutettiin monitapaustutkimuksena. Primääri, laadullinen tutkimusaineisto kerättiin haastattelemalla palkkiomalleihin vaikuttavia henkilöitä kahdeksassa eri Suomen markkinoilla toimivissa hakukone-, digi-, ja mediatoimistoissa. Tutkimus on pääsääntöisesti deduktiivnen eli siinä rakennetaan teoreettinen malli hakukonemainonnan palkkiomallien määräytymisestä yhdistelemällä agenttiteoriaa sekä sen laajennuksia. Teoreettista mallia testataan empiirisessä kontekstissa arvioimaan, kuinka hyvin se pystyy ennustamaan sekä selittämään palkkiomallien valikoitumista hakukonemainonnassa.

**Keskeisimmät löydökset**
Tulokset paljastivat seitsemän eri palkkiomallin olevan käytössä Suomen markkinoilla ja että yksi niistä, "uusi komissio", on kirjallisuudelle kokonaan uusi. Löydökset osoittivat, ettei mitään näistä palkkiomalleista pidetty erinomaisena, vaan että jokaisen kohdalla oli tehtävä kompromissejä eri toivottavien ominaisuuksien tärkeyden suhteen. Jokaisen toivottavan ominaisuuden tärkeysarvioon vaikuttaa suuri määrä kontekstuaalisia tekijöitä sekä asiakassuhteen alussa että sen edetessä. Agenttiteorian todettiin olevan hyvä ennustamaan palkkiomalleja asiakassuhteen alussa, mutta sen ennustus- ja selityskyky heikkenevät asiakassuhteen edetessä. Tämän todettiin johtuvan agenttitoerian kykenemättömyydestä selittämään eri ominaisuuksien tärkeyden muuttumista asiakassuhteen aikana tai käsittämään luottamuksen merkitystä asiakassuhteessa.

**Avainsanat**
toimistojen palkkiomallit, hakukonemainonta, agenttiteoria

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# 1 INTRODUCTION

## 1.1 Background

Advertising agencies are means for firms of all sizes and business models to be able to outsource their online and offline marketing activities in order to tap into professional expertise and potential time and cost savings (Smith & Chaffey, 2005). As the volume and complexity of available online and offline advertising media increases (Horsky, 2006), the need for hiring specialized service providers for consulting, creating and managing digital content and advertising campaigns on behalf of clients is forecasted to increase (Eleveld, 2012). Reports suggest that the expected growth trend in agencies is picking up (Johnson, 2014). This is already reflected in advanced markets such as the U.S. where agency employment is at a record high since the dot-com-bubble and increasingly shifting from traditional into digital media activities at a rate of 12% annually (ibid).

Search engine advertising (SEA), also referred to as keyword advertising, pay-per-click advertising and paid search, is the paid digital marketing activity of attracting traffic to websites via Internet search engines. Since its rise in the late 1990's, search engine advertising has been argued to have had a dramatic impact on modern advertising for firms of all sizes. The revolutionizing measurability and tracking quality brought by SEA and digital advertising has enabled marketers to quantifiably examine the efficiency and effectiveness of their objectives through various tracking technologies and web analytics measurement systems (Grensing-Pophal, 2014). SEA is now globally estimated to be the most popular form of digital marketing available; constituting approximately half of all online advertising expenditure of firms of all sizes (Abou Nabout et al., 2014). Paid search advertising currently forms the largest part (36%) of Finnish advertiser's digital advertising spend (TNS Gallup, 2014). As firms and their management are continually pushed for growth, increased efficiencies and results, even under current recessionary economic circumstances (Talouselämä, 2014), it is increasingly important to examine and understand the factors which lead to the selection of a particular search engine advertising agency compensation scheme designed to maximize advertising efficiency and effectiveness. Research in the area of search engine advertising as well as related compensation models is still in its infancy and has only recently begun to reach the level argued to be appropriate for this increasingly significant advertising channel (About Nabout et al., 2012).

Agency theory is a stream of literature that examines how a relationship is managed between a client and an agent who is contracted to perform a particular service on the client's behalf. Contracting an agency to carry out an advertising activity involves a firm finding a reliable agency business partner and those parties reaching a satisfactory agreement which ensures that the goals and interests of particularly the commissioning party, the client, are met. Agency theory is poised towards addressing the risk of opportunistic behaviour by agents under conditions of asymmetric information by aligning the interests of the principal and the agent through contractual arrangements (Eisenhardt, 1989a).

## 1.2 Research Problem and Gap

According to agency theory, the interest tensions between an advertising client (*the principal)* and an advertising agent *(the agent)* toiling under circumstances of uncertainty and risk can be aligned through contractual arrangements. These arrangements range from compensating the agent for advertising outcomes (outcome-based contracts) or advertising activity behaviours (behaviour-based contracts). The focus of agency theory is on identifying the most efficient contractual model for governing the principal-agent relationship. Applying an agency theory perspective to studying search engine advertising agency contracts can be deemed appropriate as it meets several of the critical circumstances described by Eisenhardt (1989a:71):

1) *Substantial goal conflict* exists between the parties providing incentive for opportunistic behaviour. This is clearly present as the advertising client wants maximum advertising results with minimum expenditure yet the agency's short-term utility is maximized by the highest possible agency fee payment accompanied with minimum effort and campaign production costs.
2) *Outcome uncertainty is high* in search engine advertising, which is influenced by, among other things, continuously changing advertising features, competitors and overall auction intensity. These make advertising outcomes subject to a considerable amount of risk and uncertainty.
3) *Verifying the agent's behaviour is difficult* as search engine advertising involves combining a multitude of account optimization procedures that combine both manual and automated techniques. The commissioning client may or may not have access to the advertising platform itself to verify that any advertising activities have been carried out.

Though agency theory has been applied to advertising through numerous conceptual and empirical studies for several decades (see e.g. Spake et al. 1999; Ellis & Johnsson 1993; Bergen, Dutta & Walker, 1992; Abou Nabout et al., 2012), no academic studies currently exist on what contractual models are available and commonly used, specifically for search engine advertising services in the Finnish market nor the international market for that matter. This is of particular interest not only due to the importance of SEA to businesses of all sizes, but also due to the recent emergence of more sophisticated tracking technologies and analytical systems. These could be the answer to numerous scholars' calls for increased measurability, as the key to making compensation models based on advertising outcomes, as opposed to carried out advertising actions, increasingly more efficient (Spake et al. 1999; Ellis & Johnsson 1993; Swain, 2004). Recent research has not kept up with what possible shifts may have happened in the market and little is known of what types of contractual models are currently in use and why. This study therefore attempts to address this specific question and shed light on what kinds of contractual models are currently in use and explain why. This is of particular analytical interest as there have long been calls for advertising agencies to adapt their compensation models for providing clients with increased efficiencies (Swain, 2004). Strong calls have also been made for tying compensation closer to results yet the proliferation of outcome-based compensation models into the market place has, at least based on extant research, been found to have been unexpectedly slow. This has been deemed surprising considering the drastic improvements digital marketing has afforded to measuring marketing effectiveness compared to traditional advertising (Yoon & Kim, 2001). The early studies of Zhao (2005) argued that though performance-based compensation models were showing slow signs of increased use, these were still not well understood by neither clients nor agencies and that they have received insufficient attention from the academic community. It is therefore still largely unclear, what factors, if any, might be impeding the adoption of more outcome-based compensation models considering the particularly measurable nature of search engine advertising. Furthermore, it is unclear how relevant these theories might be since the explanatory power of agency tehory in understanding SEA compensation models has not been adequately explored.

## 1.3 Research Questions and Objectives

The objective of this study is to describe what kinds of compensation models are available for SEA advertising clients in the Finnish market. The study also aims to explain why these models are being used as well as how they are determined for individual clients. In alignment with the goals of earlier scholars applying agency theory to examining advertising agency contractual agreements, the goal of this study is to 'provide advertisers and their agencies with a menu of managerial implications for advertising agency contract negotiation' (Ellis & Johnson, 1993:79). The aim of this study is therefore to provide clients and their agencies with valuable guidelines on the specific contexts in which certain types of compensation models may be preferable to others. Moreover, this thesis sheds light on understanding what factors, if any might still be impeding the wider adoption of advertising agency contracts that focus on outcomes as opposed to actions – a question argued to still be largely unexplained by extant, increasingly dated, research (Zhao, 2005; Davies & Prince, 2010). Moreover, this study notably answers these questions through primary data gathered from the agency side as opposed to the client side. Assuming the agency perspective is done in order to derive both principals and agents fresh insight from a completely new perspective since all extant agency theory studies on advertising compensation models have been conducted with data gathered only from the client side (see Spake et al. 1999; Davies & Prince 2010; Davies & Prince 2011).

***Research Objectives***

- Describe a typology of SEA compensation schemes and the circumstances for when one scheme may be preferable to another.
- Explain how and why certain compensation models are currently being selected for SEA in the Finnish market.
- Investigate whether and why performance-based compensation models are being used for SEA services in the Finnish market.
- Evaluate how well agency theory helps predict compensation model selection for SEA services.

***Research Questions***

1. What compensation models are used for SEA services and why?
2. How are compensation models selected for SEA services?
3. Why (or why not) are performance-based compensation models used for SEA services?
4. How well does agency theory predict compensation model selections for SEA agency-client relationships?

## 1.4 Limitations

This research contributes towards improved understanding of search engine advertising agency compensation model determinants and the contract negotiation processes. Due to the chosen qualitative nature of the study, the thesis does not, nor does it even attempt to assess the relative actual higher or lower efficiencies of a particular contractual scheme. The findings therefore do not answer the question of whether one model might be statistically bringing clients a higher return on investment compared to another model, or whether clients are, on average, more satisfied with one model over another. Moreover, the scope of the study is limited to examining search engine advertising as a particular form of advertising. As such, the findings cannot be generalized to apply to contracts used for other forms of online or offline advertising, though the findings indicate that interlinkages do exist. Finally, the empirical part of this study has been conducted within the context of the Finnish market and as such the generalizability of the findings are limited to this specific market.

## 1.5 Structure of the Thesis

The study begins with a literature on general agency theory. This if followed by a contextual review that describes the research context of search engine advertising, the different types of advertising agencies examined as well as the nature of professional business services. The later section of the literature review relates the theory more specifically to advertising and describes how agency theory as a stream of literature can help us understand advertising agency compensation schemes and the nature of the client relationship. Several extensions and criticisms to agency theory are also examined in order to critically identify the short-comings of the theory as well as demonstrate the complexity of real-life organizational circumstances and decision-making processes. The methodology section of the thesis describes and justifies the methodological choices and analytical tools used for the empirical section of the study. Validity, reliability as well as ethical considerations are also addressed. The findings section contains the empirical findings of the multiple case study, identifying and explaining how model selection decisions are driven by a multitude of factors. The findings section concludes with an advertising agency compensation scheme determination model that summarizes the main findings. The discussion section examines the variables found in the empirical model and evaluates how these align or deviate from what agency theory would predict thus esting the theory's explanatory power. The thesis concludes by providing broad answers to the research questions proposed in the beginning of the study. Key managerial implications are also assessed from the perspective of both advertising clients and agencies. The study concludes with a examnations of its limitations and suggestions for future research directions.

# 2 LITERATURE REVIEW

## 2.1 Agency Theory

The following section describes agency theory constructs on a general level. After a brief contextual review, the middle section of the literature review then delves into discussing how agency theory helps us understand the particular context of advertising agency-client relationships. The last part of the literature review discusses criticisms of agency theory and how the theory can stand to benefit from being complemented by additional theoretical streams.

### 2.1.1 Agency Theory Overview

The original founding scholars of agency theory are usually regarded to be Arrow (1971), Ross (1973) and Spence and Zeckhauser (1971 referred to in Kivistö, 2007) who originally defined the nature of the principal-agent relationship and examined available relationship governance mechanisms. Agency theory involves examining the relationship between at least two parties where one (the principal) assigns a task to another party (the agent) to be performed on its behalf. The nature of the task is such that it involves delegating at least some degree of decision making over to the agent (Ross, 1973; Jensen and Meckling, 1976). Agents are not only used for delegating labour but they are also a means for the principal to be able to access the specialized expertise held by the agent (Zhao, 2005). Maintaining several assumptions, the value of agency theory lies in both predicting what contractual model will be chosen to govern the business relationship as well as helping predict how various models may affect managerial behaviour (Arrow, 1985; Hendry, 2002). Agency theory has long been applied to the study of multiple disciplines such as finance (Fama, 1980), accounting (Lambert, 2001), organizational behaviour (Eisenhardt 1985) as well as marketing and sales (Bergen et al., 1992).

One of the most influential scholars in agency theory has been Eisenhardt who developed empirically testable hypotheses for managerial and organizational literature to address principal agent problems (1985; 1988). Eisenhardt's later works also made significant contributions by developing the agency theory subset variables that help predict how changes in the operational context affect efficient contract determination (1989a). Consequently, this study first discusses some of basic variables and assumptions of agency theory and then later delves deeper into Eisenhardt's subset variables together with the works of scholars who have applied the elements to the particular context of advertising agency client relationships. The below Table 1 summarizes the key agency theory concepts and assumptions, which are elaborated on in the upcoming sections.

Table 1 Agency Theory Overview (adapted from Eisenhardt 1989)

| | |
|---|---|
| **Key idea** | Principal-agent relationship should reflect efficient organization of information and risk bearing costs i.e. minimize agency costs. |
| **Unit of analysis** | Contract between principal and agent. |
| **Human assumptions** | Motivated by self-interest; will engage in opportunistic behaviour<br>Bounded rationality: Parties act rationally but within the limits of time, cognitive ability and information availability.<br>Risk aversion |
| **Organizational assumptions** | Information asymmetry between principal and agent<br>Efficiency as the effectiveness criterion<br>Partial goal conflict between parties |
| **Information assumptions** | Information is incomplete (information assymmetry between parties)<br>Information is a purchasable commodity |
| **Contracting problems** | Moral hazard (agency shirks on its responsibilities)<br>Adverse selection (agency may intentionally or unintentionally misrepresent its cabilities to perform the work)<br>Risk sharing in uncertain environment |
| **Problem domain** | Principal and agent have differing goals and risk preferences |

The focus of agency theory is on identifying the most efficient contract to govern the relationship bewteen the two parties. The most efficient contract is considered to be the one that produces the highest results at the smallest possible overall *agency costs* (Eisenhardt, 1985). Agency costs are the sum of three factors: 1) monitoring costs to the principal from verifying the agent's actions, 2) bonding costs for the agent to ensure the principal is not engaging in actions that could harm the principal, and that it will compensate to the client if such harm does incur, and 3) residual loss i.e. the losses incurred to the principal if the agent's actions are eventually suboptimal for the principal (Jensen & Meckling, 1976). Moreover, agency theory modelling usually assesses what is the most efficient contract from the perspective of the principal, as opposed to the agent, or both parties jointly. This is done because the overall assumption is that the principal is the dominant party in the relationship as it has the option to choose from multiple potential service providers (Eisenhardt, 1989a). This has indeed been taken as the basis of all extant conceptual empirical agency theory applications to advertising agency relationships (see Bergen et al., 1992; Ellis & Johnson, 1993, Zhao, 2005, Davies & Prince, 2010; Abou Nabout et al. 2012).

Agency theory assumes that there is significant environmental uncertainty and that both parties are assumed to be inherently self-serving, and operating under circumstances of *information asymmetry* i.e. a differing level of information and knowledge between the parties. A significant amount of information is tacit and typically held only by the agent

(Davies & Prince, 2010). The nature of information is assumed to be such that it is a commodity, which can be purchased for example at the expense of time (Eisenhardt, 1989a). As such, agency theory is closely related to transaction cost economics, which focuses on examining vertical integration (Beccera & Gupta, 1999) i.e. firm's outsourcing decisions and especially how cost minimization is of pivotal concern. Time expenditure is thus considered to be a form of transaction cost, which either occurs before or after a contract is struck (Arrow, 1969). Pre-contractual costs include the time expenditure going into gathering information, and the cost of negotiating and specifying contractual terms, whereas post contractual transaction costs include contract monitoring, enforcement and amendment in the case of misalignments (Williamson, 1985). Morever, the principal and agent are also assumed to have differing goals and risk preferences (Eisenhardt, 1985), which affects their preferences on what actions are appropriate.

Agency theory typically categorizes the contracting problems faced by the principal depending on whether they are pre-contractual or post-contractual problems i.e. whether they occur before or after a contract is reached. These categories were originally named by Arrow (1985) and are respectively referred to as the *hidden information* and the *hidden action* models (Arrow, 1985). These two models are typically examined in isolation though it is acknowledged that they can be addressed simultaneously (Bergen et al., 1992).

### 2.1.2 The Adverse Selection Problem: The Hidden Information Model

Considering the prevailing circumstances of infromation asymmetry, the hidden information model examines whether or not the agent has the skills and characteristics necessary to complete the tasks required by the principal. Moreover it addresses what measures and expenses the principal is willing to undergo to establish an agent's level of ability. The hidden information problem, more typically known as *adverse selection* in financial and insurance literature, refers to the problem of the agent potentially misrepresenting its intention or ability to act in the principal's interest in the beginning of the relationship before a contract is struck (Bergen et al., 1992; Hendry, 2002). Other agency theory scholars acknowledge that this issue may still continue as the relationship progresses (Eisenhardt, 1989a) indicating that the adverse selection problem may also persist over time. Bergen et al., (1992) provide principals three means for reducing information asymmetry: screening, signaling and providing opportunities for self selection. These are briefly discussed below.

***Screening***, involves the principal gathering information about prospective agents in order to assess their quality. Carrying out screening activities involves the principal assessing the trade-off between the costs associated with carrying out screening activities and the costs associated with the agent not performing to expected standards. Though screening can be expensive it is suggested to be, nevertheless, the best option for reducing the impact of the hidden information problem if the potential impact of a bad selection is potentially severe (Bergen et al., 1992). Examples of screening in the context of advertising agencies could be information gathering through agency websites, interviewing agency executives and gathering references.

***Signalling***, involves an agent engaging in activities that seek to reveal its nature and capabilities to the prospecting principal (Bergen et al., 1992). Signaling could for example take the form of agents aquiring professional qualification and degrees to demonstrate subject matter competence.

***Providing opportunities for self-selection***, involves the principal presenting prospective agents with the option to partake in activities that allow it to signal competence and motivation. A decision on the agent's behalf to not partake or to drop out at an intermediate stage would constitute self-selection (Bergen et al., 1992). An example self selection could be a client requesting multiple agencies to riggorously audit and report the advertising development opportunities they can identify for the client.

### 2.1.3 The Moral Hazard Problem: The Hidden Action Model

The hidden action problem occurs after an agreement has been made. Eisenhardt conceptualizes two post contractual problems faced by the principal, referred to as the agency problem and the risk sharing problem (Eisenhardt, 1989a).

**The *agency problem*** concerns the conflicting goals between the principal and its agent as well as the difficulty and expenses for the principle to verify the agents actions (Eisenhardt, 1989a). The agency problem thus stems from the existence of information asymmetry as well as the assumption that people are inherently motivated by self-interest (ibid). The underlying tension in the agency client relationship is therefore the assumption that the principal's utility is maximized by the highest possible outcomes (e.g. profits), whereas the utility of the agent is positively related with compensation and negatively related with effort. The agent is thus expected to seek maximum compensation at minimum effort (Ross, 1973; Coughlan & Sen, 1989; Hendry, 2002). For any given contract to be accepted by the agent, its reservation utility must be met and it therefore acts as a constraint (Ross, 1973).

**The *risk sharing problem*** involves examining differences between the risk attitudes of the principal and agent. In an environment where outcomes are subject to uncertainty, one party may be inclined to being more risk averse than the other resulting in a disagreement in what actions are preferable (Eisenhardt, 1989a). Simplistic agency theory models assume that the agent is more risk averse than the principal (ibid). Inside a firm for example, an employee tends to prefer job security whereas an entrepreneur is willing to tolerate more risk (Spake et al, 1999). Outside the firm, the degree of the agent's risk aversion depends upon the level of competition and the consequent buyer versus supplier negotiation power differential (Ellis & Johnsson, 1993).

As the agent is typically more knowledgeable about the assigned task than the principal, this creates an opportunity for the agent to behave opportunistically and pursue its own interests at the expense of the principal's (Fama, 1980). The term *moral hazard*, typically substituted by the term *hidden action* in the advertising field (Bergen et al., 1992) is used to refer to the lack of effort from the side of the agent to pursue its principal's goals (Holmström, 1979). For example, this could take the direct form of an agent's manager consciously shirking on his or her responsibilities, or be more subtle in the form of the manager's personal career advancement goals taking time precedence (Hendry, 2002). The hidden action model essentially involves aligning the interests of the principal and the agent with a contractual agreement that reduced the probability of opportunistic behaviour and incentivizes the agent to take actions that maximize the principal's profits as well as its own compensation (Spake et al., 1999; Bergen et al., 1992).

#### 2.1.4 Behaviour-based and Outcome-based Contracts in Agency Theory

Contractual agreements discussed in the hidden action model generally fall into two categories: the *behavioural-based* or the *outcome-based* approaches (Eisenhardt, 1989a; Eisenhardt, 1985; Bergen et al., 1992). In the behaviour-based approach, information asymmetry is reduced between the principal and agent through the use of information systems that monitor the agent's behaviour and reveal its actions to the principal. This verification of the agent's alleged actions makes the agent less likely to behave opportunistically but does not come without monitoring cost (Eisenhardt, 1989a). In the outcome based approach, the interests and goals of the principal and agent are sought to be aligned through incentivizing and motivating the agent to act in the interest of the principal through transferring part of the principal's risks over to the agent (Eisenhardt, 1989a). In this model, the compensation is derived from evaluating actualized performance against predefined goals. Outcomes are not only affected by the actions taken by the agent but are also subject to environmental factors such as competition intensity and technological developments. These create risks and uncertainty that either party, or partially both, must bear (Eisenhardt, 1989a).

Comparing the two contractual approaches against each other involves evaluating the trade-offs between the cost of measuring behaviour with cost of risk transfer and the difficulty of measuring outcomes in environments with different levels of uncertainty and risk (Eisenhardt, 1985; 1988). The cost of risk risk transfer in an advertising context might mean that an agency requires its client to pay a premium fee, if it is required to take-on its client's business risks such as seasonality variations. Eisenhardt argues that the lower the outcome uncertainty, the lower the price of transferring risk to the (presumably more) risk averse agent. This makes the outcome-based contracts more efficient and attractive for the principal under lower risk circumstances i.e. when the premium to be paid for risk transfer is low. Outcome-based contracts are therefore preferable to the principal when the cost of transferring risk from the principal to the agent is less than the cost of monitoring the agent's behaviour. In contrast, behaviour-based contracts are preferable when the cost of transferring risks from the principal to the agent is higher than the cost of monitoring agent behaviour (Eisenhardt, 1989a).

Agency theory further addresses the ease of measuring behaviours and outcomes through the variables of task programmability and outcome-measurability. Task programmability refers to the nature of the task itself as either being static or dynamic (Eisenhardt, 1985) and is defined as the 'degree to which appropriate behaviour by the agent can be specified in advance' (Eisenhardt, 1989a:62). The degree of task programmability affects how difficult and costly it is for the principal to set up information systems to monitor the behaviours of the agent (Eisenhardt, 1985). Dynamic and undefined tasks are considered more difficult to monitor than simple, structured tasks. Outcome measurability, on the other-hand refers to the degree in which outcomes can be easily ascertained once achieved (ibid). Measuring monetary golals or sales volumes is for example deemed easier than measuring a more abstract concept like brand awarenss (Spake et al., 1999). When outcomes are not easily measured this makes outcome-based contracts less attractive and behaviour-based contracts become more attractive as they can be more easily determined (Eisenhardt 1989a).

The following Figure 1 summarizes basic agency theory decision making between behaviour-based and outcome-based compensation models:

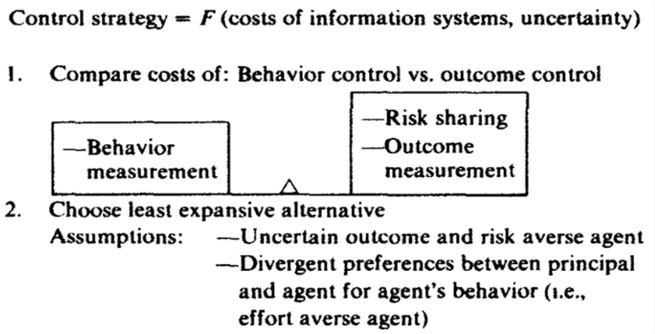



Figure 1: Agency Theory (Eisenhardt, 1985).

## 2.2 Advertising Agency Business Context

This section of the thesis appends the literature review with an overview and insights into the specific context of the study. The section begins with a review of search engine advertising as a rapidly growing form of advertising demonstraiting the significance of the topic. This is followed by a review of advertising agency types as well as the nature of their work to demonstrate how they add value to their clients.

### 2.2.1 Trends in Digital Advertising and Search Engine Advertising

Global Internet users have grown tremendously from only half a billion users in 2000 to over 2.4 billion users by 2012 (Internet World Stats, 2013). Digital advertising is taking a foothold in all areas of advertising and has been largely acknowledged as a viable advertising channel for driving a multitude of purposes: Brand building, direct response, in-store and online sales (Flosi, Fulgoni & Vollman, 2013). Studies of online advertising expenditure in Europe show that online advertising grew by 14,5% in 2011 while the growth of offline advertising remained low at 0,3%. Part of the growth differential has been attributed to the versatility of online advertising formats and the clear measurability offered by paid search advertising, which is growing faster than any other form of online advertising at the annual rate of 17,9% and amounts to 46,5% of total online advertising (Interactive Advertising Bureaux, 2012).

A search engine is essentially a database of indexed web pages and its function is to offer its users a means for finding Web pages on the Internet that are relevant to the search phrase or keyword specified by a user. The unique value of using search engines for marketing products and services is that they allow businesses to unobtrusively identify and reach potential customers precisely when they are looking for the type of product or service their firm has to offer (Mamaghani, 2009; Ghose & Yang, 2009). Search engines have been found to have a highly dominant role in the online world as more than half of traffic to websites has been found to be coming through search engines (Introna & Nissenbaum, 2000). Studies reveal that globally, 25% of internet users have bought a product online and 52% report that they used a search engine to research before purchasing (TNS, IAB & Google, 2013). Search engine marketing has thus been argued to have become the most important form of online marketing (Ghose & Yang, 2009) and arguably the most important online channel for customer acquisition (Smith & Chaffey, 2005). The search engine market is currently highly consolidated: Google appears to be the market leader with approximately 90.59% of global searches (Gandour & Regolini, 2011). Therefore the focus of this thesis is on the search engine advertising offered through this particular search engine.

The umbrella term of search engine marketing (SEM) encompasses both the paid or *inorganic* form of search engine advertising (SEA) and the free or *organic* form of search engine optimization (SEO), which are both activities geared towards attacking relevant traffic to a website (Mamaghani, 2009). SEO refers to activities aimed towards optimizing a website and its content for Google's proprietary software algorithm to perceive the website as highly relevant to a particular set of keywords and bring it to the top of the search results for improved visibility. Though appearance in the search listings for every individual query is free, website content creation does indeed carry significant time and resource implications. SEA refers to paid advertising activity whereby advertisers can pay for their ads to appear in the search listings. The focal point of this study is SEA owing to its afore described inarguable monetary significance. Notably, practitioners often use the term SEM as a synonym for SEA.

A higher position on the search results page compared to the competition is paramount to attracting busy searchers attention. The order in which search listings appear in the free search results listings section, located in the middle of the results page, is based on a Google proprietary software algorithm that seeks to identify the relevancy of each website to a user's particular query bringing the most relevant to the forefront. The order in which listings appear in the paid advertisements section located both at the top, bottom and right-hand side of the search results page, is based on a generalized, second-price auction with sealed bids (Edelman, Ostrovsky & Schwarz, 2007). An advertiser therefore submits a maximum bid through Google's advertising platform AdWords to specify what they are willing to pay for a click for a particular keyword. The relevancy of an advertisement and website to a particular query is also considered through a metric called the *quality score*, which considers among various things landing page relevance to the keyword and click-through-rate (CTR) i.e. how often an ad that has previously been showing for a keyword has been clicked on (Google, n.d.d). The realized cost per click, as well as the order in which advertisements are ranked on the search results page is based on the total resulting weighted figure of the quality score and the bids such that the highest weighted figure appears at the top (Google, n.d.a). This is also referred to as pay-per-click (PPC) or cost-per-click, (CPC) advertising, which means that an advertising expense is only accrued when a user reacts to an advertisement by clicking on it, thus making it a highly efficient and unobtrusive form of advertising (Ghose & Yang, 2009). Individual bids can vary from as low as a couple cents to beyond $10 per click depending on the auction intensity of a particular industry (Mamaghani, 2009; Schwarz, 2007).

AdWords advertising accounts can get incredibly complex with hundreds or even thousands of keyword and ad combinations with individual bids to be optimized to provide the best possible return on investment, advertisers are suggested to rarely manage their own AdWords accounts and prefer to hire dedicated agencies to devise and run campaigns on their behalf (Abou Nabout et al., 2012). The availability of tracking technologies for digital marketing and especially PPC advertising meansthat those who engage in it are argued to be put under significant pressure to produce results: 'Be aware that the very nature of e-marketing is that you may be expected to demonstrate a clear relationship between investment and return' (Smith & Chaffey, 2005:476). Lastly, it should be noted that though the focal point of this study is paid keyword search advertising (SEA) tha AdWords platform also supports broader advertising solutions through other ad formats such as video and text and image ads on YouTube and websites that partner with Google (Google, n.d.b).

### 2.2.2 Agency Organization and Functions

An advertising agency is a firm that is dedicated to providing planning, creating and management services related to advertising and promoting its clients products or services (WoonBong, Marshall & Woodside, 2009). Typical functions performed by an advertising agency include copywriting (i.e. creating content), design and final advertisement production. Advertising agencies may also conduct broader marketing services such as research and media planning as well as buying (WoonBong, Marshall & Woodside, 2009). Table 2 below summarizes the types of agencies that provide search engine advertising services and which are included in this study.

Table 2 Agency Types

| Agency Type | Activities scope | Historical trend | Organization |
|---|---|---|---|
| **Full-service agencies / Media agencies** | Strategic market planning & research, media mix selection and placement, direct market promotion, interactive marketing, advertisement planning & production (search engine marketing). *Note: The core difference between a media agency and a full-service agency is typically suggested to be that full-service agencies also provide creative and copywriting such as artwork and design. | Full-service agencies were the norm until 1980's when media agencies (also referred to as media shops) entered the scene to specialize and achieve higher economies of scale in buying various new media at bulk discounts. Set the motion for the unbundling of advertising tasks between agencies. Typical clientele include large customers who seek a wide range of services such as account planning services. | Organized in various departments such as account services, media and (creative*). May have a digital department, which can operate as integrated with the rest of the agency or as a stand-alone entity. |
| **Digital agencies** (a.k.a. Interactive agencies or new media agencies) | Online media services e.g. web design & development, creative design, search engine marketing, email marketing, affiliate marketing, display advertising, social media management. | Emerged as a new type of agency when traditional media and full-service agencies were slow to embrace the opportunities of the Internet. Rapid growth before downsizing after the dot-com bubble burst - now back on a steady but slower growth track. | Paid search advertising, organic search engine optimization, display advertising and creative copy writing functions may often be completed by separate teams. |
| **Search engine agencies** (a.k.a. SEM agencies) | Search engine marketing: search engine optimization (SEO), search engine advertising (SEA) and accompanying web analytics. Creation of text and image ads, website content creation, media purchases of pay-per-click advertising and display advertising. | Recently emerged as an agency type specialized in ROI focused lead generation and ecommerce. As SEM agencies grow, their scope may vary to take on activities that are more often associated with digital agencies e.g. email marketing. | SEO and SEA are typically maintained in separate teams. |

Table adapted based on Davies & Prince, 2011; Horsky, 2009; Mediacom (N.d.); Wray, R. (2010), KWD Digital (n.d.); Wikipedia, N.d.

Because there are various types of advertising agencies performing a varying breadth of functions, the blank term 'agency' will be used henceforth to refer to any given type of agency that offers search engine advertising services. It should also be noted that due to the relatively young age of search engine advertising as a form of advertising, what literature typically refers to as an advertising agency is the full-service or media agency type discussed below. With the continually rising demand for digital advertising, industry specialists predict that the number of agencies providing digital marketing services will double in the upcoming years, and stretch across agencies of all sizes, ranging from one person consultancies to large digital and media agencies (Eleveld, 2012).

### 2.2.3 Relationship Marketing in the Professional Services Businesses

This section discusses the notion of relationship marketing as a context for advertising agency professional services. Relationship marketing literature is drawn upon as it has been suggested useful for illustrating the nature of the advertising agency-client relationship (Halinen, 1997) and to describe how the parties may have varying levels of reletionship expectations and where these expectations stem from.

Relationship marketing is defined as the following:

> Marketing from a relational perspective has been defined as the process of identifying and establishing, maintaining, and when necessary terminating relationships with customers and other stakeholders, at a profit, so that the objectives of all parties involved are met, where this is done by mutual giving and fulfillment of promises (Grönroos, 1997:407).

The relationship marketing approach argues that both firms and clients can be in two types of modes. The two modes are the *relational* or *transactional* modes, which indicate whether a firm or its customers have chosen whether they need, wish or expect to activate the latent relationship between the parties. Whether or not a firm chooses to activate the latent relationship depends on whether the firm finds it profitable to adopt a relational or a transactional business strategy (Grönroos, 1997). If a firm chooses to adopt a relational strategy, it is argued to be important for its clients to be in a relational mode as well.

Marketing in a relationship context is described to be the process whereby perceived value is created for the customers over longer periods of time (Gronroos, 1997). A following key concept to relationship marketing is that it is not deemed sufficient for a firm to only offer a core product or service to its customers but that additional activities and resources are needed to satisfy clients' long-term value needs (ibid). Gronroos (1997) had developed the following equation on customer perceived value, which describes how additional value adding services (e.g. prompt, or severely delayed customer service) can either add or detract from a customer's total perceived value: Customer Perceived Value = Core Value +/- Added Value. Moreover, the existence of a long-term relationship offers the client additional value in terms of a sense of trust, reduced purchasing risks and a feeling of control (Grönroos, 2004). Value is described to be created in an interactive process whereby value is partly co-created by the firm and its customers and is inherent in the service production process itself, not just the final output (Gröroos, 2004).

Relationship marketing theories reveal the higher or lower importance of the service delivery process itself in advertising agency work dependant on weather an agency is pursuing a transactional or a relational mode strategy. It also explicates that the value that clients expect may or may require the agency to deliver additional value and services beyond the mere successful conduction of a SEA advertising campaign itself. Agency theory, rooted in economic theory, shows that advertising clients prefer and expect to compensate agencies for core value,  measurable outcomes. Including a relationship marketing perspective reveals that clients' perception of total results (i.e. perceived value) is also influenced and embedded in the service delivery process itself as added value. Relationship marketing theory therefore suggests that both suppliers and buyers of a service (i.e. the advertising client and agency) may or may not perceive there to be significant value and financial gain in forming a strong and personal business relationship.

### 2.3 Agency Theory in Advertising

This section of the thesis discusses agency theory specificly related to advertising and, where possible, directly to the defined context of search engine advertising.

Agency theory has been applied to the field of marketing and advertising for well over two decades exploring areas such as sales force compensation, channel coordination and control, consumer promotions (Bergen et al., 1992) as well as more recently to search engine advertising (Abou Nabout et a., 2012). The principal-agent relationship stems from the advertising client's need to collaborate with an agency in order to have an advertising activity, performed on its behalf (Spake et al., 1999). The details of the marketing activity are typically unclear to the client, but the client is aware that a significant degree of effort is needed to formulate and deliver a message through appropriately selected media (Spake et al., 1999). The client is also suggested to be aware of the fact that the level of effort applied may not be perfectly related to the actual outcome attained (ibid). A key consideration related to advertising agency theory examination is that a part of the decision making delegated to the agency involves advising or making choices on selected advertising media as well as the advertising budget (Spake et al., 1999). This is of pivotal concern as a higher available budget increases the agency's motivation to exert more effort on the client's account under all compensation schemes except for fees (discussed in more detail in the following section) since a higher media budget also increases the agency's remuneration (Zhao, 2005).

Advertising contracts are argued to be plagued by both the moral hazard and adverse selection problems of agency theory (Bergen et al., 1992). The issue of moral hazard is argued to be clearly present in the advertising industry where a client may not be fully able to monitor its agency's actions during campaign production while the agency may not be putting in the promised amount of effort (Ellis & Johnson, 1993; Bergen et al., 1992). Also, the adverse selection problem is equally maintained to be present as the agency may misrepresent its abilities to carry out an advertising campaign (ibid). In advertising terms, the existence of moral hazard and adverse selection make outcome-based contracts lucrative for the advertising client, whereas the presence of a risky competitive advertising environment makes the behaviour-based compensation models a safer and more appealing compensation method to the agency. Under competitive market circumstances, the agency will accept an outcome-based contract offered by the client when the fear of losing or not gaining a client outweighs the risk of accepting an outcome-based contract (Davies & Prince, 2010). Agencies are also suggested to be able to accept outcome-based contracts even when the premium paid for risk transfer is disproportionate to the risk because agencies are able to diversify their client portfolios (Davies & Prince, 2010).

### 2.3.1 Advertising Agency Compensation Scheme Types

Advertising agency compensations models have been suggested to have traditionally fallen into one of three categories: *commission-based, fee-based,* and *performance based* (Cantalone & Drury, 1979; Ellis & Johnson, 1993). It is suggested that there are advantages and disadvantages to each model, as well as their variants, and it is argued that 'there is no singular compensation approach that fits every individual advertiser–agency relationship - any model can work effectively when the parties interests and priorities are aligned' (ANA & AAAA, 2006:n.pag.). Employing a number of contractual models simultaneously as hybrid models has also been found to be increasingly common; case studies found a large agency using 38 different compensation models across its portfolio of clients even before the suggested increasing trend towards performance-based models began (Beals & Beals, 2001:4). In spite of the more recent increased interest towards search engine advertising service compensation schemes, it is suggested that no optimal model has yet been found for the particular context of search engine advertising (Abou Nabout et al., 2012).

The following Table 3 summarizes the compensation model types typically used in general advertising agency-client relationships and summarizes how they deal with different elements of agency theory. The pros and cons of the models are denoted from the perspective of the principal advertising client.

Table 3 Agency Compensation Models in Advertising

| Model Arch Types | Model Description | Pros | Cons |
|---|---|---|---|
| **Commission** (a.k.a. billing-based model) | Traditional model where commission is based on a defined percentage of media spend paid on top of advertising expenses. Commission traditionally at 15%, but found declining (Cantalone & Drury, 1979). | Incentive for agency to grow the client to grow their own fee (Spake et al., 1999). | Encourages media budget overspend as opposed to efficient media allocation. Agency discounts in certain media usage disincentives agency making media neutral investment proposals (Lace, 2000).<br><br>All risk held by advertising client (Spake et al., 1999). |
| **Fees** (a.k.a. cost-based method) | Agency compensated based on hourly fee for services provided. Fee contains labour costs and a mark-up for agency profit. Fee can be either fixed or variable based on realized working hours delivered (Cantalone & Drury, 1979). | Agency incentivized to give media neutral advice - no budget overspending incentive (Lace 2000). | Agency incentivized to inflate the number of required or realized working hours (Spake et al, 1999).<br><br>Little incentive or reward - no link between value created and remuneration (Lace, 2000). |
| **Performance-based** (a.k.a. incentive-based method) | Compensation based on achievement against mutually agreed on results e.g. sales, increased market share, brand awareness (Ellis & Johnson, 1993). Multiple variations exist such as *performance incentives*, which has fixed or variable fees accompanied by an additional component that adjusts up or down based on performance, and *value-based*, where all compensation is based on achieved results (Crain, 2010). | Goals alignment is achieved through transferring risks. (Abou Nabout et al, 2012; Weinberg, 1975). | Risk of agency focusing on short-term profitability goals to meet KPIs and ignore long-term brand building efforts (Abou Nabout et .al, 2012; Seggev 1992).<br><br>Risk transfer can be expensive and as the model requires agency reservation utility to be met (Weinberg, 1975). |

The below Figure 2 summarizes the different contractual models based on how they have been typically categorized along the agency theory behaviour vs. outcome continuum. Most notably, in terms of agency theory categorization, the commission scheme has been regarded to have both behaviour-based and outcome-based properties. This is argued to be the case because the scheme is based on the act of placing advertisements in various media and though it is not immediately linked to outcomes, it is outcomes that will eventually determine whether a higher investment is made in the future and whether the client relationship continues (Spake et al., 1999).

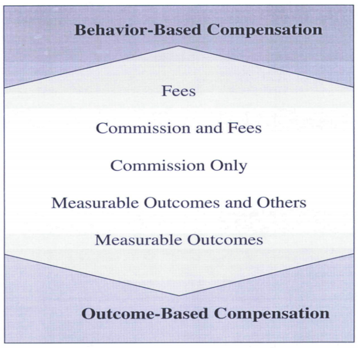



Figure 2: Agency Compensation Models: Behaviour vs. Outcome (Spake et al., 1999)

For the particular context of search engine advertising, the few existing academic studies suggest that there are largely two types of performance-based compensation methods. The first one is called *CPA, cost-per-acquisition*, where the agency covers the media budget and then receives a fee per each conversion (i.e. a lead or sale) achieved. The challenge with the model is suggested to be that there emerges a risk for the generally more risk averse agency to in fact underspend on media (bidding too low on search keywords) as its own up-side profit potential is capped. Thus the scheme runs the risk of overall limiting the profit potential of the principal. The second is called the *incentive rate based plan (IRB)* which functions based on shared profits (Abou Nabout et al., 2012). Notably the fee per conversion model has been found to be used in practice in search engine advertising whereas the IRB model for search engine advertising based on the ideas of shared profits is a purely theoretical model (Abou Nabout et al, 2012). In this plan the agency receives an incentive rate, which is a percentage of the clients profits achieved through the advertising activity after advertising expenses have been covered. The client advertiser will seek to minimize the incentive rate to be as small as possible yet it must be set at a level with which the agency can receive a minimum expected profit i.e. satisfies the agent’s minimum utility requirement. Once this condition is fulfilled, both parties’ interests will be aligned and the agency’s bidding behaviour will then seek to maximize joint profits (Abou Nabout et al, 2012).

### 2.3.2 Changes to Advertising Agency Compensation Schemes

Advertising agency compensation models have been found to have experienced significant changes over the years. Change pressures have resulted from multiple forces including the Total Quality Management efficiency revolution of the 1980's that placed expectations for the marketing and sales functions to serve as a source of increased efficiencies for firms. Moreover, stable or declining market prices have created a competitive environment where the drive for profit growth has required increased sales volumes and the need to produce higher results at lower costs (Spake et al., 1999). The long-standing agency compensation norm of commissions based on media expenditures began to be questioned with increased pressures for models that aided firms in cost cutting, and provided higher equitability and accountability (Lace, 2000). The main criticism of commissions is that though it encourages an agency to grow client sales (which in turn grow its own fee), there is also an inherent incentive for the agency to favour media budget overspending as opposed to focusing on allocating the media budget efficiently (Spake et al., 1999). The demise of the commission model was furthered by the trend that media agencies began providing value added services separate from media expenditures (Lace, 2000).

Several empirical studies found that the advertising agency-client relationship has been increasingly plagued with client dissatisfaction over traditional compensation models, placing too much focus on activities as opposed to results (Levin, 1990 referred to in Spake et al., 1999). Calls were made for agencies to 'work harder to customize their compensation structures' (Selinger, 1995:3) as well as tie compensation to actual results (Swain, 2004). Performance-based compensation has even been suggested to pose a means for agency competitive advantage in an increasingly competitive environment:

> A focus on significant and measurable results (e.g., sales, improvement in brand preference, qualified lead generation, etc.) and a compensation proposal structured on a "you pay for results" basis will get more serious attention from most clients' (Crain, 2010:27).

Performance-based models do not go without criticism as there have long been concerns that these could result in both clients and their agencies focusing on easily measurable, short terms results at the expense of long-term brand building efforts (Seggev, 1992). Emphasis is therefore placed on selecting metrics that have both long-term and short term beneficial effects (ibid).

The pressures in moving towards more performance-based compensation models have been varyingly received at the agency side: Some have been suggested to view it as an opportunity to signal accountability and value whereas others feared reduced compensation if stated goals could not be met (Gleason, 1996). Early studies in the US by the American Association of Advertisers reveal that the changes in compensation schemes indeed posed both an opportunity as well as a threat: Some agencies reported experiencing better profit margins after the once standard 15% commission scheme was no longer the norm, whereas some 45% of agencies merely reported reduced rate commissions (Spake at al., 1999). More recent studies suggest that progress has been achieved to some degree as the Association of National Advertisers research on US advertisers, that jointly controlled a budget of $250 billion USD, found that 61% of agencies had already at least some performance based compensation element in their advertising agency compensation schemes showing a remarkable jump from only 46% in 2012 and 35% in 2000 (Parekh & Bruell, 2013:1). No comprehensive studies have been found on the characteristics or prevalence of various compensation models specifically for search engine advertising in the Finnish market or internationally. Thus it is still unclear what models are currenlty in use and why certain models might be considered most appropriate considering the current level of measurement technology.

### 2.3.3 Determinants of Advertising Agency Compensation Schemes

This section discusses how the postcontractual agency theory subset variables and theoretical propositions developed by Eisenhardt (1989a) help determine the most efficient contract under varying contextual circumstances. The propositions concern the variables of monitoring costs, outcome measurability, goal conflict, environmental uncertainty, risk aversion, length of relastionship, and task programmability. The section also draws upon the conceptual and empirical studies of the scholars that have built on the works of Eisenhardt (1985; 1989a) and adapted these propositions particularly for the context of advertising principal-agent relationships. Specific considerations to SEA as a form of advertising are also addressed. The below Table 4 summarizes all the propositions and how the higher or lower presence of a particular variable is expected to affect the compensation model decision to sawy from making either behaviour-based or outcome-based contracts relatively more efficient.

Table 4 Summary of Conditions & Variables Affecting Relative Advertising Agency Contract Efficiency and Attractiveness

| Behavior-based | | Outcome-based | Proposition | Rationale |
|---|---|---|---|---|
| Low | Monitoring Costs | High | A lower/higher degree of monitoring costs makes behaviour-based/outcome-based contracts more efficient. | The lower the costs of monitoring the agent, the more relatively efficient it becomes to monitor instead of transfer risks to the agent. |
| High | Environmental Uncertainty | Low | A higher/lower degree of environmental uncertainty makes behaviour-based/outcome-based contracts more efficient. | The costs of shifting risk to the agency increases when environmental uncertainty increases overall risk making outcome-based contracts less efficient. |
| Low | Outcome Measurability | High | A lower/higher degree of outcome measurability makes behaviour-based/outcome-based contracts more efficient. | The efficiency of outcomes vs. behavior-based methods depends on how easily outcomes can be ascertained due to e.g. having various quantitative & qualitative campaign goals. Measuring outcomes requires establishing accurate metrics. |
| Low | Effect on Outcomes* | High | A lower/higher degree of effect on outcomes makes behaviour-based/outcome-based contracts more efficient. | The easier it is to link agency effort to market results, the more efficient outcome based contracts become. |
| Low | Goal conflict | High | A lower/higher degree of goal conflict makes behaviour-based/outcome-based contracts more efficient. | A lower goal conflict reduces the need and costs of monitoring agency behavior making behavior-based contracts more efficient. |
| High | Agency Risk Aversion | Low | A higher/lower degree of agency risk aversion makes behaviour-based/outcome-based contracts more efficient. | The cost of transferring risk over to the agency increases/decreases as the agent becomes more/less risk averse and requires a higher/lower premium. |
| Low | Client Risk Aversion | High | A lower/higher degree of client risk aversion makes behaviour-based/outcome-based contracts more efficient. | A more risk averse client will want to shift financial risks over to the agency to the extent that it has negotiation power. |
| Long | Relationship Length*** | Short | A long/short duration of the client relationship makes behaviour-based/outcome-based contracts more efficient. | Lower *goal conflict* reduces as the parties engage and *monitoring costs* reduces as information asymmetry reduces between parties. |
| Short | | Long | A short/long duration of the client relationship makes behaviour-based/outcome-based contracts more efficient. | *Uncertainty* reduces over time when the agency produces results (cheaper to transfer risks) & experiential knowledge makes it easier to measure agency *effect on outcomes*. |
| High | Task Programmability** | Low | A higher/lower degree of task programmability makes behaviour-based/outcome-based contracts more efficient. | Cheaper to set up monitoring for a task that can be predefined. The less the principal is able to determine appropriate behavior in advance, the more attractive it becomes to use an outcome based model where activities are not defined. |

Table created based on Ellis & Johnson* (1993), Eisenhardt** (1985; 1989a), Spake et al.*** (1999).

***Monitoring costs*** referes to the costs associated with verifying agent behaviours (Eisenhardt, 1989). The more costly it is to verify behaviours, the less efficient behaviour-based contracts become (ibid). Examining monitoring costs is particularly interesting in the context of SEA advertising as all core AdWords advertising activities carried out (e.g. adding or subtracking keywords, creating ads and adjusting bids) will be recorded in account change history visible to anyone with appropriate access to the account (Google, n.d.c). This feature offers a new kind of window to monitoring agent behaviour not previously afforded by traditional media.

***Environmental uncertainty*** refers to the degree of risk imposed by the operational environment (Eisenhardt, 1989). The higher the environmental uncertainty, the more expensive it becomes for the principal when the agency demands a higher reward for bearing a higher amount of risk (ibid). For advertising, environmental uncertainty could for example result from client seasonality, and rapidly changing AdWords auction intensity and that neither the principal nor agent can directly affect (Abou Nabout et al., 2012).

***Outcome measurability*** refers to the degree in which outcomes can be easily ascertained once achieved (Eisenhardt, 1985). The variable of outcome measurability is examined through two linked propositions in advertising. The first proposition developed by Ellis and Johnson (1993) argues that outcome-based contracts efficiently increase with the *ease of determining the outcomes*. The second linked proposition similarly argues that outcome-based contracts become more efficient when the ease of measuring the agency's *effect on achieving the outcomes increases* (ibid). The second proposition therefore augments the first one by not only addressing measurability but by also stating that an agency's level of effort should have a clear connection with the realized results (Ellis & Johnson, 1993). Measuring campaign outcomes is argued to be a difficult task in itself when single campaigns may have multiple objectives (ibid) such as an SEA campaign possibly serving both performance and branding goals. It is maintained that clients that wish to use outcome based compensation schemes under circumstances where outcomes are not easily quantified will need to develop more specific and quantifiable metrics to employ such compensation methods effectively (Ellis & Johnson, 1993).

Spake et al. (1999) tested Ellis & Johnson's (1993) second proposition on a sample of 349 advertising clients in the US and found partial support for the two propositions on outcom measurability but only under certain conditions. The propositions were supported by the findings that outcome-based compensation models were more often associated with business-to-consumer clients as opposed to business-to-business relationships where determining outcomes were more difficult. However, the authors' finding that the type of outcome-based compensation model that more frequently occurred with the examined clients was a combination of fees and commissions, as opposed to a fully outcome-based compensation model, suggested that imprecision in advertising measurement was an issue that hampered the adoption of purely outcome-based compensation models (Spake et al., 1999). Moreover, the quantitative study enabled the scholars to not only identify ease of measuring advertising and effect on advertising but also the perceived importance of advertising to the client. The authors analysed the correlation of perceived advertising importance and the used compensation model and concluded the following on the importance of advertising to the client relative to the ease of measuring outcomes:

> [B]ecause measuring advertising effect is neither cheap nor trivial, ease of measurement alone will not prompt clients and agencies to move toward outcome-based compensation. Advertisement must also be an important part of the marketing mix (Spaket et al, 1999:68).

In SEA advertising terms,  the findings could indicate that the type of advertising client (B2B or B2C), the availability and cost of applying cheap tracking technologies (e.g. Google Analytics) as well as the client's perceived importance of SEA advertising, could also have significant implications on the compensation model selected.

***Goal conflict*** refers to the degree of interest deviation between the agent and principal (Eisenhardt, 1989a). The third proposition by Ellis and Johnson (1993) on advertising agency compensation models argues that the higher the degree of goal conflict between the advertising agency and client, the more suitable performance-based compensation schemes become. This is argued to result from the fact that a lower level of goal alignment makes it necessary for the client to transfer risks over to the agency whereas a high level of goal alignment reduces monitoring costs (Ellis & Johnson, 1993). Spake et al. (1999) ad to this by specifying that this results from the existence of trust between the parties. Morgan & Hunt (1994) suggest that congruous values between contractual parties results in higher levels commitment and trust. This is however do not supported by Spake et al. (1999)  who found no statistical support for this propofition. This is however aknowlegded to potentially result from the way the study was constructed whereby it examined the differences between the agency and client's philosophical similarities, values and treatment of customers as opposed to goal conflict pertaining to a particular campaign (ibid). As such, this shortcoming leaves significant room for evaluating the level of goal conflict between the client and agency's expectations for the planning, execution and measurement of a particular SEA advertising campaign, especially if the advertising goal of the campaign is easily quantifiable, such as sales through a webshop, as opposed to a more complex advertising goal such as brand awareness.

***Risk aversion*** involves loosening the static assumption of the more risk averse agent. If the agent becomes less risk averse, outcome-based contracts become preferable as the cost of transferring risk decreases. This makes it increasingly attractive for the principal to pass risk onto the agent. If however the agent becomes more risk averse, the cost of the principal transferring that risk to the agent increases, making behaviour-based contracts more attractive (Eisenhardt, 1989a). Accordingly, Ellis and Johnson (1993) propose that the use of performance based compensation should increase with the level of client risk aversion. This is contended to be the case as risk averse clients will want to transfer as much of the uncertainty to the advertising agency as possible. The limit to this is suggested to be the negotiating power of the client as well as the agency's perceived level of risk, that one of their competitors would be willing to make the client a similar or better offer (ibid). The theory of the generally more risk averse agent in ad agency-client relationships is suggested to be the prevailing view of most authors (Zhao, 2005). Zhao (2005) accepts this same assumption and argues that it is supported by agencies resistance to transitioning towards performance-based compensation as well as ad agencies' profits, revenues and market capitalization usually always being less than their clients', making them more vulnerable in relative terms.

The client-side empirical studies of Spake et al. (1999) are limited to only examining the degrees of risk aversion experienced by the principal advertiser, leaving the agency side unaddressed. The studies partially support the proposition that a higher degree of client risk aversion makes outcome-based contracts more probable as it was found that advertisers who more often participated in the advertising activities (clients that have the need to monitor their agencies more closely is taken as a proxy for higher risk aversion) were more likely to use the more outcome-based compensation model of commissions and fees. As such, a significant limitation to this model seems to be that a client's higher participation in an agency work could also indicate the existence of a more strategic partnership, an issue that is later addressed and corroborated to be the case by the authors Davies & Prince (2011). Overall, there seems to be room for more empirical studies to find increased definition and assess the meaning of the nature of the degrees of both client and agency risk aversion.

***Length of relationship*** examines the effect of the duration of the agency-principal relationship (Eisenhardt, 1989a). Agency theory predicts that as the relationship progresses, information asymmetry is reduced between parties as they engage (Lambert, 1983). Ellis & Johnson (1993) propose that the longer the relationship between the agency and the client, the less likely it is for an outcome-based compensation model to be used. This is argued to be the case as the client's increased amount of history will reduce information asymmetries and possibly reduce the client's need for risk transfer due to adverse selection i.e. the fear that the agency is not able to perform as it initially claimed (ibid). Davies & Prince (2010) elaborate that outcome-based contracts are also more favourable in the beginning of a relationship when monitoring systems have not yet been set up and the client's understanding of agency processes are at a lower level. Spake et al. (1999) elaborate on the matter hypothesising that over time, overall uncertainty will decrease as the degree of diversion between the agent's and principal's degree of goal conflict, ease of measuring agency effect on outcomes and monitoring costs will decrease. Specifically a reduction in monitoring costs and degree of goal conflict favour behaviour-based contracts in longstanding advertising agency-client relationships. It is also aknowledged that the opposite could be true, as well, since a decrease in monitoring costs and the difficulty of measuring agent effects on outcomes favours the use of outcome-based compensation models. Spake et al. (1999) thus contend that as an advertising relationship progresses, the contract will either sway towards having more outcome or more behaviour-based properties. The further studies of Davies & Prince (2010) tentatively support this notion as behaviour-based compensation models were more frequently found in transitional as opposed to initial or mature relationships (Davies & Prince, 2010). Spake et al. (1999) advise that a prudent model for an initial advertising agency client relationship is to start with a contract that contains both outcome-based and behaviour-based characteristics and adjust the contract as the relationship progresses. In summary, evidence is mixed and it is still unclear how agency contracts might change over time and whether and what impediments to change might exist.

***Task programmability*** refers to the nature of the task as having varying degrees of measurability (Eisenhardt, 1989a). The more difficult it is for the principal to determine appropriate agent behaviour in advance, the more attractive it is to employ an outcome-based contract. A predefined task is also less costly to monitor as it is easier to set up appropriate monitoring systems (Eisenhardt, 1985). Task programmability as a variable has not been explicitly examined by previous advertising related agency theory studies yet it has been aknowledged to be an important consideration. Advertising agencies have traditionally been hired for their creative capacities (Lace, 2000) and the nature of their work is such that 'the multiple tasks performed by an ad agency act in a complex way jointly to produce advertising outcome' (Zhao, 2005:257). The work done therefore has synergistic effects and the outcomes of an agency's advertising efforts cannot necessarily be measured only as the sum of individual activities (ibid). Advertising agencies have also been argued to shy away from traditional service fee pricing models, such as those used for doctors and lawyers, because the outcome of the advertising produces results are on a sliding scale (e.g. sales profits, brand recognition) and is thus more complex and not as straightforward as aiming to win a court case or ensure the best possible quality of life (Seggev, 1992). Finally, task programmability is included in this study due to the fact that the nature of SEA might be considered relatively more static than traditional advertising as SEA happens through the one defined AdWords platform with only a limited range of features.

#### 2.3.4 Summary of Issues Unaddressed by Agency Theory

Several issues still remain inaccurately explained by agency theory related to advertising, and more specifically search engine advertising: Risk aversion from the perspective of the agency has not yet been addressed, and there is considerable ambiguity concerning the impact of goal conflict and relationship length on compensation model selection. Furthermore, the nature of SEA as a form of advertising might differ significantly from other forms of advertising leading to a higher level of task programmability and thus different models now being more viable.

Measurability is a key agency theory issue still left with ambiguous empirical support. A core question that still remains largely unaddressed is the reasons behind why performance based compensation models still seem to have not gained as much traction as their merits would suggest (Davies & Prince, 2010). An explanation offered by Spake et al. (1999) as to why advertising contracts at later relationship stages may still pertain more behaviour-based as opposed to outcome based properties, is that the costs of monitoring behaviour are still less than the costs of setting up and maintaining systems to measure agency effects on outcomes. Moreover, it is believed that clients are reluctant to disclose the necessary level of details required for effectively setting up such measurement systems (Gleason, 1995) such as profitability data that an agency could opportunistically use also for the benefit of the client's competitors (Davies & Prince, 2011). Therefore, in the light of more advanced and cost efficient tracking systems such as Google Analytics, it seems reasonable to further investigate what real-world factors, such as client or agency skill level, deficient harmonization of multiple information systems or type and level of competition in a specific client's industry, might be affecting the adoption of outcome-based compensation models. Moreover, two-part contracts such as the performance incentives have been suggested on multiple occasions, to have received little attention from academic literature for advertising in general  (Spake et al. 1999), as well as over a decade later for search engine advertising in particular (Abou Nabout et al. 2014).

Previous research on advertising agency compensation models determination recognizes that other social factors not fully grasped by the economics-focused agency theory may also be affecting compensation models decision (Spake et al, 1999, Bergan et al, 1992, Davies & Prince 2010). Since agency theory is based on economics principals it has been criticized for having limitations in social contexts where other increasingly complex factors may be at play (Eisenhardt, 1989: Cuevas-Rodrigues et al. 2012; Fehr & Falk, 2002).  Further studies have been called for to investigate the meaning of softer factors such as easy budget forecasting as a significant factor in compensation model decisions (Abou Nabout et al., 2012). The following section delves further into critical agency theory limitations, such as the theory's inability to explain the significance of the relatinship itself and the meaning of trust in agency-client relationships. Including theoretical lenses that go beyond economic theory is necessary as relationship marketing literature as a context for advertising agency work reveals that core advertising outcomes may not be sufficient when total client total value is strongly influenced by perceived value (Grönroos, 1997). As such, the following section brings additional theoretical lenses that challenge some of the core agency theory assumptions, such as self-interest seeking and opportunistic behaviour, and offers further explanations for explaining advertising agency-client relationships and their governance mechanisms.

## 2.4 Agency Theory Criticism and Complimentary Theories

Agency theory maintains several assumptions on the role of the relationship and contract as well as the nature of the parties involved. The assumptions of opportunistic behaviour, goal conflict, economic utility, efficient contracts and consistent risk preferences may not always hold in the SEA context where an agency might excert significant extra effort to build a strong and lasting client relationship. The assumptions of agency theory are suggested to be shaken by findings that people as social beings are motivated by a multitude of factors such as emotional utility for carrying out the principal's wishes, desire to work on interesting tasks, and a desire to reciprocate gestures of good will (Fehr & Falk, 2002). Neglecting these factors and focusing solely on incentive and control mechanisms through contractual agreements has been argued to ignore the fact that alternative means could be used for reducing agency costs (Cuevas-Rodrigues et al. 2012).

Several authors argue that agency theory has not run its course but that it is recommended that it be combined with other theories so that these will, together, yield more realistic views of the actual complexity of organizations, and contractual arrangements across organizations (Eisenhardt, 1989; Becerra & Gupta, 1999; Cuevas-Rodrigues et al. 2012). This view has also been reflected in agency theory research related to advertising agency compensation: Though previous scholars have found agency theory useful for understanding the advertising agency contractual relationship, agency theory alone has been argued not to be able to fully grasp the nature of the relationship (Spake at al, 1989; Davies and Prince, 2010). As a result, several extensions to agency theory have gradually emerged. The most relevant ones including trust literature, stakeholder theory, institutional theory, prospect theory and switching costs are discussed in the following sections.

### 2.4.1 Trust Literature Perspective

Agency theory assumes that the relationship between the principal and agent is only a source of costs that need to be mitigated through contractual arrangements. Trust literature takes a different stance on reducing relationship governance costs. Though it is acknowledged that reducing relationship governance costs is essential, it is maintained that a prime objective is to create an adequate environment for 'constructive relationships' (Cuevas-Rodrigues et al., 2012:532). The emergence of trust in relationships is suggested to reduce information asymmetry between the parties because communication can be more open and honest (Zaheer, McEvily & Perrone, 1998). Trust in relationships is also suggested to not only reduce the principal's need to monitor the agents actions (Beccera & Gupta, 1999) but also provides additioanal value through quicker coordination, decision making and implementation (Cuevas-Rodrigues et al., 2012; Neu, Gonzalez & Pass, 2011). This means that the relationship can be a source of perceived value (Grönroos, 1997). Relationship marketing literature further discusses the importance and ability to capture these benefits of trust through the emergence of a so called *Trusted Advisor* role in interfirm service sales relationships (Neu, Gonzalez & Pass, 2011). The trusted advisor is described to be a desirable and rare role whereby a sales person develops and in-depth understanding of a client's business and then provides impartial solution planning and implementation work for the client. The work is carried out in a highly collaborative manner (Neu & Brown, 2005).

Agency theory has been criticized for overemphasizing the economic utility paradigm, which has been argued to hamper the emergence of trust and a cooperative climate to a business relationship (Fehr & Falk, 2002). This is suggested to be of paramount importance because an expectation of trust, loyalty, honesty and good will have been emphasized to be a necessity for any functional business relationship where work is being delegated (Hendry, 2002). As such, agency theory has been largely criticized because of its failure to grasp the meaning of trust between the actors and therefore this has been argued to render its predictive validity debatable in actual social contexts (Cuevas-Rodrigues et al. 2012; Eisenhardt, 1989). Moreover, trust in relationships is suggested to offer an alternative means for solving the goal conflict problem in agency theory, separate from the prescribed control versus incentive measures. This is argued to be necessary as the stick and carrot methods of agency theory could in fact undermine the emergence of trust in principal-agent relationships and have the opposite desired effect of increasing the possibility of the agent's opportunistic behaviour (Cuevas-Rodrigues et al., 2012).

The sources of trust in advertising agency-client relationships, specifically, have been divided into pre-contractual *general trust*, formed based on information gathered on the agency's reputation, and post-contractual *specific trust,* which emerges during the course of the relationship through interaction (Halinen, 1997). Trustworthiness has been argued to be important as it has been maintained to be an important source of competitive advantage in both specifically advertising agency work (Davies & Prince, 2005) as well as other professional service businesses due to its intangible nature, meaning it cannot be readily transferred from one relationship to another (Neu, Gonzalez & Pass, 2011).

Though acknowledging trust undermines the self-interest assumption of agency theory and assumes that the parties are in a transactional mode (Grönroos, 1997) the compatibility and complementary nature of agency theory and trust literature is still largely maintained when basic assumptions are relaxed or extended (Beccera & Gupta, 1999; Cuevas-Rodrigues et al., 2012).

### 2.4.2 Stakeholder Theory Perspective

Stakeholder theory ads to the agency theory discussion by suggesting that agents are not only motivated by pecuniary benefits but that people as social beings value relationships. This leads them to value justice and fairness in their business dealings. Reciprocity refers to the the strong need and tendency for people to reciprocate a positive or negative gesture with a gesture in kind (Fehr & Falk, 2002). Reciprocity has generally been argued to be an important factor in considering economic incentives. It is argued that whether an agent considers a pecuniary compensation gesture as either being an act of kindness or hostility, will either have a positive or negative motivational implication, respectively (ibid). A gesture's kindness or hostility is assessed through perceptual fairness, which is formed by the equitability of the distribution of the likely payoffs to a suggestion (ibid). The existence of perceptual fairness has been argued to have significant commitment implications for both parties to an advertising agency relationship (Davies & Prince, 2010). Moreover, by investing in their relationships with their principals, agents can create social debt, which considering social norms will trigger a sense of reciprocity (Fukuyama, 1995 referred to in Cuevas-Rodrigues et al., 2012). Cuevas-Rodrigues et al. (2012) suggest that creation of goodwill 'can produce a social asset that can be drawn on should changing conditions require contributions from stakeholders that exceed the economic benefits of the exchange' (p.533). Moreover, as the name of the theory suggests, it is argued that agencies face the need to balance between the varying goals of multiple stakeholder at the principal firm (Cuevas-Rodrigues et al., 2012). Thus it is propositioned that outcome-based pay is less frequently used as the number of principal actors increases as disagreeance on goals is expected to increase (ibid.) This challenges the assumption that (overall) higher goal conflict between principals and agents would lead to outcome-based contracts as the agent cannot accept an outcome-based contract, if the multiple principals cannot agree on what goals are to be achieved.

Stakeholder theory strongly challenges the agency theory assumptions of participant motivation being only hinged on self-interest and economic utility since people are social and moral beings that are excited by factors beyond money value relationships. The perceived fairness of any given gesture will have significant motivational implications that should be considered in appropriate incentive selection.

### 2.4.3 Institutional Theory Perspective

The institutional theory perspective on compensation challenges the agency theory assumption of the parties reaching an economically efficient contract. This is done through the notion of normalized industry practices whereby the social context of a firm leads it to conform to industry practices, values, norms and beliefs in the effort to reach legitimacy and social acceptance (Zucker, 1987; Eisenhardt, 1988). The compensation model decisions of a firm operating in any given industry is thus argued to be subject to the firm's industry specific norms that lead to isomorphism within the industry environment (Zucker, 1987). An integral part to this theory in relation to agency theory is that institutionalized practices are suggested to be maintained even in the event of changes in technology or job content (Eisenhardt, 1988) and that these may maintain irrespective of task performance levels (Zucker, 1987). Both agency theory and institutional theory are thus suggested to assume a rational compensation model determination process though agency theory bases the logic on the efficient contract whereas the institutional perspective bases this on the logic of social legitimacy (Cuevas-Rodrigues et al., 2012).

### 2.4.4 Prospect Theory Perspective

The prospect theory perspective challenges the agency theory assumption of the principal's and agents static risk preferences. As a neo-classical economics model, agency theory is criticized for focusing too much on the assumption that principal's and clients are inherently and continually risk averse (Wiseman, & Gomez-Mejia, 1998). Wiseman and Gomez-Mejia (1998) argue that adding a behavioural approach to agency theory can enhance its explanatory and predictive capabilities. Though the assumption of risk aversion can be relaxed within agency theory, as was demonstrated before, agency theory alone offers no explanation for why relaxing the assumption may indeed be necessary. Including a prospect theory perspective into agency theory analysis helps explain principal and agent risk preference variation.

Prospect theory suggests that social actors may change their risk preferences over time and based on the framing of their contexts (Kahneman & Traversky, 1979). The behavioural economic approach of prospect theory posits that an individual's risk utility curve operates such that the curve is concave for gains but convex for losses, indicating that the disutility offered by a loss is higher than the utility offered by a gain of the same magnitude (ibid). This is suggested to be a sharp contrast to the linear risk and reward relationship assumed by economic theories (Mukherji & Wright, 2002) such as agency theroy. Though economic theories assume all actors have the same risk utility curve, empirical studies assert that individuals have differing and subjective preferences that vary over time, contexts, situations and circumstantial contingencies (Mukherji & Wright, 2002). While agency theory assumes a rational approach to decision making whereby actors are profit maximizing, prospect theory takes a behavioural approach emphasizing that the context influences the decision and that individuals are not, in fact, *profit maximizing*, but *loss minimizing* (ibid). Moreover, it has been found that firms employing agents that are pursuing an innovator, *prospecting strategy* searching for new products and markets, are more inclined to assume higher degrees of risk (Miles & Snow, 1978 referred to in Cuevas-Rodrigues et al., 2012). As such, Cuevas-Rodrigues et al., (2012) argue that while agency theory focuses on *minimizing risk*, prospect theory amends the picture by emphasising that individuals may actually be more prone to *minimizing losses*. Consequently, this means that the risk preferences of a given principal or agent can vary based on the context and time, and that the multiple individals within a principal or agent can have differring risk preferences.

Prospect theory challenges the agency theory assumption that principals and agents are utility mazimizers. The theory also demonstrates that studying the nature of agents or principals may require digging deeper into identifying the individual employees of a single principal or agent. Morover, examining risk preferences can become increasingly complex when not all employees of a single principal or agent can be assumed to have homogenous and stable risk preferences over time and context.

#### 2.4.5 Agency Switching Costs

Agency switching costs are another factor that is suggested to affect agency compensation models through changes in client commitment and the parties' power differential. Davies and Prince (2010:13) define switching costs as the 'time, effort, money, and psychological burden involved in setting up a relationship with a new agency or the benefits lost from terminating an agency relationship'. Switching costs are are derived from human capital and are incurred from both set-up costs (measures taken to ensure that an agent is able and equipped to transform its skills and resources to produce value for a particular client) and exit costs (forgoing the benefits of the built-up, non-transferable value, if the relationship is terminated). The degree of power held by the client as well as its degree of commitment to the relationship is suggested to correlate with higher degrees of switching costs. In principle, the higher the switching costs, the less likely a client is to change its advertising agency. In theory, and as supported by clients surveyed in North America, the use of outcome-based compensation is correlated with the higher degree of switching costs in the initial and later stages of agency-client relationships (Davies  and Prince, 2010).

Switching costs are suggested to be high in the beginning of the relationship when the client has just made a high personal and psychological commitment to the newly hired agency (Davies & Prince, 2010). Projects assigned to the agencies are typically suggested to be shorter and more measurable in the beginning of agency-client relationships when trust is still weak (Davies & Prince, 2005). As the relationship progresses, switching costs reduce and the client recuperates its initial relationship investment costs (Davies & Prince, 2010). At this intermediate relationship stage, clients are speculated to potentially behave opportunistically and wish to reduce the total agency remuneration in intermediate relationship stages when information asymmetry and uncertainty have reduced, indicating the use of behaviour based models. Switching costs begin to increase again once the relationship progresses and trust develops in the relationship. The client also becomes more dependent on the stable advertising results it is receiving. As the content of the work becomes more strategic, outcome-based contracts become more probable over time once the agency's effect on outcomes becomes evident (ibid). Switching costs have also been found to vary based on client size such that large customers have higher switching costs due to using a broader range of services from their agencies and a tendency to develop deeper relationships and using agencies more as strategic partners as opposed to ad hoc project managers. A broader range of services means higher client exposure. This further increases switching costs through requirring rigorous efforts in the agency selection and set-up processes (Davies & Prince, 2011).

The following Figure 3 illustrates the behaviour of switching costs over time, revealing that switching costs are highest in the early and more mature stages of the agency-client relationship.

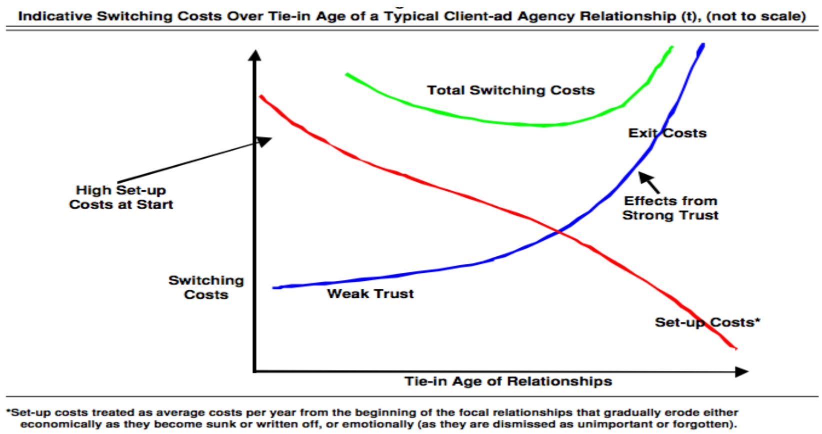



Figure 3: Switching Cost Development Over Time (Davies & Prince, 2010)

Swithcing costs are incorporated in this study as to identify whether these might or might not be affecting the SEA compensation model over time, context and varying degree of strategic significance of the advertising form. Switching costs are particularly interesting to be studied in the context of SEA since it can be assumed that SEA switching costs are fairly low compared to other advertising especially, if the advertising client has administrative access to their AdWords account (Google, n.d.c). In such a case a significant part of the value added by one agent may be transferable to be the starting point of another agent who may thus more quickly grap the objective of the advertising. Since swithcing costs build upon trust literature, it similarly challenges the assumption that the compensation model decision is consistently driven by pure economic utility considerations. Morover, similarly to prospect theory, the switching costs approach builds on agency theory and takes the changeing context into consideration arguing that parties will be more or less likely to behave opportunistically based on the subtle shifts of information and power between them over time. As such, swithcing costs introduces an additional cost for the principal to consider when evaluating the value of a given agency relationship.

## 2.5 Literature Summary & Theoretical Framework

The theoretical framework presented in Figure 4 draws together the actors and variables considered by Agency theory. The objective of the theoretical framework is to provide a guide for testing the explanatory power of agenct theory in SEA contractual agreements over time. The framework builds heavily on the works of Bergen et al. (1992) and contributes to the authors' work with additional theoretical lenses as well as respect for the temporal element of agency-client relationships. The two time periods are color coded to illustrate the temporal nature of the different challenges faced by the principal. T0, in blue, indicates the time before a contract is struck. T1, in red, denotes the more advanced stages of the relationship.

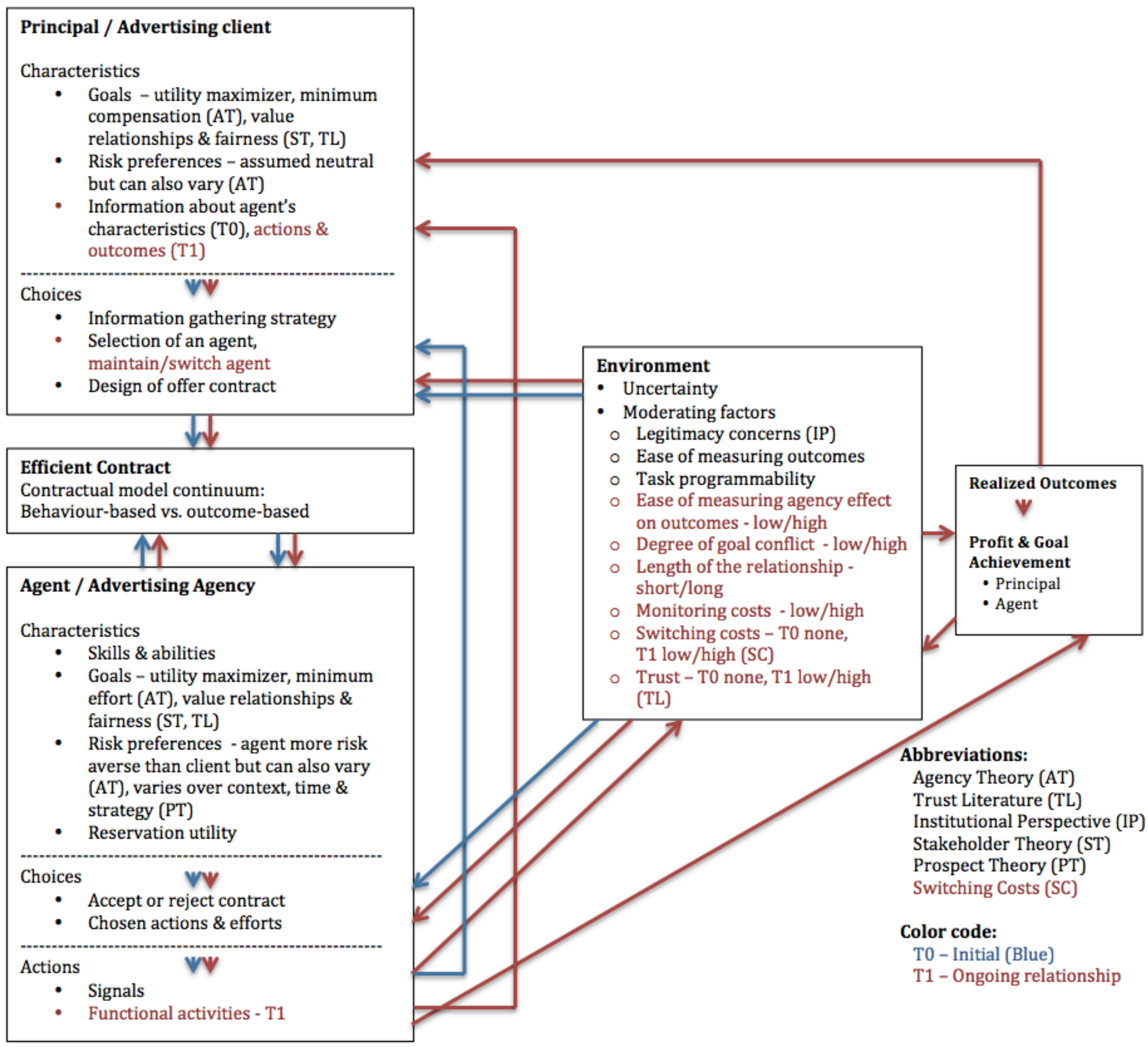



Figure 4: Theoretical Framework: Agency Theory & Critical Extensions

At the initial T0 stage, the advertising client faces the *adverse selection* problem i.e. the risk that an agency might be misrepresenting its intention or ability to conduct the desired SEA service appropriately. To mitigate this problem, the principal with limited understanding gathers as much information about one or multiple possible agents as is economically viable. The principal is aware that there is considerable uncertainty in the environment and that this, together with the agent's actions, will define realised outcomes when a contract is struck. Once the principal has found a good agent, it proposes a contract to the agent. The principal takes its own goals, both parties risk preferences and multiple other contextual factors into consideration while designing the most appropriate contractual model along the behaviour versus outcome continuoum. The objective of the contract is to minimize relationship governance costs, maximise principal gains and minimise the agent's incentive to engage in *moral hazard* i.e. shirk on its agreed responsibilities. Agency theory assumes the parties are inherently motivated by self-interest and expects the agent to wish to exert minimum effort while receiving maximum compensation. The agent is also assumed to be inherently more risk averse and thus prefers a behaviour-based model with a guaranteed payoff, whereas the principal advertiser would prefer an outcome-based model to align goals by transferring business risks over to the agent. The agent takes its own goals, risk preferences and contextual factors into consideration when accepting or rejecting the offered contract.

At the more advanced and ongoing T1 stage, the relationship length has increased and the principal has gathered experiential information on the nature of the agent either through measuring results, monitoring behaviour or both. Depending on the contract terms, the principal may choose to continue, modify, or end the contract with its current agent after a certain time period has lapsed. The principal takes its gained experiential information as well as possible changes in the contextual circumstances into consideration when making a second round decision. Notable contextual changes, highlighted in red text, are that switching costs may have been introduced, and there may or may not now be significant changes in the other moderating factors of ease of measuring effect on outcomes, degree of goal conflict, length of relationship, monitoring costs, and trust. The agents functional activities can affect some of the moderating factors: Carrying out agreed responsibilities and delivering results may, for example, build up trust in the relationship.

Agency theory and its predictive capabilities in real organizational contexts have been criticized for its many simplistic and pessimistic assumptions as well as its inability to encompass the full nature of the relationship and emergent trust between the parties. Many authors still maintain that that agency theory holds and that it us fully compatible when combined with useful extension theories (e.g. see Cuevas-Rodriguez et al., 2012; Beccera & Gupta, 1999).  Several other theories are therefore drawn upon to refine and elucidate the full nature of the principal-agency relationship and potentially challenge the discussed agency theory assumptions. The purpose of this study is thereofore to test this model and consequently the revelvance of the outlined theories in the context of SEA compensation agreements from the agent's perspective.

# 3 METHODOLOGY

This section of the thesis describes the research methods selected for this study. The methods sectionsfirst justifies the qualitative research as approach most suitable for the context. Secondly, the research design is explicated to elaborate on the data sources, data gathering process as well as the data analysis methods. The final methods section evaluates the validity and generalizability of the results.

## 3.1 Research Method

The empirical section of this thesis is a qualitative, interview-based multiple case study on eight agencies providing SEA services in the Finnish market. Given the nature of the research questions, this study combines explanatory and descriptive elements to describe phenomena governed by multiple variables as well as shed light on why this is happening in certain specified contexts (Saunders et al., 2003). This study therefore combines both the inductive and deductive research approaches. The study is primarily deductive as it uses available theories to make predictions and offer explanations (Chalmers, 1999). This is done by taking previous researchers' agency theory hypotheses as the foundation of this study's theoretical framework, thereby testing the propositions in the defined new context of SEA advertising. The study is also slightly inductive i.e. deriving theories from a set of data gained through solid empirical research (ibid), as the study strives to go beyond mere deductive theory testing and inductively develops new insights and extends theory to fill current gaps. The use of both approaches is acclaimed by authors such as Saunders et al. (2003) who describe the frontier of these approaches to be blurry and that a combination of the two is thus beneficial.

The case study approach was selected for this thesis because it is seen as particularly appropriate for answering *how* and *why* research questions for complex phenomena in contemporary settings (Yin, 2009). Moreover, a descriptive approach is used as it is argued to provide important support for case study research by richly illustrating the studied phenomena on which data is gathered (Saunders et al., 2003). Multiple cases were taken into consideration in the study in order to balance both gaining deep insight into the chosen context and cases as well as to make the findings of the study more generalizable.

The qualitative study design was preferred over quantitative research methods because it has been argued to better facilitate gaining a deeper insight into the behaviour and beliefs of firms (Yin, 2009), as it has the ability to more accurately capture human impressions and perceptions compared to quantitative research (Saunders et al., 2003.) Moreover, previous empirical studies on agency compensation models have indeed been largely quantitative in nature and focused on theory testing through data gathered from client-side studies (see Spake et al. 1999; Davies & Prince 2010; Davies & Prince 2011). It has however been argued that 'quantitative research cannot deal with the social and cultural constructions of its own variables' (Silverman 2001:29, cited in Eriksson & Kovalainen 2008:4). Qualitative research has therefore been argued to be particularly useful in providing improved understanding to the issues that remain elusive after quantitative studies (ibid) and many of these have been identified during the literature review and are reflected in the research questions. This notion also supports employing a qualitative research design that can help gain fresh understanding to the issues that remain inadequately explained by previous compensation model studies. The aim of this study is to describe and explain phenomena and search for explanations instead of frequency; numerical data would therefoe not have provided satisfactory answers. Moreover, the contract between a client and its agency is highly confidential information so gaining access to and statistically analysing the nature of multiple contracts, especially across agencies, has been already previously suggested to not be feasible (Lace, 2003).

## 3.2 Research Design

### 3.2.1 Sample Selection

The empirical study was conducted as a multiple case study. The inclusion of multiple cases was deemed beneficial as it has been suggested to enable comparison across cases, therefore yielding more accurate and generalizable theory than single case studies (Eisenhardt 19991; Yin 1994). The use of multiple cases also mitigates the risk of findings being only idiosyncratic to one case instead of showing consistency across several cases (Eisenhardt 1991). This is suggested to enable the building of more robust theories (Eisenhardt 1989b).

The data for this study was collected from the agency side for multiple reasons. Firstly, all existing empirical studies on agency compensation models from an agency theory perspective have thus far been deductive, quantitative studies with data gathered from the advertising client side (see: Spake et al. 1999; Davies & Prince, 2010). Thus taking a different stance and qualitatively studying the agency side of the story was expected to provide new and interesting theoretical and empirical insights to the benefit of both advertising clients as well as agencies. Secondly, individual contracts between clients and their agencies are highly confidential information, so asking advertisers to discuss their contracts, especially in respect to which agency they are working with, has been argued to not be feasible (Lace, 2003). Strikingly, since the author of this study currently works at Google and has access to identify client and agency affiliations, this matching of agencies and clients may in fact have been possible without participants' explicit consent, and publishable as long as data would be anonymized. This option was however eliminated as it was deemed ethically inappropriate. The decision to not interview clients was also related to ethical considerations and the author's employment at Google. This study was motivated by the desire to develop new interesting insights for the benefit of both clients and agencies so the author did not wish to run the risk of accidentally introducing clients with a false sense that 'something might be wrong' with the agency or contract a particular studied client was currently using. Secondly, asking an agency directly about what compensation models they use and why was expected to provides an efficient means for aggregating an overview as to what models an entire agency systematically uses or does not use. Thirdly, agencies' key informants with experience of multiple clients and client types can be deemed to have more and varied experience in the use and use rationales of various compensation models, compared to individual client firms whose managers may or may or may not have extensive experience in several compensation models and model negotiation processes. As such, the research questions were expected to be more efficiently answered through agency-side studies as opposed to client-side studies, considering the limited scope afforded by a Master's thesis. Moreover, it should be emphasized that though the particular empirical lens assumed by this study is that of the agencies, the objective of this thesis is to primarily deductively test whether agency theory, i.e. the perspective of the (principal) client, holds, as expressed by agency key informants. The primary objective of the study is therefore to gain valuable theoretical insights for principal advertisers, yet the findings are also inarguably an interesting, insightful and rare benchmarking opportunity for agencies as well.

The sampling strategy used for this study was *theoretical sampling* i.e. adding multiple cases with the intention of selecting cases that will likely replicate or extend emergent theory by offering something new or eliminating alternative explanations (Eisenhardt 1989b). The theoretical sampling criterion applied for this case study was designed to both provide healthy variation in results, yet contain enough commonalities across cases to facilitate reasonable pattern recognition. Eight cases were initially selected based on the suggestion that the inclusion of 4 to 10 cases usually works well, in order for case studies to be both theoretically robust yet manageable in data volume (Eisenhardt 1989b). Notably, theoretical saturation, whereby adding additional cases only provides minimal incremental value (ibid), was largely already reached after 7 cases. The final case was nevertheless included due to the interview already being scheduled and the results providing additional support and several well-articulated quotations. The eventual theoretical sampling criterion applied for this study is as follows:

1. All agencies have clientele in the Finnish market and thus have a common operational context and competitive situation providing a defined research context and reasonable basis for cross-case comparisons (Eisenhardt 1989b).
2. Case agencies were included from all agency types (SEM agencies, digital agencies, media agencies' SEM departments) in order to provoke the possible emergence of patterns across multiple agency types.
3. All agencies currently have one or more continuous contacts at Google's large customer sales team (Google's large customer sales department, at the time of the study, communicates regularly with a total of 10 agencies' performance departments). This can be viewed as a proxy for the agency's relative importance in the AdWords marketplace and the volume of their total client portfolio's media budget running through AdWords.

Notably, Case agency 1 is an emerging competitor in the Finnish market and is the only agency included in the study, which at the time of the interview, did not have a permanent office in the Finnish market. This agency was included in the study due to its theoretically interesting and exceptional operational model, which was also found to be affecting the agency's compensation models. These are discussed in more detail in the findings section.

### 3.2.2 Unit of Analysis

It has been suggested to be important for a study to clearly state the difference between the used units of analysis as well as the empirical units of observation (Fletcher & Plakoyinnaki, 2011). The unit of analysis, meaning the specific object examined by this study, is the contract between the contracting advertising client (principal) and the service providing agency (agent). This study is therefore considered to be a holistic case study whereby there is only one main unit of analysis (ibid) though many other mediating variables that affect the unit of analysis are indeed identified and evaluated. The empirical units of observation refer to the sources of data used for the study and these are the key informants of the case agencies, as previously discussed.

#### 3.2.3 Data Collection

This study uses *primary data* collected through interviews with key informants at the case agencies. Interviews were chosen as the appropriate means for data collection, because it has been argued to be a highly efficient means for gathering rich data (Eisenhardt & Graebner, 2007). Moreover, interviews allow for respondents to answer freely according to their own thinking (Ghauri & Gronhaug, 2005) and has been suggested to be particularly beneficial in research settings where it may be difficult for the researcher to forecast responses in advance (Daymon, 2002), as was expected when attempting to confront largely economics-based theory with empirical, behavioural reality. The nature of personal interviews also allowed for the interviewer to repeat or follow-up with clarifying questions in order to dig deeper and expose the most relevant information (Tuomi & Sarajärvi, 2002).

The interviews were conducted as semi-structured interviews whereby a list of questions were developed on a fairly defined set of topics (Bryman & Bell, 2003) initially outlined in the litereature review. The interviewing method applied in this study is considered semi-structured as opposed to structured as the interviews were conducted in a fairly conversational manner, questions did not necessarily follow in the exact preoutlined order, and the exact preoutlined wordings of the questions were not strictly followed (Bryman & Bell, 2003). Moreover, the interviewer retained the freedom to pick up with additional issues raised up by each interviewee (ibid). The rationale for selecting the semi-structured interview approach was that it affords some flexibility: The researcher wanted to strike an adequate balance between covering the areas suggested by theory whilst leaving room for the informants to potentially bring up new issues that they felt to be important. Moreover, the use of semi-structured interviews was deemed appropriate at it has been advocated to be frequently used in multiple case studies since it provides important and necessary grounds for cross-case comparability (ibid).

The interview guide was designed to address several important themes that emerged during the contextual and theoretical parts of the literature review. The interview guide was intended to first identify each compensation model used by the agency, and more importantly, the rationale for their selection. The second part of the conversation involved discussing model adaptation to individual clients as well as the model negotiation process in general. The fourth part addressed the overall client-agency operational context and was forecasted to explicate the agency theory constructs of information asymmetry, goal alignment issues and task programmability. The final part of the interview guide delved further into performance based compensation models to further identify tension points and barriers to adopting these models should they not be found to be in wide use - as turned out to be the case with most studied agencies. Because the semi-structured interview guide method may not always result in all the exact same items being discussed by all respondents when new topics may emerge (Patton, 2002), follow-up emails were occasionally carried out to seek clarification for the most important emergent concepts. The semi-structured interview guide, as a whole, is available in Appendix 1. The questions asked in the interview were carefully phrased as to be truly open-ended as has been deemed vital (Patton, 2002). The interviews were concluded with the question, 'What essential issues may I have missed or have not been covered in the discussion of this subject area?' in order to leave ample room for completely new emergent perspectives.

The data gathering period of the study took place between August and December 2014. All interviews apart from Case 1 were conducted in Finnish and either face-to-face or through video conference due to the author's residence outside of Finland. Each interview was recorded on tape and partially transcribed as a stand-alone case. In order to mitigate the barrier for agencies to take part in this public study, all case agencies and their respective interviewees participated in the study anonymously. As a result, individual case company descriptions are kept at a minimum in order to not convey recognizable traits of the individual cases, especially considering the narrow agency landscape in Finland. Table 5 below summarizes the role of each case respondent, the type of agency they represented and the length and mode of the interview conducted:

Table 5 Case Agency & Interview Details

| Total: 8 | Agency Type | Turnover 1000 EUR | Personnel | Contact | Interview Duration | Interview Mode |
|---|---|---|---|---|---|---|
| Case 1 | SEM | 4500 - 7500 | 25-30 | C-level | 1h 20min | Face-to-face |
| Case 2 | SEM | 2000 - 3500 | 25-30 | C-level | 60 minutes | Video conference |
| Case 3 | Media | 15000 - 25000 | 25-30 | B-level | 60 minutes | Face-to-face |
| Case 4 | Digital | 2000 - 3500 | 15-20 | C-level | 45 minutes | Video conference |
| Case 5 | Media | 15000 - 25000 | 25-30 | C-level | 45 minutes | Face-to-face |
| Case 6 | Digital | 2000 - 3500 | 15-20 | CEO | 45 minutes | Face-to-face |
| Case 7 | Digital | 4500 - 7500 | 15-20 | CEO | 40 minutes | Face-to-face |
| Case 8 | Digital | 4500 - 7500 | 25-30 | CEO | 40 minutes | Video conference |

Each interviewee was selected from the case agencies based on identifying themselves as either being a strong influencer on the compensation models used at the agency (high influence B-level), a key model decision makers or influencer (C-level), or the key model decision maker and at the same time the head of the agency as a whole (CEO). As such, it is assumed that the informants views are consistent with and representative of the views of the agency overall. The shortest length that any given interviewee had worked in the SEM industry was 4 years, indicating that all respondents had considerable experience in the industry.

### 3.2.4 Data Analysis

Each individual interview was first partially transcribed and then thematically coded into tables for the purpose of generating rich insights through conducting within-case analysis (Pettigrew 1988, referred to in Eisenhardt 1989b). Extensive within-case analysis was conducted in order to become ‘intimately familiar with each case as a stand-alone entity’ (Eisenhardt 1989:540). Extensive cross-case analysis was then carried out with the intention of using thematic content analysis to find similar themes and constructs across the individual cases (Eisenhardt & Graebner, 2007). Comparison across multiple cases while examining several themes simultaneously was further facilitated by the use of further matrices and tables (ibid) as well as basic spreadsheet filtering mechanisms. Key to this process was identifying emergent categorical themes and grouping the case data to identify within-group similarities and intergroup differences as suggested by Eisenhardt (1989b). This was completed with further usage of matrices and tables that were constructed and reconstructed in an iterative manner. The process of cross-case analysis was not begun until the majority 7 out of 8 interviews were conducted in order to be able to more systematically and credibly use the replication logic, whereby the same steps are executed for each individual case (Yin, 1994). This resulted in the development of an empirical compensation scheme determination model, which is the final product of the findings analysis. The pattern matching technique was then used in the discussion section to examine the empirical findings variables and redefined constructs against previous theories suggested by relevant literature (Yin, 2009; Saunders et al., 2003).

## 3.3 Validity and Reliability of the Study

According to Yin (2009), the rigor of a study is determined through its validity and reliability and can be tested along the specific dimensions of construct validity, internal validity, external validity and reliability. Other authors argue that in qualitative research, the issue of conformability is also important (Guba & Lincoln, 1994) and is agreed to be highly relevant due to the authors' present role at being employed by Google. All suggested dimensions are addressed separately below though they are acknowleged to contain significant interlinkages (Gibbert, Ruigrok & Wicki, 2008).

***Internal validity**,* or *credibility* in qualitative research (Bryman & Bell, 2003)*,* concerns the issue of whether the causal relationships between variables are valid (Gibbert, Ruigrok & Wicki, 2008). The causal relationships between variables and results in this study are deemed to be at a high level due to adhering to the suggestion of using a clear research framework (ibid) and the dedicated use of matrices, summarizing rationales and supporting quotations in explaining the relationships between each variable in the findings and discussion sections. Moreover the pattern matching technique used in the discussion section is suggested to improve internal validity as it requires findings to be analysed and tested in the fire of extant knowledge (ibid).

***Construct validity*** examines whether the relevant concepts of a study are accurately conceptualized. Construct validity is therefore concerned with whether a study accurately reflects reality and actually measures what it claims to measure (Gibbert, Ruigrok & Wicki, 2008). A high level of construct validity for this study is achieved through the suggested measure of providing a meticulous chain of evidence for the reader to trace the logic and draw the same conclusions as stated in the study (ibid). This is done through a high volume of case quotations in both the findings section as well as with additional supporting quotation tables in Appendecies 2 and 3.

***External validity*** that parallels the qualitative research term *transferability*, concerns whether the results of a study are generalizable to apply to other contexts (Bryman & Bell, 2003; Gibbert, Ruigrok & Wicki, 2008). The use of the pattern-matching logic and cross-case comparison, are applied in order to increase both internal and external validity (Yin, 2009) as multiple bases are used to gain more robustness. The generalizability of this study is based on analytical generalizability, relying on having employed a replicative logic with cross-case analysis, revealing the findings being largely consistent across multiple cases (Eisenhardt, 1989b). Essentially the level of analytical generalizability sought by this study is limited to boundary conditions pertaining to the context of the study (Finnish market) as well as the nature of the work (search engine advertising or work of similar nature). The level of generalization sought by this study is essentially to reflect the compensation model availability and model determination process in the Finnish market.

***Reliability*** addresses the issue of whether the results of the study can be replicated such that the same conclusions will be logically reached (Yin, 2009). The reliability of this study is ensured by providing a clear description of the research process and aforementioned chain of evidence. Moreover, a recommended case study database with transcriptions, emails and audio recordings was maintained for the purpose of later verification (Gibbert, Ruigrok & Wicki, 2008). Moreover the study and final product have been reviewed by an appropriate, knowledgeable supervisor as recommended (Bryman & Bell, 2003).

***Confirmability***, concerns whether the researcher is being objective to the study or whether the research is unreasonably influenced by its authors possible biases (Bryman & Bell, 2003). In terms of ethical considerations, it should be acknowledged that the researcher has been employed by Google at the time this study was conducted. The author has been an AdWords and YouTube account strategist for the Finnish market and has worked with both end-client advertisers and agencies since the summer of 2013. As such, the author has significant insights about the nature of AdWords advertising as well as the quality of the work conducted by each agency participating in the study. The author would however like to openly admit that personal understanding of advertiser-agency contracts, specifically, has not been particularly in-depth. It should be noted that this thesis has not been explicitly commissioned by Google though widespread internal interest has emerged during the course of its completion. In order to mitigate any potential biases and ensure the replicability of the study, only data explicitly gathered during the interviews has been used for this study. This is also driven by the desire to keep a high level of ethical consideration whereby respondents need not fear that their daily correspondence, as opposed to volunteered interview responses, might be recorded in this public study.

# 4 FINDINGS

The findings section of this study first describes the observations made on the different compensation schemes used at the studied case agencies. This is followed by analytically examining the specific reasons behind model selection and results in the identification of various factors that affect compensation model determination. These factors that influence model selection and the agency-client relationship as a whole are described and categorized as being either desirable features, or moderating and boundary factors. The final section brings the findings together in a model that summarizes the entire model determination process.

## 4.1 Observed Compensation Models & Their Use Rationales

The multiple case studies revealed several compensation models being used. A full review of quotations on each identified compensation model is available in Appendix 3. A commonality across all discussed models was contract term flexibility to the client: 7 out of 8 agencies reported that their contract terms were on a 1-3 month rolling basis or less, and only one agency reported that they used fixed term contracts. Overall, the results suggest that the fixed-fee model is by far the most dominant compensation model as it was reported to be the predominantly used model by 7 out of the 8 agencies studied. A distinct feature of AdWords advertising at the studied agencies was that the advertising client typically, though not always, owns the Google AdWords account, which can be easily transferred to another agency or audited by another agency. In most cases, the client was suggested to pay for their own media budget directly to Google so that the agency did not have to bear credit risk for the media budget (Cases 1, 2, 4, 5, 7). Client churn was discussed to be relatively frequent overall. As quite a sore topic, this was not further examined. The following Table 6 summarizes the previous use, current prevalence and offering of the various models at the studied agencies:

Table 6 Compensation Models Used for Search Engine Advertising

| | Contract term | Traditional Commission | Tiered Commission | New Commission | Fixed fees | Time bank | Performance bonus (+ Fixed fee / Time bank) | CPA |
|---|---|---|---|---|---|---|---|---|
| **Case 1: SEM** | None | | | Dominant (only offered) | | | | |
| **Case 2: SEM** | 1-3 months | | | | Dominant (only offered) | | | |
| **Case 3: Media** | 1-3 months | Some old clients | Few | | Dominant | | Few | |
| **Case 4: Digital** | Monthly rolling | | | | Dominant | Few | Few | Few / none currently |
| **Case 5: Media** | 1-3 months | Some old clients | | | Dominant (in use) | Dominant (offered) | (No longer used) | |
| **Case 6: Digital** | Fixed term 6-12 months | Some old clients | | | Dominant | | | (No longer used) |
| **Case 7: Digital** | 1-3 months | Some old clients | | | Dominant (in use) | Dominant (offered) | Frequent | |
| **Case 8: Digital** | Monthly rolling | | | | Dominant (only offered) | | (Previously but no longer used) | (No longer used) |

### 4.1.1 Traditional Commission

As defined in the literature review, the traditional commission-based compensation model involves the agency being compensated based on a defined percentage of the client's media expenditure. This model was currently being used by 4 out of 7 agencies studied (Cases, 3, 5, 6, and 7). All informants from agencies that used the model, however, suggested that this was an older historical model, which was currently being more or less actively phased out of use. The main rationale for the model's previous use had been based on the fact that a higher media budget usually constituted a higher amount of work for the agency. Clients currently still on the model were suggested to be ones that were part of a global deal (Case 5) or ones that had been with their agencies at the time the model was still widely offered i.e. before the year 2008. The benefits of the model involved its simplicity, flexibility and scalability. Informants stated that while the model with generally high revenues, it was being scaled down. The downsides of the model involved its intrasparency due to undefined work tasks, and unfairness because it scaled too quickly up or down either making the agency remuneration too high or too low. Case agencies 5 and 6 elaborated:

> It punishes the client when the campaigns are successful because the commission goes up when the budget goes up even when there is not any more work needed (Case 6).

> It's our aim to be transparent and fair so this is not in align with what we want so sometimes we have had to return money to the client to be fair because we have not been able to justify such a high fee. This model also does not encourage us to work as no activities or hourly work has been defined (Case 5).

Lastly, the model itself did not signal the agency's accountability or ability to deliver results.

#### 4.1.2 Tiered Commission Based on Varying Media Spend

The tiered fee based on media spend was described to be a compensation model whereby the agency is paid a percentage fee which varies up or down based on the client's media spend. The rationale behind this compensation mode, similarly to the traditional commission based model, was that a higher budget typically meant more work for the agency. This model, only suggested to be used on a couple of long-term clients at Case 3, was described to be used with clients whose media budgets had high monthly variance. The tiered fee model was suggested to be an improvement to the commission based model's potential adverse impacts on fairness towards the client and less positive or negative variance to agency profitability. This model had thus emerged to tackle the high monthly budget variance and fixed percentage commission issue present in the traditional commission model.

#### 4.1.3 Fixed-fees

The monthly fixed-fee compensation model was suggested to be currently predominantly in use by 6 out of the 7 agencies studied. The fixed fee compensation model, involves the agency making an assessment of the hourly or daily workload it believes a client requires, and then translating that assessment into a monthly fixed fee. As discussed in the literature review, the fixed fee model had emerged as an improvement to the commission model. As such the model had been widely used for the past 6 years and become somewhat of a norm and the model clients expected (Case 2).

The simplistic characteristics of this model were agreeably beneficial to both parties: It was easy for clients to understand and made calculations at both ends relatively easy. Also the model could be easily scaled across all of the agencies' clients with little administrative burden.

Other features were however more debated across the studied agencies. The model was considered only moderately flexible: Though it adjusted easily to taking on new advertising forms and varying goals (performance & branding, other media like email) there also existed a clear concern that clients risked growing out of their models, especially if growth was quick and the agency's initial forecasts are not accurate (Case 4, 5, 7). This was a particular problem of the model because fee renegotiation was time consuming and as infrequent as annually or biannually (Case 5). One agency explained:

> The problem with the fixed fee is that if the scope of the project drastically changes, the fixed fee would need to be renegotiated, which requires a lot of time (Case 7).

Moreover, the model's perceived transparency varied with some agencies detailing exactly what was involved and how long it would take (Case 2, 3), while others left the contract description more open (Case 4, 7, 8). Also the fixed-fee model's perceived fairness was debated: The model was described to occasionally have some level of up or down adaptability based on realized working hours (e.g. Case 2 & 3) or then a part of the fee could be allocated to another type of service (Case 2). In terms of risk, the fixed-fee model was described to be good for agencies as it introduced the idea of long-term cooperation. A contrary complaint however was that profitability could become strained. One agency complained:

> We may have internally noticed the fixed fee is not profitable for us and then externally the client might feel we are not doing enough for the fee (Case 7).

The model also allowed for the generally risk averse agencies to engage in testing out new products and features on a client's account which can take a significant amount of time and involve taking some risks concerning results, thus allowing for flexibility of goals (Case 4).

Similarly to the commission model, the fixed-fee model in itself does not particularly signal the agency's accountability or ability to deliver results.

### 4.1.4 Time Bank

The time bank model was described to a compensation model whereby the agency calculates the monthly minimum and maximum expected workload of a client, from which the eventual agency fee is calculated based on actual working hours rendered. The two agencies that used the model both described that the model was a more recent trend. Though the majority of their client base was still using monthly fixed fees, the time bank model was now the model they predominantly offered to new clients.

The use rationale for the model was that an agreed minimum number of working hours guarantees the agency a set return for its work, but also allows the agency to be compensated for workload fluctuations; thus mitigating the profitability risks of the agency which calculates the required workload. The model was viewed as highly fair and transparent for the client as it ensures the client only compensates the agency for actualized work hours and motivates by withholding both parties' up and downside potential:

> The time bank model has been offered for the past 2 years easy for us to maintain our own profitability; we predefine what work will be done and how many hours it requires. We will have set a specific frame of how many hour we can do min and how many hour we can do max due to human resource constraints. It's very flexible for the activity and needs of large or growing clients were their needs can change a lot and making labour hour predictions 6 months ahead can be challenging (Case 5).

Moreover, this model tackled some of the grievances of the fixed-fee model such as the fact that agencies experienced that clients would occasionally assume that their fixed-fee contracts included more work hours than was reasonable and avoids the agency from wasting time on contract renegotiation:

> Clients might have occasionally thought that the fixed fee encompassed everything and then they might have felt that we did not do enough work for that fixed fee (Case 7).

The multiple case study nature of the thesis provided some healthy variance of opinion: Case agency 8, which only advocated the fixed fee model, specifically expressed discontent about the time bank model being a 'swamp of internal complexity' for the agency and noted that it preferred to have the client conversation revolve around payment for results as opposed to agency working hours:

> We believe clients rewards us for results, not the hours worked…Looking at hours does not necessarily bring you bliss. Most clients don't even ask about the hours (Case 7).

Compared to the fixed fee, the time bank model thus argued that the agency would have to risk signalling working hours as opposed to results.

### 4.1.5 Performance Bonus

The performance bonus was found to be a model that had a time bank or fixed fee model as the basis accompanied by a performance bonus. The bonus was usually based on over or under achieving a predefined CPA level (Cases 4, 5, 6) though one agency described that it had frequently varied the metrics on which the bonus was based (Case 7). Five out of the eight studied agencies reported to have used a performance bonus at some point in their agency's history however are no longer offering it. Only one agency was found to be particularly actively offering the model yet even they noted that only half of their current client base had such a model in use.

Agencies that used the performance bonus described their reasons for its implementation as wanting to signal their company ethos of driving for results, building and ensuring client commitment to KPIs (elaborated on later) as well as incentivizing the agency's willingness to take a bit of extra risk and be fairly compensated for exerting extra effort:

> We are usually willing to drop our hourly fee and take more risk if we can reach a model that we both can accept. With the bonus model, we may not charge all hour but take a bit of risk so then it is for the benefit of the client when we put in an extra bit of effort instead of just saying that now our hours are up (Case 7).

It was suggested that the disadvantages with performance bonus contracts was that they were not only risky for the agency, but also risk averse clients also preferred not to have sudden large bonus payouts. Moreover, performance models were described to be increasingly complex, and inflexible for varying client goals:

> Challenge with this model is that most client need to grow so it's difficult to define what is most fair, is it to optimize for efficiency or increase volume. If we base the bonus model based on efficiency, it will eat out volume, if we base the bonus on volume, it can eat out efficiency. Client needs may change (Case 5).

#### 4.1.6 CPA Pricing Model

The CPA pricing model, whereby the agency receives a fee per conversion and covers all media expenditures was found to have been used by 4 out of the 8 agencies studied and only one was still actively offering it. The model's disadvantages were described to be many. The model was argued to be impossible to scale across an agency's broad client base with varying goals. From the client side, its infrequent appeal was described to stem from clients perceiving the model as too complex and expensive (Cases 2, 4, 8). Case 2 for example recalled a specific client case where it made complex calculations for estimating an accurate mutually beneficial CPA pricing model for varying sales levels, but the client ended up rejecting the idea and going for a competitor's basic fixed fee package. This is presumably because the CPA model had been perceived as too expensive and difficult for the client to comprehend. The accounting focused Case 8 further explained that there were clear issues with the risk-reward ratio that agencies could expect with performance-based models which was causing most agencies to refuse such models as being unfair:

> As a representative of an agency, I must say that if the agency takes more risk, there should be an appropriate reward to go with it as well...My opinion is that results-based models are bad models for agencies because the agency has to take a lot of the clients risks and the client is not willing to pay for the risk transfer (Case 8).

From the agency's perspective, Case agencies 2 and 3 were open to the idea of the CPA pricing model but called for further internal testing of the model at the agency side to establish its potential. Case 2 also emphasized that clients were not asking for CPA or other results based models for that matter. Case 6, which had used the CPA only compensation model, described a mixed success experience with the CPA model. It had been using a model whereby the agency paid the media budget and the client only paid a fixed fee. The model had worked well for the first year until the client wanted a CPA level reduction, which the agency did not think was possible for the amount of time that it would take to reach the goal, thus making the model unfair.

### 4.1.7 New Commission

Case agency 1, which only focused on ecommerce clients, was the only agency found to be using a compensation model whereby a client pays the agency a percentage commission on 'profitably invested media spend'. This model is hereby named as the new commission due to its similar properties yet improvements to the traditional commission model. Essentially, the entire business model of Case agency 1 functions such that an ecommerce client provides the agency with the profitability figures of all its web shop's individual products. The agency then uses its internally developed automatic bidding software to optimize the client's AdWords account to achieve or exceed a predefined profitability goal such as a ratio of 1:3 or a 1:4 return on ad spend. The agency would take a percentage commission of the clients AdWords media expenditure. The magnitude of the media expenditure was defined by maximizing the stated profitability goals considering the market demand for the client's products. Automation was not only being used in bidding optimization, but also keywords and products were created through feeds to scalably ensure the widest possible selection of the client's products being covered by AdWords advertising. Due to the compensation scheme where commission is based on a percentage of media spend, the client's profitability and the agency's revenue on the client were argued to be simultaneously maximized.

The rationale for the agency using the selected compensation model was based on multiple factors. Firstly, due to scalable automation, the compensation model was not linked to time spent on client accounts since value was not necessarily linked to expenditure. A model based on time was thus deemed illogical for the agency's scaled operational model. Secondly, the percentage of media expenditure was deemed easy for clients to understand as all calculations remained simple (e.g. X% * 1000€ = last month's agency fee). Thirdly, the selected compensation scheme, allowed for the agency to freely carry out all activities that it believed would contribute to its clients' profitability. Thus it was more or less transparent. Fourthly, the model was easily scaled across all the agency's clients that were selected based on having an ecommerce platform and conversions with a clearly defined monetary goal. As a business model, the agency and its compensation logic were geared towards signaling their drive for results. The model was very risky as the client could quit at any time, however a diversified portfolio and the scalable business model enabled the agency to drive for high revenues. Considering the defined segment of ecommerce, the agency compensation model was highly scalable though only for the particular client segment. In terms of flexibility, the model did not adjust well to workload, which was large in the beginning but less far into the relationship when high impact activities had already been completed. Moreover, the agency's focus only on profit ruled it entirely out of flexing to client's wanting variable ad media or branding as opposed to only performance goals.

## 4.2 Desirable Features of Compensation Models

The study revealed that there are a number of desirable features that agencies generally look for in compensation models. These desirable features were identified through content analysis and by placing all agency quotations on specific models into thematic matrices. The desirable features seemed to include both the agencies' own preferences as well as a reflection on perceived client preferences. The following Table 7 provides an explanation of the constituents of each discovered desirable attribute as well as quotations to support their identification, definition and relative importance.

Table 7 Desirable Features of Compensation Models

| Feature | Rationale | Supporting quotations |
|---|---|---|
| **Low risk**<br>1. Agency profit<br>2. Client budgeting | Reflection on how much risk was exerted on the agency's profitability as well as how much risk did clients need to assume for budgeting purposes. Agencies were found to be generally highly risk averse. Clients, too, were generally inferred to be risk averse and to prefer budgeting for both agency fees and media expenditure to be predictable instead of fluctuating. | *LR1: 'We need to make sure we get paid for the work done. Unfortunately it's not free' (Case 3).*<br>*LR1:'It sets the scene for long-term cooperation that is stable" (Case 2).*<br>*LR1: 'Fees enable long-term development of a client account…not too much risks for the agency' (Case 4).*<br>*LR1: 'Clients intend on growing so workload will hardly ever hold. Time bank makes it easy and reduces forecasting error' (Case 5).*<br>*LR2: 'Slow moving, traditional client's like to know their media budgets well in advance' (Case 1).*<br>*LR2: 'Marketing managers don't want large random performance bonuses to suddenly mess up their marketing budgets' (Case 8)* |
| **High Revenue** | Reflection on how much revenue potential the agency believes a model poses. This was only specifically emphasized by one agency (Case 1). | *'Our agency focuses on high growth for ourselves and clients so we need a model that can support and incentivize that' (Case 1).* |
| **Fairness**<br>1. Reward/effort<br>2. Reward/risk<br>3. Ability to affect results | A reflection of multiple elements that were perceived to contribute towards making a model fair for both the agency and the client. Fairness was broken down into three expectation elements:<br>1) Sufficient pay for the effort and time exerted by the agency<br>2) Compensation for the amount of risk the agency was expected to assume (reward/risk),<br>3) The agency's ability to affect the results on which it was expected to be evaluated. | *FA1:'We have calculated a fair price for the work and we have also had bad experiences where if we have calculated too few hours, we are unable to develop the account, which is not good for the client or us' (Case 3).*<br>*FA1: 'The fairness approach is what we hope will eventually differentiate on us' (Case 6).*<br>*FA1, 2:'We created a [CPA] model we thought would be fair for both but the client rejected it because it was too expensive' (Case 2).*<br>*FA3: 'Is it our fault, if results suddenly stop, if the client decided to cut on their TV expenditure' (Case 5).*<br>*FA3: 'We want to be compensated for the results that come through our own work' (Case 7).* |
| **Results signal** | Reflection of how well a model, in itself, was perceived to signal a focus on accountability and ability of delivering results to the client. Note: It does not reflect the agency's actual ability to deliver results as results can be delivered in any given model. | *'As an ideology, or concept, everyone would like to only pay for results' (Case 2).*<br>*'I suppose, if they [clients] could dictate the model, the CPA priced model is what they would want but we can't really offer it to new clients' (Case 4).*<br>*'We are an agency that focuses on results so we want it to be reflected in our compensation' (Case 7).* |
| **Flexibility**<br>1. Work content<br>2. Workload<br>3. Multiple client goals | Reflection of how well the model can adjust to changes in work content (e.g. a client initially or later on also taking on display and email marketing), workload (e.g. an agency requiring to work more, if a client needed a large seasonal campaign or generally growing into a larger client), and the ability of a model to accommodate multiple client goals and attribution models for the same client (e.g. a client had both performance and branding goals). Contracts were generally suggested to be too rigid over time and risked becoming sub-optimal for both parties. | *F1: 'In the larger client cases, SEM is part of a larger whole' (Case 3).*<br>*FL1, 2'AdWords is only a small part of what we do. The model needs to scale to help the client in other digital services' (Case 7)*<br>*F1, 2: 'We can more easily offer an broader services to clients to take on e.g. analytics and email' (Case 2).*<br>*FL1, 2: 'We use the same contract for all digital services. It keeps things simpler for the client…Contracts should live more according to the clients actual business needs when projects change and even the client may grow so much that pricing should change. This can be done but it has its own challenges' (Case 4)*<br>*FL1, 2,3:'Model needs to be easily scaled up or down so the client can easily buy an additional digital marketing service for a couple of months' (Case 6).*<br>*F2:'A common problem is to make the contract so tight that it does not scale into either direction up or down and stops serving either party after a year or so. Then the client can't get services from us and we can't offer them what they need. This occasionally happens' (Case 5).* |
| **Simplicity**<br>1. Agency profit calc.<br>2. Client budgeting<br>3. Client understanding | Reflection on how easy it was for the agency to calculate its own profitability (agency profit calc.), how easy it was for the client to calculate total advertising expenses (client budgeting), as well as how easy it was for the client to | *S1: 'Hourly fees are a swamp of complexity for us internally so we avoid them' (Case 8).*<br>*S1& S3:'The compensation model would need to be sectioned up making it increasingly complex and challenging' (Case 4).*<br>*S3: 'Clients can understand the model easily… This just makes the sales process a lot easier' (Case 1)*<br>*S1,2,3: 'Easier for them when its fixed, easy to understand, easy to budget what* |

| | | |
|---|---|---|
| | understand the model as the relationship progressed but particularly in the first sales negotiation situation (client understanding). | *the expenses will be, you don't have to think so much at the client end' (Case 2).*<br>*S3:''it's easy to communicate that it will require X number of hours to do' (Case 7)*<br>*S3: 'The less there are numbers, the better. Clients are usually happier with shorter, simpler contracts, the better, safer and easier it usually seems to the client...more transparent' (Case 5).*<br>*S3:'If you think about marketing psychology, everything that you cannot understand is scary and then becomes an inhibitor for sales. Everything the client can understand, enables sales' (Case 2).* |
| **Transparency** | A reflection on how easy it was for the client to keep track of what actions were being taken by the agency and how they create value.<br><br>Highly important because perceived value was claimed to be the only real value. | *"We are moving towards complete transparency; We work for agreed hours and report on those hours"(Case 7)*<br>*'All models are fine as long as they are transparent for both parties' (Case 5)*<br>*'For this price I get this kind of services aimed at producing this' (Case 2)*<br>*'We use software so the client doesn't necessarily feel that a lot is happening...'(Case 1)*<br>*'Even if we would produce really good results, but we would manage the client relationship poorly, the client might still change agency… You can't just not communicate and send bills even if you know you are producing great results' (Case 2).*<br>*'Remember, doing a good job is just them thinking you are doing a good job; perceived value is actual value' (Case 1)* |
| **Scalability** | Reflection on how easy it was for the agency to use the same model across multiple client types with varying business models and goals in order to minimize its own administrative burden. | *'We use exactly the same model for all clients so ecommerce & what we call CPA clients'(Case 1)*<br>*'How do you create a model, which can be scaled across hundreds of clients, when all of them have different kinds of business models, different metrics and ways to place value of certain actions?' (Case 2)*<br>*'We can easily apply the model [time bank] across various clients' (Case 5)*<br>*'Must get something that is easy to work through every client' (Case 6)*<br>*'Internal processes need to be simple and scalable from client to client so we don't put time away from clients into admin' (Case 8)* |

After all quotations on specific compensation models were themed under what emerged as the various desirable features, each quotation was identified as either supporting or opposing the presence of a specific desirable feature in a given compensation model. This substantiated the respondents overall notion that no single compensation model was optimal as it revealed that the compensation models carried trade-offs between the desirable features. The below table summarizes the relative presence or absence of a desirable feature in a particular compensation model. The table has been compiled by first placing all agency quotations on specific models into thematic matrices and then creating an aggregate score of low, medium, or high based on whether the findings were overall consistently positive (high), negative (low) or occasionally conflicting (medium). The full set of respondent quotations as well as the rationale for each models' derived aggregate scores for each attribute, are visible in Appendix 2.

Table 8 Compensation Model Desirable Feature Trade-offs

| | Traditional Commission | Tiered Commission | New Commission | Fixed fees | Time bank | Performance bonus | CPA |
|---|---|---|---|---|---|---|---|
| **Low risk** | Medium | Medium | Low | Medium | High | Low | Low |
| **Fairness** | Low | Medium | Medium | Medium | High | Medium | Low |
| **Transparency** | Low | Low | Medium | Medium | High | Medium | Low |
| **Simplicity** | High | Medium | High | High | Medium | Low | Low |
| **Flexibility (within client)** | High | High | Low | Medium | High | Low | Low |
| **Scalability (across clients)** | High | High | Medium | High | High | Low | Low |
| **Results signal** | Low | Low | High | Low | Low | High | High |
| **High Revenue** | High | Medium | High | Low | Medium | High | High |

### 4.3 Moderating & Boundary Factors of Compensation Models

This section provides a description of the boundary and moderating factors of compensation models. Moderating factors are defined as those that make a specific desirable feature more or less important. Boundary factors are defined as factors that make the importance of a feature cease completely. Each moderating and boundary factor and its effects on the relative importance of the desirable compensation model features are explained. The data has been largely organized into tables (Tables 9 though 19) for brevity.

Model selection decisions encompassed both a reflection of agencies past experiences with clients as well as a desire to take new relationships to a particular level. Thus agencies were aware that certain moderating factors could reduce the potential negative effect of the absence or presence of a particular feature. The codes of T0 and T1 have been consistently used throughout the section to denote whether the variable would have an immediate or delayed impact on the compensation model decision and client relationship. The following table provides a summary of the features and their impact and these are further explicated in the subsections that follow.

Table 9 Moderating Factors Importance Impact on Desirable Attributes – Beginning (T0) and During Relationship (T1)

| | Low risk | Fairness | Transparency | Simplicity | Flexibility | Results signal | Scalability | High revenue |
|---|---|---|---|---|---|---|---|---|
| **Client knowledge & experience** | | ↑T0 | ↓ T1 | ↓ T0 | ↑T0, ↑T1 | ↓T0, (helps produce better actual results) | | |
| **Trust** | | ↑T0 | ↑T0, ↓ T1 | | ↑T0, ↑T1 | ↓T1 | | |
| **Historical trend** | | | ↑T0 (Current) | | ↑T0 (Current) | | | |
| **Concern for agency reputation** | | ↑T0 | | | | | | |
| **Agency growth mandate** | ↓T0 | | ↓ T0 | | | ↑T0 | | ↑T0 |
| **Externalities** | ↑T0 | ↑T0 | | | | ↓T0 | | |
| **Agency influence** | ? | ? | ? | ? | ? | ? | ? | ? |
| **Client influence** | ↓T1 | ? | ? | ? | ? | ? | ↓T0, ↓T1 | |
| **Agency experiential knowledge** | ↓T1 | | | | | | | |
| **Competitive environment** | ↓T1, ↓T0 (not currently) | | | | | ↓T0 | | |
| **Time constraints** | | | ↑T0 | ↑T0, ↑T1 | ↑T0 | ↓T0, ↓T1 | ↑T0 | |
| **Goal type** | | | | | | ↑T0 | | |
| **Budget constraint** | ↑T0 | ↑T0 | | | | ↓T0 | | |

*Impact of all variables denoted as a higher degree of the moderating factor leads to the denoted weighting.

***Contract Negotiation - Client Preferences, Negotiation Power, Experiential Data & Competitive Environment***

This section groups together a large number of moderating factors that were found to have similar effects. Table 10 summarizes the effect on specific feature evaluation in the beginning of the relationship (T0) as well as when the relationship progresses (T1). An upward or downward arrow denotes the increasing or decreasing importance of an attribute. Unaffected attributes are not included. The section below further explicates the feature evaluation and context.

Table 10 Agency vs. Client Negotiation Influence, Competitive Intensity & Agency Experiential Knowledge Effect on Feature Valuation

| **Attribute emphasis & effect** | **Rationale** | **Quotes** |
|---|---|---|
| ↓↑Any agency specific feature preferences | Agencies suggest their influence on model selection is generally higher than clients' due to agency's perceived role as model experts. | ---*'Clients usually provide very little thoughts or requests on what model should be used… Very little feedback on what model they have previously used or so forth. After a first meeting they may request an offer and we decide on a model. After we send it to the client they may come back to us to discuss the rates' (Case 4).*<br>---*'Clients rely on our advice on model selection to understand what the models are' (Case 6).*<br>---*'Only 1/20 clients ever instigate a compensation model negotiation' (Case 8).* |
| ↓↑Any client specific feature preferences | Agencies varyingly accommodate client preferences. Specifc client preferences are suggested to be rare. | ---*'We don't have to place models while being blind, we usually meet with the client a couple times and we try to map their needs and challenges and based on these assess what is the easiest model for them...Often we ask, which model would they prefer. The client will usually somewhat respond a couple that might be most preferable to them' (Case 5).* |
| Scalability<br>↓T0, ↓T1 | The total scope and volume of advertising reduces agency total risks and agencies that gain a larher scope may be willing to make more client specific adjustments either in the beginning or as the relationship progresses. | ---*'If the client has a really large scope of digital services (SEO, emails etc.) we might agree on a discount on their SEM services when the client as a whole becomes more profitable and less risky. We also get efficiencies when we not only analyze and monitor SEM performance but a larger scope of digital traffic' (Case 4).*<br>---*'If there is only search, we need to calculate the profit very tightly just for that but if there is others then the profit is calculated more as a whole' (Case 3).* |
| Low Risk<br>↓T0 (competition)<br>↓T1 (client influence, experiential knowledge reduces uncertainty) | Increased competition could make the agency need to compromise or at least reconsider its own risk bearing preferences in the beginning or as the relationship progresses.<br><br>Agency experiential knowledge gathered over time with the specific client reduces uncertainty and the agency may be willing to bear more risks over time (T1)* Agencies seldom seek risk themselves so client influence is also usually involved before the agency assumes risk. | ---*'Another option is that we also look at the competitive situation and think about how our model plays with the competition' (Case 5).*<br>---*'Finnish agencies have not been willing to take on models that assume that much risk and are so complex and difficult to setup' (Case 7).*<br>---*'Clients hardly ever ask for them [performance-based models]' (Case 2).*<br>---*'We are actually always ready to move towards a partially results based model but we need at least 3 months of our own data to establish the correct metrics levels….' (Case 7).**<br>---*'After a while, if we believe that the scope of the clients' SEA should increase, we might suggest a higher monthly fee. Then a client may come back to us with a counter-offer saying that the increase of scope could be achieved through a performance bonus such that we will receive the bonus, if predefined goals are exceeded' (Case 4).** |

The interview findings reveal that the SEA contract negotiation process usually involved the agency meeting with their prospective client once or twice to discuss the client's needs. Larger client cases where the client held a bidding competition and submitted project specifications for what they wanted from the agency were suggested to be fairly rare (Cases 2 & 5). Thus the majority of agency contract negotiation work involved the agency evaluating the client's needs and submitting an offer to match the expected workload evaluated by the agency (Cases 2 to 8). The clients' participation in negotiating the selected compensation model was agreed across cases to be small. Agencies usually only sought client's input on the selected model to discover whether they had any particular preferences to accommodate. Model selection was thus usually based on expert recommendations made by the agency (Cases 3 to 7) or then entirely dictated by the agency's only model used (Case 1, and mostly also Cases 2 & 8 that usually only used the one fixed fee model). In the model selection process, agencies would discover whether they had any particular client preferences (bias towards a model or desirable feature) they needed to accommodate. Thus the focus of the initial contract negotiation process hardly ever focused on the contractual model itself but the rates and work scope within a model, which was usually recommended by the agency. All studied agencies reported that contract modifications within a specific compensation model (such as percentage commission, hourly fee) were frequent.

In general, the scope of a client's whole advertising was described to affect the contract such that if the client only wanted a narrow range of services, the agency would need to meticulously calculate that its profit was maintained at a certain level. If the client however also had other advertising such as display and social media, an individual contract could contain leeway to account for the client's desired activities as a whole.

Changes from one compensation model to another, over time, were found to be very infrequent and irregular apart from the general trend of gradually moving away from the traditional commission model. Also Case 7 had a common practice of frequently introducing the idea of performance bonuses in the beginning of the client relationship where it would take effect after 3 months into the relationship. Other agencies reported little to no changes or highlighted other changes in the account management work such as digging deeper into high potential accounts industries in order to justify a higher fixed fee (Case 2). Case 1 similarly reported that as the length of the customer relationship increased, it would increase its account management activities; the agency had even sent one of its client's to an industry conference at the agency's expense. The objective of increased account management activities was to retain the client and maintain their level of perceived value. Case 1 also reported that because most of its campaign building & set-up activities (value adding activities) were carried out during the first year of the client relationship, it would often decrease its percentage of media spend commission as its ability to add value to the client at the same rate reduced.

The level of competitiveness in the market was found to have an effect on agencies valuation on their need to bear risks. Essentially the agencies reflected that should competition be fiercer, they might need to consider bearing more risk. Notably, this was not currently perceived to be the case. Moreover, agencies that accrued more experiential knowledge over time through working with a client were willing to consider bearing more risks as the agency had a better idea of established performance levels so uncertainty was not as high as in the beginning of the relationship. Also, client negotiation power and tactics were found to, at least at one agency, have influenced the agency to bear more risks as Case 4 introduced a performance bonus instead of a higher fixed-fee as a means for expanding a client's account later on in the client relationship.

***Historical Trend***

Compensation models in search engine advertising were found to have experienced trend changes over time such that some models were dominantly prevalent, being offered at certain times due to certain features becoming more or less important over the years. The general historical compensation trend echoed by several agencies (Cases 5, 7, 8) is summarized in the below Table 11.

Table 11 Historical Pattern of Compensation Models in SEA & Effect on Feature Valuation

| Time period | Model | Attribute emphasis & effect | Rationale | Reasons for deviation from norms |
|---|---|---|---|---|
| - 2008 | Traditional commission | ↑ Simplicity<br>↓ Transparency | • Traditional commissions had been the prevailing trend in advertising where simplicity was the norm. | • Intransparent. Media budget inflexibility. |
| 2008-2012 | Fixed fees & performance (variations) | ↑ Results signal<br>↓ Low risk | • Traditional commissions began being replaced by fixed fees and performance model variations (CPA or model and CPA-based performance bonus).<br>• General distrust in SEA as a new industry – high performance expectations. Focus on signaling results. | • Traditional commissions began being replaced by fixed fees and performance model variations (CPA or model and CPA-based performance bonus).<br>• Agencies had bad experiences with performance-based models. Models require e.g. agency taking risk and compromising on flexibility. |
| 2012 - | Fixed fees, time bank | ↑ Transparency<br>↑ Flexibility | • Fixed fees and time-bank as the new norms in a more mainstream industry. | • Increasing movement towards transparency being more important for clients and flexibility when digital is growing quicker than traditional media. |

***Client Knowledge & Experience***

Client knowledge & previous experience in digital marketing, SEA and working with agencies was also found to have varying effects on the client relationship and compensation. Table 12 summarizes the effect on feature evaluation in the beginning of the relationship (T0) as well as when the relationship progresses (T1). This is followed by a further contextual description below.

Table 12 Client Knowledge & Experience Effect on Feature Valuation & Relationship

| **Attribute emphasis & effect** | **Rationale** | **Supporting quotations** |
|---|---|---|
| ↓Transparency (Less pressures), T1 | Knowledgeable clients can read results. | ---*'Working with people who know how to read results is easier. We just want to communicate how much revenue they got an at what cost, which is their profit' (Case 1)* |
| ↑Fairness (Agreement on importance), T0 | Knowledgeable clients are increasingly willing to pay a fair price. Higher knowledge levels typically correlated with larger clients. | --- *'Savvier clients understand that time equals money and if they want to get results, they will not come for free or in an hour or two per month' (Case 3).*<br>---*'Smaller clients may sometimes think that a lower fee makes it cheaper not seeing that it will also limit the potential of the account… This is not a problem with the larger accounts probably because there are dedicated people responsible for search engine marketing and they see our side of the story as well...they have more experience on how it all work in general...'. (Case 4).*<br>---*'Large clients do not push down fees because they may often have personnel who have either worked with an agency for a long time or have actually in the past worked at an agency themselves. This is because they have seen both sides and understand how it works for both sides' (Case 5)* |
| ↓Simplicity (Less pressures), T0 | Knowledgeable clients are able to cope with more complexity. | *(See above)*<br>---*'The fact that the client was an intelligent buyer makes it obviously easier to talk to them and do sales with them...We tend to have a broader scope with them' (Case 2).*<br>---*'If the client is not knowledgeable or responsive, it is difficult for the agency to push things and do as much as we can at our end, it just won't work' (Case 5).*<br>---*'Sometimes it can be frustrating if the client wants multiple things at the same time, like okay now there is just this specific small sum and the client wants to always be at the top slots of search, with a specific CPA…The variables fight against each other and cannot be optimized at the same time' (Case 2).*<br>---*'The reason we want this model [performance bonus] is because it also makes the client commit to certain results. If we don't nail down the metrics, the client may change their mind' (Case 7).* |
| Flexibility (High knowledge), ↑T0, ↑T1<br><br>Flexibility (Low knowledge) ↓T0, ↓T1 | Higher client knowledge correlates with increased scope & volume requiring more flexibility (work content, workload, goals).<br><br>Flexibility in individual KPIs is a challenge for agencies. Inflexibility may even be preferable with clients with low knowledge because it requires the parties to set aside time to agree on the metrics. | |
| ↓Results signal, T0 (Less important, overall easier to produce actual results) | Knowledgeable clients have the ability to demand more from their agencies (more pressures) but they were also described to understand the challenges with attribution and thus preferred non-performance models.<br><br>A more knowledgeable client also helps their agency focus on the right things and eventually produce better results (regardless of the selected model). | ---*'If you know more about search, you can obviously assess the quality of the work better and demand more' (Case 3).*<br>---*'A more knowledgeable client who is very informed is ready to go beyond a last click attribute on model to thinking about attribution within a wider context. With savvier clients when we move away from last click instant results to thinking more strategically about customer lifecycles, our compensation models actually move away from results. Then the KPIs must be different' (Case 7).*<br>---*'Clients like the wrong numbers. A lot of work on having to educate customers on what is a conversion and other basic things' (Case 6)*<br>---*'A knowledgeable client can focus on the right metrics for their firm' (Case 2)*<br>---*'A client that is not quite up-to-date with this world will be difficult to get through that we would do the right things for them. Then we will be locked in doing what was best practice in 2008 and that is the challenge' (Case 7).* |

Client's experience of working with agencies was frequently described to help the agency perform to a higher standard and enabled the agency to more easily reach a model that was mutually fair. This client knowledge could be gained either during the current relationship or the client's previous agency relationships. Pressures for lowering fees were usually described to only stem from small to medium sized clients as opposed to large clients. These smaller clients were suggested to not be able to understand the activities enabled by the appropriate fee unlike larger clients who often employed dedicated digital marketing experts. Client's understanding and digital knowledge enabled them to both demand more from their agency, engage their agency better and as a byproduct motivate their agencies to better results. Most notably, higher knowledge levels correlated with larger clients who often used a broader scope of advertising thus passively emphasizing more flexibility. Client knowledge could already exist at the beginning of the relationship or developed over the course of the relationship. Client knowledge enabled a broader scope, which also required increased flexibility. Moreover, less pressure for taking on risker performance-based models came from more knowledgeable clients who were described to understand the complexity of attribution models.

A recurring tension point in agency client relationships, which stemmed from inadequate knowledge, were issues with key performance indicators; more specifically what level they were at, how many could be achieved simultaneously and also whether clients could commit to keeping them fixed and remembering them. This was stated to be more frequent with clients that did not understand the necessity to select and maintain certain KPIs. The overall consensus was that regardless of the model used, having clear, defined goals was an important part of the agency's ability to deliver results since a "result" is whatever the parties have agreed is a result (Case 1, 3, 5, 7). Several agencies complained about clients often requesting for multiple conflicting goals to be achieved at the same time:

> It's important to agree on a hierarchy of goals, if you want both cheap traffic and conversions with high value then that is just not going to work (Case 3).

Moreover, it was suggested that the KPI disagreement problem existed across multiple stakeholders at the client. Case 1 elaborated on a large client case where 'the CEO wants more profit, the guy below him wanted more revenue, and the person below him wanted more conversions'. A client's failure to align its own stakeholders could even require the agency to sub optimize to keep its clients satisfied because 'in the end, the customer is always right though as experts we have the responsibility to say that in the light of my experience and knowledge, this is not the best thing to do' (Case 3).

KPI alignment was generally suggested to be achieved through communicating with the client to agree on goals. This came at the expense of time investment from both parties.

Aligning goals could be achieved within the domain of any compensation model, however, it appeared that one agency used the performance bonus compensation model specifically for the reason that it created an easy gateway for getting both parties to the complete the time consuming process, which would then help the agency perform to expectations (Case 7). Overall, the findings suggested that the existence of disagreements on KPIs affected the compensation model attribute valuation such that a high degree of disagreement on KPIs made the agencies value inflexibility as opposed to flexibility. Thus it appeared that particularly, though not only, in the presence of clearly definable monetary goals (i.e. correlates with client goal type), agencies in fact value *inflexibility* in models because defined goals are easier to deliver on (e.g. Case 1 emphasizes ecommerce clients & Case 7 is a highly performance oriented digital agency).

### *Trust*

Trust was found to play a crucially important role in agency relationships and compensation. Table 13 summarizes the feature evaluation effects of trust and this is followed by a contextual description below.

Table 13 The Effect of Trust on Effect on Feature Valuation & Relationship

| **Attribute emphasis & effect** | **Rationale** | **Quotes** |
|---|---|---|
| Transparency ↑T0 | Agency wants to signal its good quality by emphasizing transparency in the beginning. | ---*'We are moving toward complete transparency; We work for agreed hours and report on those hours' (Case 7).* |
| Fairness ↑T0, | Clients are treated fairly in the hopes that they would become long-term business. | *'It's all about relationships and trust that helps us in retaining customers and growing them and ourselves in the long-term...The fairness approach is what we hope will eventually differentiate us. There are cowboys out there' (Case 6)* |
| Flexibility ↑T0, ↑T1 | Trust is an antecedent for clients increasing their advertising scope & volume and thus their business with the agency. Agency hopes and anticipates that trust will emerge requiring more flexibility (work content, workload, goals). | ---*'Our goal alignment usually best comes when we have proven to the client that we are worth their trust. The more we prove our value, the more the client will offer us challenge. ... If the client does not trust us, they will not be able to accept what we are offering. If they have not worked with us, they will not accept those ideas… Being a trusted partner enables everything' (Case 5).*<br>---*'Contracts should live more according to the clients actual business needs when projects change and even the client may grow so much that pricing should change' (Case 4).* |
| Results signal, ↓T1 (Less pressures) | Trust (and experiential knowledge) removes pressures from the need to signal agency results producing capabilities through the model itself. The emergence of trust also reduces pressures off the need so deliver *actual results* when the client understands interdependencies between the client and the agency in producing results.<br>Lack of trust means that a performance-based compensation scheme cannot be verified (in the beginning of a relationship)*. | ---*'The relationship eases the tension off of the results. If we have a good spirit together, then results are something that are looked at together: Aha, so this time WE have not been able to achieve as much as we hoped. A good relationship means that problems are faced together, then it's not anyone's fault in particular, there is no blaming finger…' (Case 8).*<br>---*'In my opinion the trust comes from people. Bad results aren't a problem if things otherwise work well and good results are useless unless the client relationship is otherwise functional' (Case 5).*<br>---*'A performance-based system requires trust but the agency is the one that sits on the analytics system. You almost need a third party to validate that there is no abuse' (Case 8)*.* |

The studied agencies were entering into client relationships with the intension of creating long-term partnerships with their clients. The role of trust plays a pivotal role for the compensation model feature evaluation in both the initial and ongoing stages of the relationship: In the beginning when it is absent, but hoped and anticipated to emerge (T0), as well as when the relationship progresses and it became / did not become present (T1). Though the respondent's definition of trust was not explicitly asked for, trust seemed to emerge between agency and client representatives, over time, through the quality and quantity of communication accompanied with results. Important means for building trust in a client relationship were suggested to be embedded in daily activities such as the agency's quick response times, insightful suggestions as well showing interest in building the client's account and demonstrating that the maximum value was being produced to the client at the current expense levels (e.g. Case 1, 3, 7). Most notably, trust was perceived as an antecedent of client growth as only a client that trusted the agency, over time, was going to take the agency's (expansionary) advice. As trust built up, clients would (hopefully grow) and required more flexibility, which needed to be accounted for in the beginning of the relationship. Trust that emerged during the course of the relationship eased the tension off both the need to signal the agency's ability to produce results through the contract type, as well as the actual need to deliver results when the client would become aware of the parties interdependencies in results production. Moreover, a lack of trust in the beginning of the relationship made using performance-based models difficult because their complexity almost required an intermediary to verify that there was no abuse.

***Time Constraints***

Time constraints were found to be an important moderating factor for client relationships. The effects of time constraints on desirable feature evaluation are summarized below in Table 14.

Table 14 Time Constraints Effect on Feature Valuation

| **Attribute emphasis & effect** | **Rationale** | **Quotes** |
|---|---|---|
| Transparency<br>↑T0, ↑T1 | Perceived value was claimed to be only value. Time constraints made agencies prefer models that would easily communicate to the client in simple terms what it is they were getting. | ---*'...it's easy to communicate that it will require X number of hours to do" (Case 7).* |
| Simplicity<br>↑T0, ↑T1 | Time constraints make agencies need to emphasize simplicity both in the beginning sales process as well as when the relationship progresses. | ---*'Developing the model can take up more time than actually producing the service and slows down the sales process (Case 8).*<br>---*'Compensation agreement negotiation takes up a lot of time that we don't want to waste too many times' (Case 7).*<br>---*'Contract renegotiation can takes a lot of time' (Case 1).*<br>---*'Model needs to be easily scaled up or down so the client can easily buy an additional digital marketing service for a couple of months' (Case 6).* |
| Flexibility<br>↑T0 | Renegotiating contracts is highly time consuming thus time constraints pressure preference for contracts that are more flexible from the start. | |
| Scalability<br>↑T0 | Agencies want to limit their time on internal processes. | ---*'Internal processes need to be simple and scalable from client to client so we don't put time away from clients into admin' (Case 8).* |
| Results signal<br>↓T0, ↓T1 | Implementing complex results tracking systems takes up time that neither party has. Clients are unwilling to commit the time to set up performance-based models. | ---*'It [performance-based model] only requires more time and effort from the client side to decide to do it together but then it's a different question whether they are ready to make that decision' (Case 2)* |

The role of communication time in trust building was viewed as extremely important for agency-client relationship success and longevity. The main constraint for transparency and results creation was found to be, in deed, the lack of time. Some agencies pinpointed the most important contributor to relationship success and longevity down to individual person-level chemistry and trust as this was the factor believed to make or break the client relationship (Cases 1, 3, 4, 8). Moreover, clients were suggested to take communication for granted and were hesitant to compensate their agencies for it because it did not directly contribute towards value creation. Furthermore, the paradox that emerged across all agencies was the fact that communication and the resultant client relationship quality superseded the importance for the agency to deliver actual results. Time constraints thus emphasized the need to make the model itself naturally transparent for the client. Clients were indeed argued to be irrational and Case 1 culminated their thoughts on client irrationality and the need for communicating value in this extreme thought-provoking example:

> Remember, doing a good job is just them thinking you are doing a good job; perceived value is actual value. ...What I am finding out now is that it may not be so important to make the client 20k more money, it is maybe more important to get them 10k more and then spend the extra time just letting them know how good you are, what you are going to do, just holding their hand through the whole process.... If we make then that 20k more, they should be very happy but the thing is they won't understand that that 20k was only because you have the great software, you are focusing on profit, you have the AdWords account set up this great way. So what we should rather be doing is that focus less on doing really really well for the client and more on communicating what you are doing and why you are doing it, take them out for a dinner or whatever traditional way of doing it because the clients will not always make decisions based on rational results.

A related frequently suggested strain in the agency client relationship was that the person responsible for and specialized in account optimization was unlikely to be able to have the time to also manage the client relationship to a high level of standard, especially for a large sized account (Cases 3, 5, 7). Case 5 explicated that the need for communicating the value created through SEM and other digital advertising had only recently grown to such a high magnitude as it correlated with the recent rapid growth of digital advertising budgets. The study in fact revealed that several agencies (Cases 2 & 5) were in the early stages of conceptualizing some kind of a new digital account manager role to be a day-to-day middleman between clients and SEM consultants. Moreover, time constraints at both the agency and client ends made the agencies emphasize simple and flexible models that required minimal sales time and input from the client in both the beginning of the relationship and as it progressed. Time constraints also made the agencies focus on scalability to minimize internal admin time.

***Concern for Agency Reputation***

The findings indicated that the studied agencies had a strong concern for their reputation among clients and peers in the industry and that this made them emphasize attention to the element of fairness. The effects of reputational concerns are summarized in Table 15 below.

Table 15 Concern for Agency Reputation Effect on Feature Valuation

| **Attribute emphasis & effect** | **Rationale** | **Quotes** |
|---|---|---|
| Fairness<br>↑T0 | Agencies that highly care about their reputation emphasize fairness for their clients. | ---*'Clients rely on our advice on model selection and understand what the models are. The fairness approach is what we hope will eventually differentiate on us. There are cowboys out there' (Case 6).*<br>---*'It's a small market we care about our reputation and being fair with our clients in every respect' (Case 3).* |

***Agency Growth Mandate***

The study found that agencies seemed to internally have a varying degree of growth desires. Notably, only one of the studied agencies was specifically found to be particularly aggressive about its growth desires (emphasizing the variable of "High revenue") whereas other agencies growth desires were more subtly embedded in the element of fairness (reward/effort & reward/risk). Table 16 below summarizes how the degree to which the agency was seeking aggressive growth affected their attribute evaluation.

Table 16 Agency Growth Mandate Effect on Feature Valuation

| Attribute emphasis, effect | Rationale | Quotes |
|---|---|---|
| Transparency ↓ T0 | The agency that sought high growth was willing to trade of transparency because the client was not expected to know the necessary things to achieve that quicker growth. (Note: That the growth mandate reverses the effect of time constraint on making the model itself easily transparent for communicational purposes.) | ---*'It's a good model [New Commission] because the truth is the client doesn't even know what it is that we should be doing and we need to get there quickly' (Case 1).* |
| Low Risk ↓T0 | A high growth was expected to come with more risk taking. | ---*'We are able to bear a considerable amount of more risks than maybe other agencies because of the scalability element and market diversification' (Case 1).* ---*'After a month the client will be like OK, you did not hit my 5:1 return on investment you only did 4:1 why is that and then we'd get fired… The client can quit us any time, say, even one day in' (Case 1).* |
| High revenue ↑T0 | Agencies emphasis on a desire to gain high revenues and quick internal growth varied based on company preferences. Others addressed this through profitability and fairness concerns. | ---*'We work a scalable business model and we are after significant growth for ourselves and our clients so we need to keep everyone's up-side potential open' (Case 1).* ---*'Time bank has been offered for the past two years for us to maintain our own profitability…We can't put up with unprofitability' (Case 5).* |
| Results signal, ↑T0 (Less pressures) | The agency emphasized its business model's tendency to produce superior results and emphasized the client's ability to leave the agency at any point in time, if results were not delivered. | ---*'We only focus on profit or revenue, nothing else…. It's important to agree in a ratio of return…. We promise a certain return and work only towards that. I can freely focus on the products that have the highest profit impact as that will get us better results, more budget and more commission' (Case 1).* |

### *Externalities*

A number of externalities such as tracking system errors, seasonality and the use of multiple agencies were found to reduce the agency's ability to affect the outcomes of their search engine advertising efforts. These were found to emphasize the sense of fairness, disincentive risk taking and thus reduce the importance to signal results through the model. Table 17 below summarizes externalities effect on feature evaluation.

Table 17 Externalities Effect on Feature Valuation

| Attribute emphasis & effect | Rationale | Quotes |
|---|---|---|
| Fairness ↑T0<br>Low Risk ↑T0<br>Results signal, ↓T0 | Externalities (tracking system failure, heavy seasonality changes, use of multiple agencies) reduce the agency's ability to affect outcomes (Fairness: 3. ability to effect results) making agencies emphasize fairness, unwillingness to take large risks and reduced the importance of signaling ability to produce results through the model itself. | ---*'The Finnish agency landscape is still very fragmented with clients having numerous agencies...there is at least three agencies sitting down in the same meetings. When the landscape is fragmented, this means that everyone has had an effect on each other's results and cannot be held accountable for the results. Using more performance-based models would require consolidation and we are far from it in this market' (Case 5).* ---*'Client wants to set targets to be based on something that isn't actually under our control. ...The performance of the web shop is based on a lot of other things like what they are doing offline like TV, Print and Radio, the campaigns of their competition etc. and that is not fair for us to' (Case 7)* ---*'Seasonality & other media expenditures significantly affect how the client's SEM does as a whole' (Case 3)* ---*'Clients might delete tags off of their websites and then it's difficult to verify results' (Case 1).* |

### *Client Goal Type*

Whether or not the client had an easily quantifiable and meaningful goal was an essential part of whether it was important to consider signaling results and taking on performance-based models in general. Without a monetary value goal, these were deemed less relevant. Table 18 below summarizes how client goal type affects attribute evaluation.

Table 18 Client Goal Type effect on Feature Valuation

| **Attribute emphasis & effect** | **Rationale** | **Quotes** |
|---|---|---|
| Results signal<br>↓ ↑ T0 | The lower the degree of measurability in terms of dollar value goals with a specific client, the less important results signal becomes for that individual client and vice versa. | ---*'They [CPA model] only work for a small segment of clients e.g. banks, travel packages or really simple online sales… there is a clear value at the end' (Case 8).*<br>--- *'It won't work with clients that don't have a clear dollar value related to a conversion' (Case 6).*<br>--- *'CPA based models are not applicable to all kinds of clients so such models are not easily scaled. Conversion volumes or values can be too low to base much on them' (Case 4).* |

### *Budget Constraints*

Budget constraints were found to be a significant factor in attribute evaluation and its effects are summarized in Table 19 below.

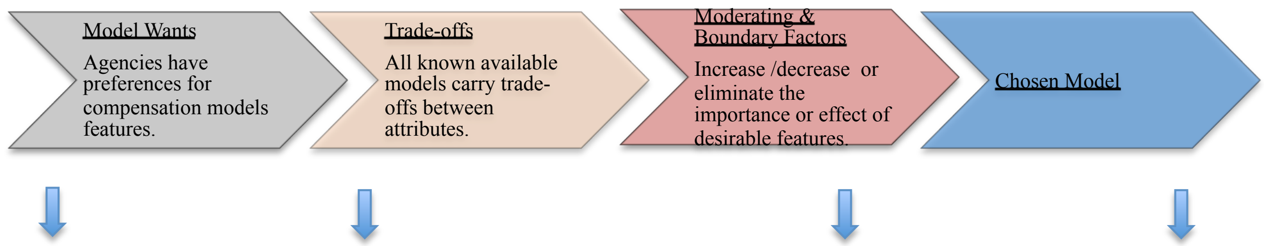
Table 19 Budget Constraints' Effect on Feature Valuation

| **Attribute emphasis & effect** | **Rationale** | **Quotes** |
|---|---|---|
| Fairness<br>↑T0, ↑T1<br><br>Low Risk<br>↑T0, ↑T1<br><br>Results signal<br>↓T0 | Agencies' awareness & experience of client's existing budget constraints mean that they fear that they might not be able to be compensated for the additional risk they assume. This makes them emphasize fairness more i.e. striking a good balance between reward/risk and emphasize fewer results signaling models. | ---*'The truth is, we want clients that are looking for growth and if the client is truly looking for growth we pull the budget taps open for as long as it is profitable .As long as the client has inventory to sell, market demand should determine the budget spent...we just get it at the best possible rate of return on investment...This is usually, though not always the case' (Case 2).*<br>---*'They [budgets] are meant to be uncapped but then they suddenly might not be. This limits the agency's profit potential' (Case 1).*<br>---*'Capped budgets stop the agency from taking more risk because their up-side potential can be limited' (Case 6)* |

Budget constraints were described to be a frequent issue that made performance-based models less attractive, when the revenue potential of campaigns could be limited. Thus agencies believe no appropriate award might be available for taking on more risk. Budget constraints were suggested to stem from clients' traditional way of doing things and this budget irrationality was lamented as it often stopped the agency from producing the results it thought it could have been able to achieve. A capped budget affected agency motivation negatively as it reduced high profit potential as well as the opportunity of growing the agency remuneration under all compensation schemes when the scope of work remained limited. As such, budget constraints were also describe to affect overall agency motivation.

### 4.4 Findings Summary: Agency Compensation Scheme Determination Model

This section summarizes the agency compensation model determination process. No single model was considered optimal and comparing the models against each other involved evaluating the trade-offs to be made between the various desirable features. This evaluation was based on agencies own priorities as well as the presence or absence of moderating and boundary factors. The moderating and boundary factors increased, decreased or eliminated the perceived importance or effect of each desirable feature either before the relationship had begun (T0) or during the course of the relationship (T1). The below Figure 5 illustrates in a model how the various factors affect how compensation models are determined




| | Model 1 | Model 2 | Model X |
|---|---|---|---|
| **Low risk** | Medium | High | Low |
| **Fairness** | Medium | High | Medium |
| **Transparency** | Medium | High | Medium |
| **Simplicity** | High | Medium | Low |
| **Flexibility** | Medium | High | Low |
| **Scalability** | High | High | Low |
| **Results signal** | Medium | Low | High |
| **High Revenue** | Low | Medium | High |

| | Mod. 1: Client knowledge | Mod.2: Competition | Etc. | Model X |
|---|---|---|---|---|
| **Low risk** | | ↓T0 | | Low |
| **Fairness** | ↑T0 | | | Medium |
| **Transparency** | ↓ T1 | | ↑T0 | Medium |
| **Simplicity** | ↓ T0 | | | Low |
| **Flexibility** | ↑T0, ↑T1 | | ↑T0 | Low |
| **Scalability** | | | | Low |
| **Results signal** | ↓T0 | | | High |
| **High Revenue** | | | | High |

*Example: An agency ranks its preferences on the different features and e.g. considers Low Risk, Flexibility, Scalability and Simplicity particularly important leading it to prefer either Models 1 or 2. Moreover, though Model 3 scores low on the desired attribute of Low Risk, the existence of particularly high Competition in the market means the normal preference for low risk might become less important and take precedence over other desirable features.

Figure 5: Agency Compensation Scheme Determination Model

# 5 DISCUSSION

The empirical contribution of this study is a process model for SEA contract selection that identifies the desirable and moderating features of compensation models and their boundary conditions. The study's theoretical contribution lies in revealing when, where and how different theoretical lenses have explanatory power in the chosen context. The section begins with an initial discussion of the found compensation models. This is followed by an analytical dissection of the desirable and moderating features of compensation schemes. The final part ties the section together with tables and a discussion that synthesises the empirical context with the principals of agency theory, both in the initial and progressive stages of agency-client relationships.

## 5.1 Compensation Model Analysis

The study revealed a number of compensation models being used, mostly echoing that models used in traditional advertising were also applied to the SEA context. An important issue to revisit is the question of what actually constitutes behaviour versus an outcome-based compensation model, especially considering that this has already previously been found to be an issue of definition and debate (see Spake at al., 1999; Ellis & Johnson, 1993). Since nearly all of the studied agencies were found to be operating with contracts that could be easily dissolved within a short time, ranging from only days to a couple months, it could be argued that all of the contracts in SEA agency work are somewhat outcome-based: A client that is not satisfied with the results can dissolve the relationship fairly quickly since unbundling various online and offline advertising services between agencies was common. This seems especially true when the switching costs of a search engine advertising agency relationship seem considerably lower to that described by previous authors who studied creative agency work switching costs (Davies & Prince, 2010), where the client cannot similarly leave an agency with a built-up, fully functional AdWords account that may or even may not require continual management.

The study revealed a completely new compensation scheme hereby named as the new commission scheme. Categorizing this scheme seems particularly difficult as the fee itself is based on media spend (behaviour-based), however no actions are detailed while the results must be within a specified return or the agency can be dismissed at any point in time (outcome-based).

The new commission scheme seems to be the first empirical account of a close variant of the theoretical 'IRB' compensation model conceptualized by Abou Nabout et al. (2012) briefly discussed in the literature review. Some clear differences do however exist. The new commission seems to, in fact, go beyond the conceptualized IRB model, as the use of automation solves the budget and bidding problem by removing human influence and letting the market and client profitability data direct optimal bidding and investment levels for ecommerce clients. Another key difference is also that the IRB bases the agency's compensation on the profit of the client whereas the new commission bases the agency's compensation on a percentage of the client's media spend. As such, the theoretical scheme could be considered still slightly more performance-based than the discovered empirical scheme. A merge of the two schemes, with the commission of the new commission scheme being based on the profit as opposed to the media spend, could result in the ultimate performance-based model for performance driven ecommerce clients. Notably, this model was found to be highly inflexible and unable (a least without modifications and increased complexity) to accommodate for anything but performance SEA goals. This means that though it poses an interesting new opportunity for ecommerce advertisers, it is still not a complete 'holy grail' for advertisers seeking to expand into branding goals as well. This study serves to paint a more holistic picture of the multiple complex factors that alone and in conjunction affect the compensation model decision. As such, it reveals that it may be more practical for clients to focus on comparing the complete set of trade-offs between various models and assess what meets their firm's specific requirements at a certain point in time instead of putting too much emphasis on wanting to compensate based on results or behaviours.

Comparing the use of the various schemes across the types of agencies studied (see Table 6), the findings suggest that compensation scheme usage correlates with the history of the agency as well as the scope of its offerings (e.g. media agencies have a history of using commissions). This indicates that SEA cannot always be examined in isolation. Notably, the trend of which models being offered by each agency type seem to be diminishing as most agencies (Cases 2-8) conform either towards the fixed-fee or time-bank schemes. Literature suggested that advertising agencies typically shy away from fee-based models because of the complex and synergistic nature of advertising that involves high degrees of creativity (Seggev, 1992: Zhao 2005; Lace, 200). This does not seem to be an issue of equal importance for search engine advertising as the nature of the work is significantly less complex and creative compared to creative agency work. As such, the fee is seems to be deemed appropriate. Previous studies also called for more in-depth studies on hybrid compensation models i.e. models that encompass both behaviour and outcome based elements (Spake et al. 1999). This study reveals that their application in SEA services is currently at a very low level and seems to be driven by the importance and emphasis on the desirable feature of simplicity.

## 5.2 Discussion of Empirical Variables

The following Table 20 summarizes the theories used to explain the desirable features and moderating factors of compensation models and these are analysed in more detail in the upcoming section.

Table 20 Theoretical Groundings of Desirable Features and Moderating Factors

| **Desirable Features** | **Moderating Factors** | **Theoretical Explanations** |
|---|---|---|
| Low risk<br>1. Agency profit<br>2. Client budgeting<br>3. High Revenue | Agency growth mandate<br>Budget constraint,<br>Competitive environment | Agency Theory, Prospect Theory,<br>Transaction Cost Economics |
| Fairness<br>1. Reward/effort<br>2. Reward/risk<br>3. Ability to affect results | Concern for agency reputation | Agency Theory, Stakeholder Theory,<br>Relationship Marketing, Trust Literature |
| Results signal | | Agency Theory |
| Flexibility<br>1. Work content<br>2. Workload<br>3. Multiple client goals<br>Simplicity<br>1. Agency profit calc.<br>2. Client budgeting<br>3. Client understanding<br>Transparency | Time constraints | Agency Theory, Transaction Cost Economics |
| Scalability | | Economies of Scale |
| | Client knowledge & experience | Agency theory (partially explained by task programmability) |
| | Client negotiation influence<br>Agency negotiation influence<br>Historical trend & Experience | Negotiation Theory,<br>Trust literature,<br>Institutional theory, Path dependency |
| | Client goal type<br>Externalities,<br>Agency experiential knowledge | Agency Theory |
| | Trust | Trust literature, Relationship marketing |

***Compensation Model Negotiation, Client Knowledge & Experience, Historical Trend & Agency Experiences***

Previous research had called for more investigations into the meaning of negotiation procedures in compensation model determination (Spake et al., 1999). Contrary to core agency theory literature, the findings of this study suggest that agencies have a considerably more active role in the compensation negotiation and model selection than merely accepting or rejecting an offer as had previously been assumed by multiple authors (Bergen et al., 1992,: Spake et al, 1999; Zhao, 2004; Davies & Prince, 2010). This finding provides tentative support for the decade old claim by Zhao (2005) that the full spectrum of compensation models may (still) not be accurately understood by both parties.

The phenomenon of agencies suggesting models could be explained by trust literature through the existence of *general trust,* meaning that there exists confidence in the agency through its reputation even before any actual interactions or performance takes place (Halinen, 1997). The phenomena could also be explained by negotiation theory whereby special knowledge and expertise can serve as the source of power (referred to as expert power) for one party to have its will be done over another's in a negotiation situation (Kim, Pinkley & Fragale, 2005). Moreover, as agencies claim they have knowledge about the models and were found to usually make the first model suggestion, this could also to be triggering what negotiation theory refers to as the anchoring effect whereby the first offers act as anchors and have an 85% correlation with final outcomes (Galinsky & Mussweiler, 2001). It should be noted that this negotiation flow does not necessarily mean that agencies have an upper hand in the overall negotiation proceedings since any given contract can still be highly efficient as clients were suggested to frequently discuss rates *within* a specific mode. A client could thus still be getting bargain rates within a proposed model such as a low fixed-fee. The implication of this finding is however that agencies' own preferences, particularly for scalability across clients (discussed in more detail later), which primarily only benefits the agency, could be perhaps even subconsciously taking precedence over unique client needs i.e. flexibility within an individual client. The question that then follows is whether a client who is offered a fixed-fee might have considered themselves to be better served by a time-bank model, which some agencies might be less prone to suggest due to its administrative implications for the agency. The main trade-off between the fixed-fee and time-bank models is reduced simplicity to gain more flexibility (see Table 8). The time-bank model is less simplistic for both parties yet the administrative burden falls harder on the agency side to keep keep track and communicate the activities and work completed.

Moreover, the study revealed that agencies seem to have a tendency to fixate on only a small number of models and adhere to the models that clients expect. This phenomenon seems to not only be explained by scalability but also by the institutional theory perspective whereby agencies adhere to normalized industry practices (Eisenhardt, 1988) because these demonstrate its legitimacy (Zucker, 1987).

Furthermore, in terms of compensation model determination, the competitive situation suggested that few agencies were pressured to offer performance based models. As such, a client's ability to enforce a performance model request in the beginning of a relationship would be unlikely to succeed. However, as the relationship progressed, a reduction in uncertainty through agency experiential knowledge, made agencies willing to consider a performance-based model. For the majority of cases (all but Case 1 and Case 7) performance-based models were not being actively offered by agencies, so a key determinant for these to be assumed is that the suggestion must come from the client. This seems to be in accordance with agency theory as agent's are suggested to prefer behaviour-based models and thus unlikely to suggest otherwise. Moreover, though Ellis and Johnson (1993) speculated that contract tailoring and hybrid models could serve as a source of potential competitive edge for agencies, it seems that all apart from one agency (Case 7), do not view this potential as particularly lucrative. This seems to stem from all the trade-offs associated with the performance bonus model summarized in Table 8.

The moderating factor of client knowledge seems to mostly relate to agency theory as existing somewhere between task programmability and information assymmetry yet it is not accurately captured by either. Task programmability focuses only on the nature of the task itself as being either dynamic or static thus affecting how difficult and costly it is to set up monitoring for the task (Eisenhardt, 1985). As such, it's most stringent definition does not account for the participants' *understanding* or *experience* of how programmable a task is. Moreover, the element of information assymmetry mainly examines the principal's different levels of knowledge of the agent's behaviours and the costs associated with getting this information (ibid). Thus it does not accurately capture the notion that over time, the principal may not only have a better understanding of the agency's way of working but also a developing understanding of the task itself. In summary, the elements of agency theory cannot accurately account for either participant's initial or growing experiential knowledge of the nature of the task over time. The findings of this study indeed suggest that client knowledge of the task improves over the principals' experience gained through both firsthand AdWords experience as well as experience gained through previous and current agencies. A significant factor also seems to be that both clients and agencies' previous experiences can be either positive or negative and this experiential baggage may be carried over into future new agency-client relationships. This was suggested to be the case in regards to performance-based models whereby both agencies and more experienced clients avoid performance-based models due to awareness of the issues associated with them. This phenomenon could be explained by path dependency whereby previous experiential history influences future decisions in complex environments, even when previous circumstances no longer prevail (Koch, Eisend & Petermann, 2009). Considering the high compensation model concentration on only certain models, this indicates that path dependency may be a significant decision making factor for both clients and agencies alike. Moreover, the study revealed that agencies had fewer problems with agreeing on and maintaining KPIs with clients that had a higher level of knowledge. This finding is in keeping with agency theory, which sugges that that goal conflict is indeed reduced by less information asymmetry between the parties (Spake et al, 1999) adding, however, that this can already pre-exist in the beginning of the relationship and not only as a particular relationship progresses.

Interestingly, the element of client knowledge and experience seems to be following what the porposition of task programmability would predict (see Table 4). The findings suggest that clients with particularly low levels of knowledge and experience in SEA (typically small clients) were more likely to request outcome-based compensation models. The study also finds that the opposite is true: a higher degree of client knowledge results in the higher use of behaviour-based models as clients that were described to be highly familiar and experienced with SEA were argued to prefer behaviour-based models. As such, client knowledge levels seem to follow the same pattern as what the proposition of task programmability would predict though the above discussion emphasizes that the two cannot be taken as synonymous.

### *Simplicity, Flexibility, Transparency & Time Constraints*

The moderating factor of time constraint and related desirable features of simplicity, flexibility and transparency seem to be explained by agency theory and more specifically through its roots in transaction cost economics (Arrow, 1969; Williamson, 1985). In the beginning of the relationship, under circumstances of information asymmetry, agencies will prefer models that will minimize time expenditure costs that go into contract negotiation. A simple model is preferred because it is an easier and quicker sale that minimizes time costs for both to communicate and understand the contract scope. Some agencies were also taking negotiation time further into consideration longer down the line through the element of flexibility (e.g. through the time bank model), which then allowed them to minimize negotiation time expenditure also later in the relationship. Moreover, the preference for transparency in contracts is directly explained by agency theory whereby a model that allows for clearly communicating what actions are being taken is preferred as this will reduce monitoring costs for clients.

The need for flexibility warrants further discussion as it is an important consideration for efficient contract determination for the SEA context. This is because flexibility involves examining the nature of the work and amount of effort required at various stages of the relationship. For the purpose of efficient contract determination, the study suggests that the nature of SEA is such that it may experience diminishing marginal returns, whereby an agency can add a considerable amount of value in the beginning but less as the account becomes more developed (Case 1). The implication is that the required workload reduces considerably over time unless there is something in the nature of the client's business, which requires considerable changes, or then there emerges a large new feature up-date for AdWords, demanding more work. The study included a number of different agencies (SEM, Digital and Media) in order to provoke differences between their service offerings. Based on the study, it seems that agencies stabilize the issue of diminishing marginal returns by broadening the total scope of overall services offered to the client over time. This enables them to justify either growing the account and agency remuneration, or then maintain the fee at a stable level. Overall, the findings indicate that regardless of the model being used, clients should carefully consider what rate they are paying at each stage with varying levels of effort and added value. Key to this is maintaining contract negotiation terms such that this is possible or then selecting a model that allows for easy adjustments.

***Low Risk, High Revenue, Competition, Agency Growth Mandate***

The findings related to agency and client risk preferences reveal both alignment and deviation from what agency theory would predict. On the agency side, the majority of agencies were indeed found to follow the classic model of what agency theory would predict. These agencies were risk averse and there was no indication that this risk aversion would not remain stable over time as has been suggested (Eisenhardt, 1989: Eisenhardt 1985). Consequently, it seems that very little portfolio risk diversification, beyond merely having a large client base, was taking place. This seems to be contrary to what previous scholars had assumed to be the case in advertising (see Davies & Prince, 2010). Moreover, these agencies would only accept risk should the competitive environment require them to do so (Ellis & Johnson, 1992). This was evident from the domineering preference for models that were deemed to be high in, the desirable feature, of low risk as well as the complaints that clients were unwilling to compensate the agencies for risk transfer should either party suggest a performance-based model. The findings however revealed that these same case agencies were not indicating a particular preference for high revenue (only fairness i.e. reward/risk or reward/effort) and high revenue was explicitly emphasized by only one agency, the new market entrant Case 1. This contrasting finding revealed that a more accurate explanation for the apparent phenomena could be provided by prospect theory whereby the majority of the studied agencies were in fact loss minimizers as opposed to profit maximizers as has been previously suggested could be the case in social settings (Cuevas-Rodrigues et al., 2012; Mukherji & Wright, 2002). Moreover, only Case 1 seemed to have what was labelled as a high growth mandate in the empirical model, which was leading it to be willing to take a higher amount of risk. Thus, the profile of this agency seemed to fit that of a prospecting strategy whereby the agency was seeking new markets and willing to assume more risk due to strategic reasons (Miles & Snow, 1978 referred to in Cuevas-Rodrigues et al. 2012). Overall, the findings suggest that for the specific context of SEA, it is sufficient to examine agency risk preferences on the agency level as opposed to take it to the individual agency employee level. However, considering the qualtiative nature of the study, it should be noted that the other agencies may also have implicitly considered high revenue to be an ouctome of the other models.

Prospect theory also seemed to have further explanatory value in explaining client-side risk aversion. On the client-side, the study revealed that clients, too, were described to be highly risk averse but that this had experienced changes over time: Clients were argued to be no longer as systematically concerned about the value of AdWords advertising, resulting in less performance-based compensation models being demanded of agencies in more recent times. This further supports the notion that risk preferences can vary over time based on contextual factors (Kahneman & Traversky, 1979). Furthermore, contrary to agency theory predictions, the case agencies' descriptions of client risk aversion revealed that client's risk utility curves seem to also have similar characteristics to that of agencies: Risk averse clients preferred behaviour-based models (fixed-fees and time-bank) because these mitigated the risk of sudden changes in the client's marketing budget for both agency fees as well as media expenditure. This agency theory anomaly and resulting similarity in risk utility curves seems to be explained at least partially by the limiting contextual factor of budget constraints; clients in the real-world do not have a running budget tap even if advertising were successful. Too much unexpected success is thus even perceived as a problem and requires agency fees and media expenditures to be more or less accurately predictable.

***Client Goal Type, Agency Experiential Knowledge, Externalities***

The moderating factors of client goal type, agency experiential knowledge and externalities are clearly explained by and in line with agency theory: The more measurable the outcome and the higher the effect the agency believes it has over the outcomes, the more likely it is for outcome-based compensation models to be used (Eisenhardt, 1989; Spake et al. 1999: Ellis & Johnson, 1993). The empirical findings however suggest that the underlying drivers may not only be purely economical agency costs and risk calculations but an overall sense of fairness. This is perhaps more accurately explained by stakeholder theory (Cuevas-Rodrigues et al., 2012).

***Scalability***

A compensation scheme's desirable attribute not explained by agency theory is the agencies preference for models to be scalable across their client portfolios. Agencies' drive for scalability across clients can be seen to be primarily motivated by the basic economic and accounting principle of economies of scale whereby it is desirable for a firm to limit variance in order to minimize its total average (service) production costs (Silberston, 1972). Scale and scope economies in keeping overall agency costs low have previously proven to exist within individual accounts as well as being found to be an important factor for agencies (Silk &

Berndt, 1993). In essence, the cost savings achieved through agencies' scalable operational model could be enjoyed entirely by the agencies themselves in the form of higher profit margins. It is, however, also possible that internal scalability also helps maintain low costs to an agency's entire client base. Thereby clients could also experience scalability as an indirect benefit. Compensation model determination is a multivariate decision, so considering the dominant importance of low risk, it could be that the scalability preference is a convenient by-product, simultaneously fulfilled by the higher importance of other factors such as flexibility.

***Results Signal***

The desirable feature of results signalling seems to be explained by the hidden information model of agency theory (Bergen et al., 1992) whereby an agent engages in activities that reveal its nature and capabilities to the principal. Echoing the suggestions of Crain (2010) the study revealed that emphasizing the characteristics of a compensation scheme itself could be used in the sales negotiation process to reinforce an agency's message of its ability to deliver results. Conversely, other models that did not signal accountability were suggested to even serve as a negative signal should the conversation move too far from results to discussing working hours.

***Perceived Fairness & Concern for Agency Reputation***

The desirable feature of fairness as well as the moderating factor of concern for agency reputation can be seen to have multiple theoretical explanations. When broken down into its constituents (reward/risk, ability to effect results, reward/effort), it is seemingly explained and in line with agency theory: The agent is only willing to take on client risks, if a premium is offered for the risk transfer, the agent must be able to have a clear affect on outcomes, and an efficient contract does not under or over compensate the agent (Ellis & Johnson, 1993). The last part however requires additional theoretical explanation because though the element of reward/effort meant that risk averse agents want to make sure that they are adequately compensated, the same agencies suggested that they would feel obliged to also return a part of the fee, if they perceived themselves to be largely overcompensated. Moreover, the importance of this desirable feature increases as the agency becomes more concerned for its reputation. These joint findings are indeed not explained by agency theory, which assumes that an agency is only motivated by self-interest and focused on maximizing its fees and minimizing its efforts (Eisenhardt, 1989; Coughlan & Sen, 1989). This deviation could still be partly explained by agency theory itself when a short-term profitability time horizon is replaced by a long-term time horizon: Risk averse agents want *long-term* business, which is making them act in ways that will minimize their risk of losing the client. A further illustrative explanation could be offered by combining relationship marketing theory and stakeholder theory. Stakeholder theory explains how agents as social beings generally value relationships, justice and fairness in their business dealings (Cuevas-Rodrigues et al., 2012) and relationship marketing clarifies how emphasizing the relationship is not necessarily mere altruism, but that being in a relational mode can be motivated by this being profitable for the firm (Grönroos, 1997). This seems plausible especially considering that it is generally more costly for a firm to acquire new clients than maintain existing ones (Grönroos, 1990). The findings of this study support the notionsince several agencies emphasized the existence of a high quality relationship and trust as being the key to the agency being assigned more work and challenge. This interpretation is further supported by previous empirical findings that a sense of justice affects advertising agency and client commitment to their relationships (Davies & Prince, 2010).

***Trust***

Trust was overall found to be an important moderating factor for advertising agency relationships and compensation models. In terms of classifying the agencies relationship marketing strategies, it seemed that all agencies were in a *relational mode* (Grönroos, 1997), whereby they believed that creating high quality long-term relationships was a profitable business. Even Case 1, which desired to operate a more scalable business was beginning to realize the importance of fostering the relationship to ensure its longevity. As such their behaviours were accordingly focused on creating perceived value as was suggested to be important (Grönroos, 1997). All the agencies stressed the importance of perceived value resulting from both the core value as well as the added value activities of customer service and communicating the value creation process itself.

Trust played an important role in determining agency compensation models at each step of the relationship. The findings from Case 8 corroborate the claims of Spake et al. (1999) who maintain that the absence of trust is an impediment to the adoption of performance-based compensation in the beginning of a relationship: Tracking systems may be so complex that they require a high degree of trust especially, if the tracking system is managed by the agency side. This phenomenon in not captured by agency theory, which assumes that a performance-based compensation model is indeed preferable particularly in the absence of trust (Eisenhardt, 1989).

As the agency-client relationship progressed, trust enabled growth, which made flexibility more important to accommodate growth. Adding in a multitude of additional media and various branding and performance goals thus also made outcomes less easy to ascertain. As such, the emergence of specific trust i.e. trust that emerged through interactions (Halinen, 1997), over time, could indirectly lead to reduced outcome measurability. This type of causality is outside the predictive capabilities of agency theory.

Interestingly, the findings of the study do not directly support the proposed link between agency theory and trust literature whereby trust reduces monitoring costs in principal-agent relationships (Beccera & Gupta, 1999). This is deemed to be the case because regardless of what compensation model was being used or whether the relationship had high or low trust; agencies constantly faced the need to spend a large amount of their time reducing information asymmetry by communicating value to their clients. This involved communicating both what *actions* had been taken and what *results* had been achieved because clients want to hear about both agency efforts as well as results. As such, the finding indicates that if agencies are in a relational mode and seeking to build and maintain trust, both behaviour-based and outcome-based contracts involve a high degree of monitoring costs to the client. This finding is contrary to agency theory, which assumes that monitoring costs and cost of measuring outcomes and risk transfer are on opposite sides with one that focuses only on verifying actions and another on verifying results (see Figure 1 by Eisenhardt 1985). As a theory based on economic and bounded rationality, agency theory does not accurately capture the important difference between perceived value and actual value as well as how it affects the relationship. Essentially, for a client to make an outcome-based compensation model truly efficient, it would need to signal to its agency its desire to have a purely transactional mode relationship and then expect nothing more than a numerical report. It seems that especially Case agency 1 would appreciate clients such as these as it operates a comparatively more transactional relationship than the other case agencies, however based on its practical experiences with clients from various international markets, such clients seem few.

Another highly important finding was that trust, characterized as a high quality interpersonal relationship between the parties, was not only found to reduce the agencies' need to signal results but also to produce actual results. The reduced need to signal results in a relationship characterised by trust is most likely explained by reduced information asymmetry as the client gains positive experiential knowledge about the nature of the agent. Essentially the client's fear of adverse selection diminishes when the agency has already proven its value. The reduced need to produce actual results was explained by the client understanding that there existed a clear reverse agency relationship whereby the agency is highly dependent on the client in order to produce results. It appears that the emergence of trust also mitigates the agent's fears of moral hazard, when it believes and trusts that the partner is working to the best of its abilities under environmental uncertainty. The client's willingness to overlook the agency's shortcomings can be further explained by stakeholder theory whereby the agency's previous trustworthy and dedicated behaviour has created social debt with which the client is willing to overlook the fact that it's purely economic expectations may not always be met (Cuevas-Rodrigues et al., 2012)

In aggregate, as already predicted in the literature review, the key limitation of agency theory was found to be its inability to encompass the element of trust between the client and the agency as well as how trust evolves and affects the client relationship over time.

## 5.3 Agency Theory Contextual Synthesis

This section of the discussion synthesises the empirical context and empirical model findings with the principles of agency theory. In summary, the findings from the study suggest that when the empirical model variables are combined with the main constructs of agency theory, agency theory serves as a good predictor of compensation model decisions in the beginning of the agency-client relationship however that predictive accuracy diminishes as the relationship continues. For this reason, the empirical contexts of T0 (beginning of the relationship) and T1 (existing relationship) are examined separately.

### 5.3.1 <u>Predicting Initial Compensation Model Selection with Agency Theory</u>

Agency theory's key limitation for describing initial compensation model determination is that it does not accurately capture the meaning of the negotiation process in compensation model selection, nor does it explain the differences of importance between the different variables. The below Table 21 provides an overview of the combined theoretical and empirical model variables. The blue indicators delineate the situation(s) found in the empirical context before a contract is struck (T0). The relative concentration of the dots on the left side accurately indicate that a behaviour-based model is usually selected in the beginning of the relationship, unless the agency is less risk averse or the competitive environment exerts more pressures. Essentially, agency theory provides accurate initial compensation scheme predictions due to the very high importance of agency risk preferences and outcome measurability in determining initially selected schemes.

Table 21 T0 – First Contract Determination Context

| **Behavior** | | **Outcome** | **Desirable Features** | **Moderators** | **Explanation** |
|---|---|---|---|---|---|
| Low | Monitoring Costs | High | Simplicity, Transparency, | | Monitoring costs are perceived to be generally high but these can be reduced by agencies' frequent communication and choosing models that are easier for client to understand and track tasks. |
| High | Environmental Uncertainty | Low | Low risk | Externalities | Agencies generally found to perceive the environmental uncertainty to be high e.g. client seasonality. (Case 1 tackles this issue by portfolio diversification as suggested by Davies & Prince, 2010) |
| Low | Outcome Measurability | High | Flexibility | Client goal type, Time constraints, Trust (absent) | Agencies perceive outcome measurability, per se, to be high due to level of tracking technologies but time constraints, externalities and the lack of trust make the ease of measuring outcomes generally low and more costly in terms of set-up and maintenance time. Also, clients have various performance and branding goals making it difficult to satisfy all of these. The absence of trust makes verifying outcome-based contracts costly in the beginning of a relationship. |
| Low | Effect on Outcomes | High | Fairness | Externalities | Perceived to be low due to seasonality, use of other media & multiple agencies. |
| Low | Goal conflict | High | | Client knowledge | Goal conflict manifested mainly as conflict on KPIs (selection & maintaining over longer periods of time) and was higher with clients perceived to have less experience and knowledge of SEA. Case 7 idiosyncratically suggests that an agency may suggest an outcome-based contract in order to align goals. Agency theory predictions are thus fulfilled but not because the client wants to transfer risks but because the agency wants to make sure it can perform to expectations. Overall, there is no conclusive evidence that initial goal conflict results in higher use of performance-based models as was already found by Spake et al. (1999). |
| High | Agency Risk Aversion | Low | Low risk, High profit Fairness, | High growth mandate, Competition | Majority of agencies found to be highly risk averse and more specifically loss minimizing (prospect theory). One agency willing to assume risk due to apparent prospecting strategy. Generally the current level of competition requires competitive fees but does not require taking on risk. |
| Low | Client Risk Aversion | High | Low risk, Fairness | Results signal, Competition | Some (smaller) clients are suggested to be more risk averse and ask for outcome-based contracts to which agencies are not pressured to agree in the beginning of the relationship due to the competitive circumstances.<br><br>Notably, clients risk aversion function seems to operate much like that of agencies' such that they, too, prefer predictability and convenience in the fee. |
| Long | Relationship Length | Short | | | NA [no support for Spake et al. (1999) notion that *high initial goal conflict* and *high monitoring costs* would lead to performance based-models] |
| Short | | Long | Low risk | Externalities | When the relationship is new, *uncertainty* is high and it is *difficult to measure effect on outcomes* (even Case 7 that has performance bonus will not have bonus take effect until later.) |
| High | Task Programmability | Low | Fairness | Client knowledge | The more the client knows in advance about SEA and digital, the more likely it is suggested to use behavior-based contracts (fees & time-bank) and pay what agencies consider a fair price. |

## 5.3.2 Predicting Changes to Compensation Model Selection with Agency Theory

The main factors that change as the relationship progresses were found to be the client's experience of perceived value as well as the emergence or absence of trust in the relationship. The findings of the study suggest that the compensation model predictive capabilities of agency theory reduce as the length of the agency-client relationship increases, as the relative importance of the various desirable features change. The following Table 22 with the red dots summarizes the found changes to the empirical context over time. The following section discusses these in more detail.

Table 22 T1 – Consecutive Contract Determination Context

| Changes over time | Behavior | | Outcome | Desirable Features | Moderators | Explanation |
|---|---|---|---|---|---|---|
| - | Low | Monitoring Costs | High | Simplicity, Transparency, | Trust | Monitoring costs do not significantly reduce over time as agencies need to continually communicate value to clients in terms of both discussing results as well as how they were achieved. Trust also requires interaction. |
| Change (less uncertainty) | High | Environmental Uncertainty | Low | Low risk | Externalities, Agency experiential knowledge | Perceived uncertainty due to the environment was found to somewhat reduce and make some agencies willing to consider the use of performance-based models (e.g. Case 5, 7). |
| Potential changes (less easily measurable) | Low | Outcome Measurability | High | Flexibility | Time constraints, Trust (absent or present)<br><br>Client knowledge | If trust has not emerged in the relationship, the client is unlikely to continue with the agency as switching costs are relatively low. If trust has emerged in the relationship, and the agency can grow the client (workload, various use of media, multiple goals), this places additional pressures on flexibility making outcomes potentially less measurable than before. |
| Change (higher effect on outcomes) | Low | Effect on Outcomes** | High | Fairness | Externalities | Some agencies report improved clarity of effect on outcomes and become willing to take on more performance-based elements (Cases 4, 7) |
| Change (More or less goal conflict) | Low | Goal conflict | High | | Trust | If trust has emerged in the relationship, perceived goal conflict, if it existed, has reduced once there is a high quality interpersonal relationship. If trust has not emerged, clients may simply switch agency instead of model as model change does not tackle adverse selection problems. |
| - | High | Agency Risk Aversion | Low | Low risk, High profit Fairness | High growth mandate | No indication of changes in agency risk aversion due to relationship length. |
| - | Low | Client Risk Aversion | High | Low risk, Fairness | Trust ~~Results signal~~ | No indication of changes in client risk aversion due to relationship length however trust reduces the pressures to signal result producing capabilities and the need to deliver actual results. |
| - | Long | Relationship Length | Short | | Trust | Less goal conflict due to trust but monitoring costs remain approximately the same due to continual need to communicate value. If there is no trust and no perceived value, the client may terminate the contract due to low switching costs. |
| Change (less uncertainty and easier to measure) | Short | | Long | Low risk | Externalities | Less uncertainty and easier to measure effect on outcomes. |
| Change (More or less) | High | Task Programmability* | Low | | Client knowledge | If client knowledge and experience have increased during the relationship, the client may require more flexibility in task content (favors behavior), be able to cope with more complexity (favors outcome) or understand the challenges with attribution and the nature of agency work (favors behavior). |

As the relationship progress, the client has several options to choose from depending on the circumstances: 1) Increase or decrease remuneration in the existing model, 2) Change model to other behaviour or other outcomes, or 3) Terminate the contract and relationship. Cross-case analysis suggests that there are overall very little changes to compensation models within or between contracts but contract termination and clients moving between agencies is fairly frequent.

Agency risk aversion (low risk and competition in the empirical model) seems to be the largest determining factor in compensation model selection. As agency risk aversion remains stable over time, this indicates that transferring risks over to the agency does not become significantly cheaper over time. As such, if a client has not had a positive experience with an agency (high trust and perceived value), it is more likely to either succeed in bargaining a lower fee or then terminate the relationship (assuming it fell victim to adverse selection), as opposed to agree to a relatively expensive performance model that also requires additional set-up time investment.

The findings of the study indicate that the majority of agencies are loss minimizing and will thus suggest to begin a relationship with a largely behaviour-based model. This, together with the finding that the majority of compensation models remain behaviour-based even though there is a reduction in environmental uncertainty over time (that should predict an increase in behaviour-based models), suggests that the expalantory usefulnesss of the agency theory assumption of a linear risk-utility curve diminishes as the relationship progresses. A movement to outcome-based models seems only likely if the client specifically requests it indicating that they are willing to put in the extra time, which was found to not usually be the case. Willingness to invest extra time undoubtedly also requires that the client believes that the investment will be well worth it. Indeed the reasons for the stagnancy between contract types seem to support the proposition made by Hendry (2002) who makes the explicit distinction between *guidance costs* and *monitoring costs*, suggesting that principals will prefer informal measures of communicating and guiding their agencies as long as the expected benefits of outcome-based contracts do not justify the costs of taking the time to specify results. As seems intuitively logical, compensation schemes do not seem to change unless there is a clear benefit to be gained, and it appears this is often not believed to be the case. This also supports the earlier suggestion by Spake et al. (1999) who argue that advertising must be an important part of the marketing mix to the client because measurement is neither cheap nor trivial. The findings thus indicate that the introduction of the concept of switching costs to augment agency theory is indeed important as was suggested by Davies & Prince (2010). The findings in this particular empirical context, however, do not necessarily fully support the hypothesized model changes as presented in Figure 3 whereby model selection will follow an outcome-behaviour-outcome change pattern. The initial deviation from the hypothesis is explained by the dominant influence of agency risk aversion, usually ruling out performance-based models and causing a jump directly to the second stage. The findings generally seem to support the authors' third notion that outcome-based contracts are associated with later stages of the relationship and with higher switching costs. As such, the reasons why most clients stagnate and usually do not seem to adopt performance-based models at later stages seems to be influenced by the fact that clients do not necessarily see their SEA service providing agencies as strategic partners.

The findings have interesting implications on monitoring costs over time. Though information assymmetry reduces as the parties engage, monitoring costs still remain high due to the significance of perceived value. The explanatory capability of agency theory thus seems to reduce over time since the theory can only account for economic core value and not the principal's perceived value, which is increasingly important for agencies to maintain long-term client relationships. As such, agencies may prefer models that allow for ample time to contribute towards managing the relationship, and an outcome-based contract is not necessarily going to provide monitoring cost efficiencies in terms of relationship management. The cliché of 'results speak for themselves' unfortunately does not seem to hold.

Clients' stagnation into using behaviour-based models could also be influenced by their relational intent. A client that is satisfied with its results, trusts its agency and expriences high perceived value is unlikely to want to compromise its results and good relationship. Thus it is unlikely to force a risk transfer change on its agency against its will. As such, the validity of the opportunistic behaviour and self-interest assumption of agency theory seems to diminish over time when the principal becomes increasingly aware of the importance of fairness. An act perceived to be done out of spite would most likely trigger the negative effects of reciprocity reducing agent motivation (Fehr & Falk, 2002) and potentially undermine the trust in the relationship (Cuevas-Rodrigues et al., 2012). This is especially likely if the agency's negotiation response would be to counter offer a less risky but more flexible model such as a time-bank model. In conclusion, a performance-based model will only be taken on further into the SEA advertising relationship if both parties view it as beneficial and fair.

The findings indicate that though information assymmetry reduces as the parties engage, monitoring costs still remain high due to significance of perceived value. Moreover, though monitoring costs remain high, behaviour-based models persist. The explanatory capability of agency theory thus seems to reduce over time since the theory can only account for economic core value and not the principal's perceived value, which is increasingly important in agencies maintaining long-term client relationships. This challenges the agency theory assumption of efficiency as the effectiveness criterion (Eisenhard, 1989a) when agencies that focus effort into non-core communicational activities to their client will be able to maintain clients for longer periods of time.

# 6 CONCLUSION

## 6.1 Summary of Main Findings

This qualitative multiple case study based on interview data gathered from the agency side, investigated and described the various agency compensation models available for search engine advertising in the Finnish market. The objective of the study was to go beyond mere description and explain how and why compensation models are determined. The empirical findings revealed that compensation models used in search engine advertising are determined by agencies and clients prioritizing and balancing the trade-offs between what features are considered to be most important for a compensation model, since no single model was believed to encompass all desirable attributes (low risk, high revenue, fairness, transparency, simplicity, flexibility, scalability, and results signal). The importance of an individual feature is increased or decreased by a number or moderating and boundary factors that may already exist before the relationship is initiated, or emerge as the relationship progresses (historical trend, concern for agency reputation, agency growth mandate, externalities, client knowledge & experience, client preferences, client negotiating power, trust, agency experiential knowledge, competitive environment, time constraints, client goal type, budget constraints). Agency theory was generally found to offer satisfactory explanations for most of the discovered desirable and moderating factors of compensation schemes, though various additional complementing theories were necessary and valuable in explaining some completely deviating (e.g. scalability, historical trend) and generally aligning variables with considerably better accuracy.

The findings of this study indicate that agency theory is a sound predictor of SEA compensation models in the beginning of the relationship mainly due to agency risk aversion appearing to be the most, and outcome measurability the second most, important factors affecting initial SEA advertising compensation scheme selection. This finding, together with the notion that clients are hesitant to compensate agencies for taking on their business risks, offers a brief explanation as to why performance-based compensation models still appear to be infrequently used, even though tracking technologies were acknowledged to have significantly improved. The predictive accuracy of agency theory was found to reduce as the relationship progressed since agency theory was not found to be able to accurately explain why certain moderating factors (e.g. trust, client knowledge and the need to signal and produce results) become more or less important as the relationship progresses. The agency theory assumptions of risk neutrality and opportunistic behaviour thus diminish over the length of the relationship. In essence, agency theory could be used to argue that since the most important determining factor of compensation schemes is agent risk aversion, which does not change over time, agency theory provides a descent prediction that schemes will usually begin and remain as they are depending on whether the agent is generally risk averse or not. Though this explanation is largely valid, it would be considerably lacking in accurately depicting the whole complexity of the social context and the significant role of trust in the agency-client relationship.

Explicit, non-theoretical, summary answers to the first two empirical research questions are provided in Appendix 4 for managerial readers wanting a brief, yet slightly more detailed overview.

### 6.2 Theoretical Implications

This study has several important contributions to examining agency compensation schemes from an agency theory perspective. Previous quantitative advertising compensation scheme studies from an agency theory lense have been silent on the relative importance of the agency theory taxonomy constructs initially developed by Eisenhardt (1989a). Moreover, as previous advertising agency specific studies have focused on client side data, these have not been able to assess agency side risk aversion. This study addresses these particular shortcomings and provides compeling evidence to suggest that the previously empirically forsaken contruct of agency risk aversion, interestingly, appears to be perhaps the most decisive theoretical proposition. This seems especially significant considering that there seemed to be largely two types of agencies (*profit maximizing* versus *loss minimizing*) and this had perhaps the most significant impact on the initially chosen compensation scheme, which then had the tendency to maintain throughout the relationship.

In summary, whilst agency theory was found to be a sound predictor of some of the underlying features of initial SEA compensation schemes in the beginning of a client relationship, it was found to be unable to explain how certain features become more or less important as the relationship progresses and as trust builds up between parties over time. Overall, the empirical findings of this study suggest that agency theory is a good predictor of the final outcomes of compensation model negotiations for search engine advertising agency relationships, yet the findings also provide empirical support for the notion that agency theory, alone, is not able to provide a full explanation for describing the nature of the full set of factors that drive the agency compensation model decision. Attempting to explain advertising agency compensation models decisions with agency theory alone might perhaps be likened to attempting to fit a square peg in a round hole: If you chisel the sharp edges off, the block will fit, yet half of the story will go missing. This study therefore echoes the previous conceptualizations of Hendry (2002) who suggests that when additional behavioural theory elements (namely trust and an assumption of agent honesty) are added to augment standard agency theory, these provide more accurate explanations of phenomena, yet these still yield similar results to what standard agency theory would predict. Moreover, this study suggests that much of the factors that affect compensation model decisions may also lie in the model negotiation process and the power and knowledge levels (awareness of available schemes and attribution models) of the participants. This further supports the notion that agency theory stands to benefit highly from the aid of other streams of literature.

## 6.3 Managerial Implications

### 6.3.1 Client-side Managerial Implications

This study provides advertising clients a window for examining the types of compensation models currently used in SEA advertising in the Finnish market. Moreover, the model developed in this study provides a window for clients to see how agencies evaluate the important trade-offs to be made between the models as well as what implications these have. Heightened awareness of the nature of the models themselves as well as the tendency for agents to be the stronger influencer in model selection, can help clients decide for themselves whether it would be necessary for them to take a more active role in model negotiation. Appendix 5 provides a convenient one-page overview of the pros and cons of each compensation model from the perspective of both clients and agencies.

Moreover, the study highlights some important aspects related to all compensation contracts that enable the client to maximize results, minimize risks and reduce the costs of monitoring the agency. These are for example the findings that a more knowledgeable and engaged client is typically believed to get more out of its agency regardless of what model is being used. Also, an important best-practice seemed to be that clients withhold ownership of their AdWords accounts. This reduces their exposure to adverse selection by keeping switching costs low while maintaining access to the AdWords accounts makes it easier to check account activity levels to evaluate the occurrence of moral hazard.

The findings suggest that SEA advertising contracts are fairly stagnant over time regardless of the selected model. Because adequate and perceptually fair compensation was found to have important motivational implications for agencies, clients seeking aggressive growth should consider either adopting models that easily accommodate for growth (time-bank model) or possibly consider renegotiating their contracts more frequently. In essence, though it is definitely not preferable to over compensate an agency, undercompensating an agency is likely to curb agency side growth efforts and should thus be avoided.

The findings of the study and the accompanying model provide an explanation for why the majority of agencies are hesitant to accept performance-based compensation models. Client-side managers can use the model to examine what the important trade-offs implications of wanting a performance-based model for their firm are, and help them evaluate whether such a model is desirable for their firm in the first-place. Managers wishing to pursue a performance-based compensation can use the model to assess whether they are willing to satisfy the additional requirements needed of moving towards these models (e.g. more time intensive, higher risk premium, and must minimize budget constraints).

### 6.3.2 Agency-side Managerial Implications

The model developed in the study provides an overview of the factors that the studied agencies need to examine while making compensation model decisions. As such, the model can be used by agencies to make more conscious and strategic compensation model decisions to account for the various different moderating factors that emerge, particularly during the course of the relationship (e.g. trust). This can be particularly useful for agencies where the people designing a client contract may not be the ones that manage the account itself as the model identifies how the importance of certain features may increase or decrease as the relationship continues.

This study provides Finnish advertising agencies with an overview of the compensation models currently used in the Finnish market. The findings reveal that there is a general trend towards increased transparency and flexibility, favouring fixed fees and time-bank models for agencies that are largely risk averse. Simultaneously, there is a new type of agency operational model based on automation entering the Finnish market. This operational model, focusing only on a narrow niche of ecommerce allows for a new type of compensation model, titled here as the new commission model to be used. Finnish agencies are likely to be highly interested in this agency's operational model and compensation scheme, as this outlier agency compromises on a number of the features that Finnish agencies conventionally value for the hopes of gaining higher revenues. This new emergent operational model and accompanying compensation model may pose future change pressures to the Finnish competitive landscape.

### 6.4 Limitations of the Study

The limitations of this study result from the way the study was designed. As noted before in the methodology section, the analytical generalizability of this study is contended to pertain to interorganizational contracts between two parties operating under a particular set of contextual attributes (i.e. Finnish market, search engine advertising, similar work content that is not highly creative). The study found that compensation model decisions are driven by a large number of interdependent variables. Considering this, the study cannot nor does it even attempt to claim that all possible determinant variables have been covered. Similarly, the study does not claim that all possible types of compensation schemes have been fully covered by the study and aknowledges that other models and variations may indeed exist and emerge as the industry develops.

A significant boundary condition for the study also lies in its timing, sampling and data sources. The study was conducted as a cross-sectional study yet respondents were required to recall longer periods of time. Respondents described models and their usage to have evolved over the passed 6 years requiring them to think back significantly. Moreover, respondents were asked to not name any clients and speak on an aggregate, agency level only in order to ensure client confidentiality. As such, if the usage of a particular model was very infrequent at an agency, such as with most performance-based models, respondents' discussion of the benefits and pitfalls of these models might have been based on only a relatively small number of client case experiences. In terms of sampling, though the agencies participating in this study were not meant to be any kind of representative sample, the agencies willing to participate in the study were coincidentally among the largest agencies in Finland. This means that these agenices' responses may have been, in principle, skewed towards challenging the agency theory assumptions of opportunistic behaviour and risk-utility curve linearity as these agencies' strong reputations and client bases may make risk taking and opportunistic behaviour naturally less necessary for them compared to smaller challenger players in the market. Moreover, it can be assumed that only the agencies that perceive themselves to be generally honest and doing a 'good and fair job' for their clients would wish to discuss their client relationships and compensation models. This relative honesty as a starting point may potentially further skew the results away from agency theory opportunism. As such, the findings of this study may not accurately reflect the relative importance of the various decisionmaking variables for an agency that might aknowledge itself to be frequently and intentionally engaging in moral hazard. Consequently, a broader agency base may have yielded different results yet access to such for qualitative interviews was deemed unaatainable. The main theoretical finding that the explanatory power of agency theory diminishes over time is hinged on the contextual requirement that the moderating factor of trust is highly significant. As such, this finding may not hold its power in cases of client relationships that are more transactional in nature and the presence or expectation of trust does not mitigate opportunistic behaviour.

The purpose of this study was to build and test a theoretical model for SEA compensation model determination. As such, the theories used to explain the findings were largely limited to the ones preidentified in the literature reviews. Consequently, it should be noted that alternative theoretical explanations beyond the ones identifies could provide further, even more accurate explanations of the phenomenon. Moreover, though the author has made significant efforts to mitigate personal bias due to a high degree of knowledge in SEA, some personal bias may still have subcosciously affected the analysis of the results.

Finally, it is important to restate that this study does not, nor does it attempt to, answer the question of whether one compensation model is objectively better (more efficient, or produces better results) than another. The study has described the nature of the available compensation schemes and the emergent empirical compensation scheme determination model has explained the contextual factors that lead agencies to perceive one model to be more suitable than another. Thus the findings, in fact, support previously made claims that any compensation model can be equally viable as long as client's and agency's goals and interests are aligned (ANA & AAAA, 2006), adding that these should reflect varying contextual circumstances.

### 6.5 Suggestions for Further Research

The study revealed that clients (principals) may have a less dominant role in the compensation model selection process than was previously believed. Thus future research should focus particularly on verifying and examining what could be the client side reasons for low participation in model selection. It is important to evaluate whether potential low participation might stem from clients making a conscious decision or due to being ill-informed about the model options. The latter may have important implications for contract efficiency and appropriateness for meeting unique client needs as agencies could have a tendency to compromise individual client goals in favour of their own internal scalability and simplicity preferences. This would be particularly interesting to examine in the context of a client and an agency negotiating between two behavioural models (e.g. fixed-fee and a time-bank) model where risk transfer is not an issue and agency opposition could merely be largely grounded in reduced scalability nd higher admin for the agency itself. Since time-bank models are the growing trend, these cases could be increasingly frequent.

This study examines compensation model determination from the perspective of agencies. Further studies on the topic of compensation models should consider repeating the study from the perspective of clients to seek further validation for the empirical model and following agency theory evaluation. Moreover, considering that a number of the studied agencies indicated a desire for growing their clients yet failed to do so (either due to compensation stagnancy or clients' general lack of drive to reach a satisfactory outcome-based contract), further studies should focus back on client-side studies and investigate the roots of this stagnancy. This could help identify possible solutions for putting more Finnish advertisers back on a growth path. In light of the findings of this study, the author advocates that these studies either be conducted by an independent party, or then by a Google employee working in extremely close collaboration with the participating agencies as not undermine the trust in the agency-client relationship.

The findings indicate that switching costs are an important consideration in agency client relationships even to the point where the longevity of the relationship is negatively related to the need to produce and communicate outcomes to the client. As such, future studies could investigate the level of AdWords account ownership as well as account activity as predictors of client satisfaction in their agencies. Moreover, considering that the findings suggest that a higher level of knowledge enables a client to demand more, it could be interesting to investigate whether small advertising clients are even aware of the fact that they can indeed own their own AdWords accounts and easily monitor their agents' actions through the change history function. This is an important consideration as heightened awareness of this opportunity could serve as a partial means for clients to help manage the moral hazard problem suggested by agency theory.

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## APPENDIX

### Appendix 1: Interview Guide

**1. Background information on the interviewee & agency**

**2. Compensation models used**
2.1 What compensation models do you use and why?
2.2 How can clients and agencies' interests be aligned through contractual arrangements or other means?
2.3 How often are contracts adapted to individual clients?
2.4 How are contracts typically negotiated?
2.5 How often are changes made to a contract over a client's lifecyclee? Is/would this be necessary and why?
2.6 How have compensation models changed over time? What kind of internal or external pressures might you have had?
2.7 What are some of the most critical factors to a successful agency-client relationship and why?

**3. Performance-based compensation models (in more detail)**
3.1 Why do you (/do you not) use performance-based incentives with your clients?
3.2 What are the challenges or barriers related to adopting such models?

**4. Themes overlooked**
4.1 What essential issues may I have missed or have not been covered in the discussion of this subject area?

## Appendix 2: Model Desirable Feature Responses by Case Agency

This summary table has been removed to preserve respondent anonymity. Readers may contact the author and requests to view this table will be handled on a case-by-case basis.

## Appendix 3: Summary of Model Specific Quotations

Theese summary tables have been removed to preserve respondent anonymity. Readers may contact the author and requests to view the tables will be handled on a case-by-case basis.

## Appendix 4: Summary Answers to the Empirical Research Questions

*Q1: What compensation models are used for SEA services and why? Q2: How are models selected?*

Agency compensation models used in search engine advertising are determined by prioritizing and balancing the trade-offs between what features are considered to be most important for a compensation model, as no single model has been found to encompass all desirable attributes (low risk, high revenue, fairness, transparency, simplicity, flexibility, scalability and results signal). The importance of an individual feature is increased or decreased by a number or moderating and boundary factors that may be exist before the relationship is initiated or emerge as the relationship progresses (historical trend, concern for agency reputation, agency growth mandate, externalities, client knowledge & experience, client preferences, client negotiating power, trust, agency experiential knowledge, competitive environment, time constraints, client goal type, budget constraints). The study reveals that agencies have a key role in suggesting which compensation model is to be used in a particular client relationship. The found models and their implied prevalence are summarized in Table 6.

The currently predominantly used compensation model in SEA services in the Finnish market is the fixed-fee model, which is based on specifically or broadly defined activities to be completed within a specified time. With the prevailing trend in compensation focusing on higher transparency there seems to be an increasing amount of time-bank compensation models being used for newly formed contracts. The popularity of these models seems to stem from the fact that in Table 8, these models score either a ‘high’ or a ‘medium’ in most features, with lows on the features that the majority of agencies value less (high revenue) or which they know they can compensate for once the relationship progresses (trust and delivering results reduces the need to signal results through the compensation model itself). The following is a summary of the factors that have led to fixed fees being the dominant model and time-bank fees gaining more momentum as described through the variables discovered through the course of the study:

1. Agencies are generally highly risk averse. As agencies have a significant role in model selection they will suggest models that they believe will reduce their own risks. The reduction of risk is allowed by prevalent market conditions where few competitors are suggested (or found during this study) to be willing to assume more risk and offer performance-based models.
2. The time-based models of fixed-fees and time-bank are relatively simple, allowing for clients to easily understand the models and thus they pose minimum psychological barriers during the sales process.
3. Most of the studied agencies are in a relational mode and their objective is to build long-term trusted partnerships with their clients. Trust is viewed as extremely important as it is regarded as an antecedent for growth as only a client that trusts its agency is willing to expand its advertising, and fee with the agency. Thus in their initial compensation model selection decision, agencies emphasise fairness in order to foster the emergence of a climate of trust and also flexibility so that they can easily capitalize on that emergent trust and accommodate for desired future growth. Both of these are sufficiently provided for by the fixed-fee and time-bank models.
4. Agency's value scalability across their portfolio of client and the fixed-fees & time bank fees are largely scalable across all kinds of clients with varying business goals and attribution models.

*Q3: Why (or why not) are performance-based compensation models used for SEA services?*

Results based models were found to be scarcely used for compensating Finnish SEA services. The reasons for performance-based models' unpopularity among the majority of agencies is evident from Table 8, which summarizes how these models (performance bonus & CPA) compromise agencies desirable attributes scoring either a 'low' or a 'medium' on most desirable attributes. Thus these models are initially preferred by agencies only when they value high revenue and signal the ability to deliver results. Based on the study, this is not often the case and almost never occurs in the beginning of a relationship. The following summarizes the reasons for the infrequent use of the results-based compensation model based on this study:

1. The majority of agencies are risk averse and prefer to minimize losses as opposed to maximize gains. Only a few agencies were found willing to assume more and usually only as the relationship progressed when environmental uncertainty was perceived to have decreased. The competitive environment does indeed pressure agencies to provide competitive prices but not to take on client's business risks through performance-based models. Thus the motivation for taking on a performance-based model has to be more or less agency driven – which is usually not the case. As agencies were found to largely dictate the compensation model selection decision, unless a client specifically asks for performance-based elements to be introduced at a later stage, this will rarely happen because it is preferable for an agency to attempt to negotiate a higher fee for the (existing) low risk compensation model.
2. Clients are argued to be largely unwilling to provide agencies with a higher reward for taking on more risk thus making performance based models seemingly unfair and unacceptable to agencies.
3. Time seems to be the most significant constraint for performance-based model use because these models require significant time input from both the client and agency to create a model, and select and agree upon KPIs. Agencies indicate that clients are unwilling to invest the required amount of time to create mutually beneficial performance-based compensation models.
5. Measurability is the antecedent for performance-based compensation models where clients and agencies struggle to achieve measurability due to clients not having meaningful (monetary) goals. There is also a general difficulty of establishing and maintaining mutually agreed upon KPIs partly due to the above time constraint. Agencies' effect on outcomes may also vary with the use of multiple agencies and sudden tracking system failures.
6. Clients prefer simple and transparent contracts. Including performance-based elements is perceived to unnecessarily increase contract complexity, which is deemed to be a barrier to sales. Moreover, transparency is an issue particularly in the beginning of the relationship when there is little trust between the parties where the agency is usually the more knowledgeable party that creates the measurement system.

The absence of trust in the beginning of the relationship makes performance-based models seem unviable at the time.

4. Performance-based models involve locking down KPIs for results measurement thus making the models inflexible or then time consuming to renegotiate: Set KPIs will require fixation on either optimizing for efficiency or volume and this focus may need to shift. Moreover, should trust emerge in the relationship to enable more growth, the agency is not able to quickly and easily adjust for new goals, various media and increased workload.
5. Compensation models do not seem to be taking on more performance-based elements over time because the build-up of trust in the relationship leads to the need of more flexibility for the agency to grow the client (work content, workload, and multiple client goals). Simultaneously there is less need for the agency to signal its ability to deliver results when the client has experiential knowledge on the agency. If the client experiences high perceived value and trust, it will provide the agency with more work, which is more easily accommodated by other models. If the client believes it is getting generally good value, it will continue the relationship and contract but may not be willing to invest more time into the relationship. In this case, the contract is likely to stagnate in its current form. If, however, the client's expectations have not been met and there is no trust in the relationship, the client is unlikely to want to pay a higher premium for risk transfer and invest more time and resources into the agency, - requirements for moving towards a performance-based model. Contract termination is also an easy option when switching costs are low due to relatively short contract terms and the clients typically owning the AdWords account itself.

# Appendix 5: Summary of Compensation Model Pros & Cons – Principal & Agent Perspectives

| SEA Compensation Model | Principal / Advertising Client | | Agent / Agency | |
|---|---|---|---|---|
| | + | - | + | - |
| **Traditional commission**<br>Agency compensated based on percentage of media expenditures. | • Simple, & flexible.<br>• Agency incentivized to grow account. | • Fee to agency scales too quickly up or down with small budgets and thus does not necessarily reflect agency workload > Agency might become under or over compensated in relation to actual workload.<br>• Agency incentivized to grow media expenditure but it does not (necessarily) bear any risks.<br>• Agency not incentivized to give media neutral advice.<br>• No immediate responsibility over results though relationship unlikely to continue if unprofitable.<br>• Intransparent of what activities are included in the contract. | • Low risk.<br>• Easy to calculate.<br>• Can be highly profitable for the agency, if budgets are high.<br>• Agency has up-side potential. | • Risky when fee to agency scales too quickly up or down with small budgets and does not necessarily reflect agency workload > Unfair if agency undercompensated in relation to actual workload.<br>• Sometimes requires agency to return part of fee for the sake of fairness. |
| **Tiered Commission**<br>Same as Traditional Commission but the rate varies based on media spend. | • Simple, & flexible (but slightly less than above) | • Slightly more fair than above. | • Slightly more complex to calculate but still relatively easy. | • Slightly more fair than above. |
| **Fixed fees**<br>Fixed monthly fee with the scope and content of activities more or less defined. Agency will typically have an hourly time calculation that they may or may not discuss with the client. | • Simple to understand.<br>• Makes budgeting for agency remuneration easy.<br>• More or less transparent of what is included in contract.<br>• Incentivizes risk averse agency to test new features (/does not disincentivize this)<br>• Agent can give media neutral advice. | • If fixed fee is set too low, agency is not incentivized to work on account as much as it would need. (Accepting the lowest bid offer might not necessarily be a good idea especially if the agency is not highly reputable).<br>• High risk of moral hazard i.e. agency does not put in stated effort since increased effort will not affect fee (risk may be exacerbated if client does not have access to AdWords account).<br>• Risk that agency only wants to upsell to a higher fee without taking responsibility for results.<br>• Risk of stagnancy: Agency does not bear any risk so they are not incentivized to challenge client in a rapidly changing digital environment. | • Low risk.<br>• Scales easily across all client types, sizes and business goals.<br>• Simple to communicate to clients.<br>• Easy for agency to predict internal profitability and bill in advance.<br>• One contract can be used to cover all digital services.<br>• Sets the scene for long-term account development.<br>• Gives freedom to test new features without too much risk. | • If fixed fee is evaluated too low, agency profitability is strained.<br>• If scope of work changes too quickly between review periods, agency profitability is stained.<br>• Clients may unrealistically assume their contracts are all-inclusive and demand more than the agency can reasonably offer.<br>• Agency up-side potential is locked for longer periods of time. |
| **Time bank**<br>Agency specifies a minimum and maximum number of hours that they will or can work and the eventual total will be adjusted based on actualized hours. | • Highly fair when adjusts to workload.<br>• Very clear what is included in the contract.<br>• Simple to understand.<br>• Flexible to work content. | • Dishonest agency can misreport its working hours. | • Low risk.<br>• Highly fair when adjusts to workload.<br>• Relatively simple to understand.<br>• Flexible to work content. | • Agency can get too stuck in a working hour as opposed to a results conversation with the client.<br>• Up-side revenue potential is descent, but agency will not get awarded for particularly high performance.<br>• Time bank profitability calculations can increase internal complexity. |
| **Performance Bonus**<br>A portion of the fee received by the agency is made dependent on outcomes that are locked to selected KPIs. The basis of the remuneration is a Fixed-fee or Time-bank contract.) | • Incentivize agency be a bit more accountable and focuses effort on producing results. | • Risk transfer can be expensive.<br>• Performance bonus levels are difficult to take into account in budgeting > sudden bonus payout risk.<br>• Time consuming to negotiate. | • Provides some incentive and shows agency commitment while overall risk levels remain moderate. | • Risky.<br>• Time consuming to ensure these models are fair for both parties.<br>• May be introduced as an alternative to a higher fixed fee thus requiring agency to assume risk instead of get risk free higher fee. |
| **CPA**<br>Agency covers the media expenditures and is then compensated based on a fixed fee per conversion. | • Risks transferred to agency.<br>• Agency focused to produce results.<br>• Agency that seeks higher own profits is incentivized to challenge client on existing practices. | • Risk transfer can be expensive.<br>• Client must maintain the 'big picture' of their business because agency effort is focused on KPI delivery.<br>• Agency not incentivized to take any risk and test new features.<br>• Inflexible: Client must choose result KPIs to focus on either efficiency or volume. Both cannot be optimized simultaneously. Time consuming to renegotiate, if focus shifts. | • Demonstrates agency commitment to results.<br>• Agency rewarded for good performance.<br>• If client budget is uncapped, agency upside potential is high. | • Very time consuming to set up these models to be fair for both parties.<br>• Agency needs to bear a lot of client's business risks.<br>• Locks the agency in to deliver on certain KPIs and potentially ignore other important business aspects.<br>• Inflexible: Risk of agency mindlessly delivering on either efficiency of volume goals, whichever the KPIs have been set on.<br>• Client's that have budget constrains might limit agency profit potential making risk bearing unfair. |
| **New Commission**<br>Percentage commission based on realized media expenditures. Return on investment must be continually maintained at a predefined level or agent can be dismissed at any time. | • Agency incentivized to focus on delivering profitability goals.<br>• Promise of higher results generally demonstrates agency commitment to results.<br>• Results are predefined and it is relatively easy to evaluate whether goals have been met.<br>• Relatively simple to calculate. | • Risk transfer can be expensive.<br>• Not suitable for non-monetary business goals, highly inflexible and ignores all branding goals.<br>• Workload has not been defined: Risk that agency allocates its time and resources to those clients or tasks where it believes the largest revenue impact will be made (low growth potential client expected to receive less attention).<br>• Efficient application requires having and providing profitability data.<br>• Can become expensive, if agency produces above expected results (what a shame…)<br>• Agency remuneration levels are difficult to take into account in budgeting. | • Demonstrates agency commitment to results.<br>• High revenue potential.<br>• No predefined workload or tasks enables agency to freely focus effort on the aspects that will make the highest impact. | • Agency needs to bear a lot of client's business risks.<br>• Client's that have budget constrains might limit agency profit potential making risk bearing unfair. |