

THE CPI TOP TEN:

Broken Agency Processes - Financial

By Vanessa Edwards

Welcome back for our second installment in The CPI Top Ten! Our first article in this series covered the most common broken processes from an agency Operational perspective; today's article will cover the five most commonly broken Financial processes within agencies.

A slight heads-up! The content in the following Financial processes (numbers 6-10) is a bit more complex and challenging than the first half of this article. We've done our best to strike a balance between using industry terms with more traditional business terminology, all while trying to keep the tone conversational instead of technical. With that said, sometimes there's just no way to make content sexy, fun and irreverent without losing its efficacy. But, we do know that the following information will provide you with the relevant data necessary to be a catalyst of change within your organization.

As a refresher, here is our take on The Top Ten Broken Agency Processes; we'll cover processes 6 through 10 in the following pages: with solutions and next steps. Drum roll, please...



Our Take: The Top Ten Broken Agency Processes

1. Agency Workflow: Who's on First?
2. The Scoping Shockwave
3. Briefs: Are Your Briefs One Size Fits All?
4. Over Servicing and Over Delivering
5. Resourcing Pains
6. Bill-Backs Breaking Your Back?
7. Purchase Orders: Blurred Lines
8. Credit Cards Gone Wild
9. Improperly Tracking Your Benjamins
10. Billing: Show Me the Money

Bill Backs Breaking Your Back?



Sounds like the “it” song of summer 2015, doesn’t it? Sadly, it’s not – it’s a huge problem within the creative agency industry costing agency owners and Principals significant profit.

Agencies consistently struggle to promptly and accurately bill back project-related expenses to their clients. Whether it’s not remembering to bill back expenses, not marking them up properly, not understanding contract parameters to know if the expenses are included in the contract or in addition, or miscoding expenses, agencies are eating thousands of dollars, grossly impacting project margins and Agency Gross Income. When agencies mismanage outside expenses, it often costs them 2.5 to 3 times more in direct costs than mismanaging internal labor.

a. *Mismanagement of Freelance Labor*

The great irony of freelancer labor is that you hire freelancers to increase capacity without having to hire a full time employee, thereby costing you less... however, many agencies mismanage their freelance labor so poorly that using freelancers ends up costing them more money in lost net profit. We helped turnaround an agency that lost out on a quarter of a million dollars – 7% of their Agency Gross Income! – of pure profit because they were incorrectly tracking their freelance labor. Don’t let this happen to you!

If you know you’re going to be outsourcing work to a freelancer from the beginning of a project, many Project Managers incorrectly estimate the freelancers as a pass-through expense at their net rates rather than matching their service to your agency rate card and estimating them at gross agency labor rates. Estimating freelancers as a pass-through expense results in pricing the project lower than if you were to do the work in-house utilizing your agency rate card. This sets a pricing precedent with your clients that you may not be able to maintain if you ever bring this work in-house, as there is no margin to account for employee taxes/benefits or agency overhead.

When your Project Managers create estimates, often they assume an internal employee will do the work so they accurately estimate hours at gross agency labor rates. However, if you have capacity issues part way through the project and you need to hire a freelancer to do a portion of the work, the PM often looks at the gross budget and says “oh, I have \$5,000 budgeted for copywriting; I’ll tell the freelancer they have a \$5,000 budget.” Wrong!

PM’s often make the mistake of using gross budget dollars to quote out work to the freelancer; unfortunately, what they don’t realize is that gross agency rates include an agency’s margin. When you reallocate the gross budget dollars to a freelancer instead of giving them the appropriate budget of hours at their net rate, you hand your agency margin directly to your freelancer.

b. *In/Out of Contract*

Another area that we consistently see agencies struggling with is understanding what project-related expenses to bill and when. Sometimes project-related expenses are within a fixed-bid engagement and just need to hit the project budget so the Project Manager can properly manage the project within budget. Other times, expenses are not included within the engagement contract and need to be billed back in addition to the project budget (on top of the contract). In some cases, contracts are not written clearly enough to justify billing traditional out-of-pocket expenses on top of project budgets, and agencies get stuck eating these costs.

When your employees don’t have a good handle on which expenses are included in their contract/SOW and which expenses are considered “on top” of the contract, it’s easy to get it wrong, which could considerably impact your project margin.

Many times, we have seen out-of-pocket expenses get inaccurately managed within a project budget, causing a reduction in project margin instead of being flagged and billed back to the client on top of the existing project budget. We see this a lot with expenses like stock photography, printer proofs, fonts, and shipping. While these are rarely large dollar amounts, when mismanaged across the agency, it can have a sizable negative effect on net profit.

c. Mismanaging Marked Up Expenses

We know that many agencies have moved away from marking up expenses, but for the agencies who are still able to charge markups on their project-related expenses, it is crucial that it's done correctly! When done wrong, you're literally leaving money on the table and losing profit.

Very often, agencies that can charge markup don't do a good job of communicating when it's appropriate to markup or by how much. Agencies often don't have good processes in place to review and audit expense estimates and invoice reconciliations to confirm markups are calculated properly. In many cases, when vendor invoices don't match the original estimate, there's confusion about how to cover the additional costs (e.g. eat the cost and reduce project margin vs. marking up the additional cost and billing back to client).

We also see many Project Managers get confused by markup vs. margin, and end up calculating incorrect amounts. Many accountants think in margin but most PMs and PM tools manage expenses via markup; lots of money gets lost in translation between these two things.

d. Forgetting to Bill Back

We've also seen agencies who manage huge promotional budgets, consisting of many varied outside expenses, completely forget to bill vendor invoices back to a client because there wasn't a good PO process or expense/budget reconciliation tool – or detailed project architecture – in place to track all the various estimates, quotes and invoices.

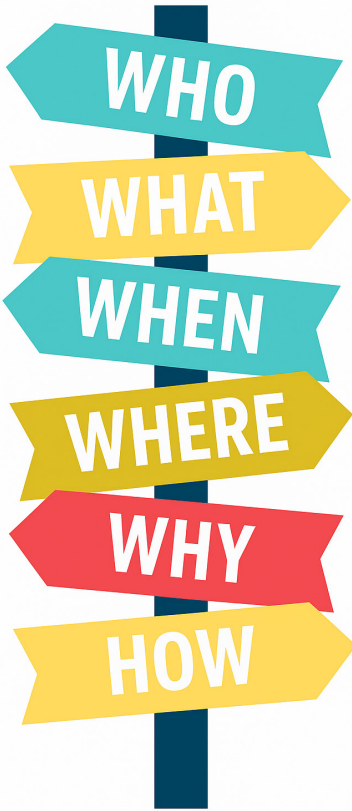
Without a good way to track project-related expenses, they can simply get lost or forgotten. When you're dealing with a large number of outside expenses, it's very easy for one or two project-related expenses to fall through the cracks. And while this may only be a small percentage of your total project budget, if it happens consistently across the agency, it has a significant effect on agency profit.

In addition, without good communication between your PM team and Accounting, you run the risk of receiving vendor invoices after you've already done your final project billing, forcing the agency to eat the cost.

Another area where we see agencies eating a lot of unnecessary costs is when they forget to bill back travel expenses. With no POs for travel expenses and expense reports often coming in months late, Accounting may have already billed the client and the agency may not be able to recoup these expenses.

Forgetting to bill back project-related expenses to your client is like throwing money out the window; every expense you forget to bill depletes your agency profit dollar for dollar.

Purchase Orders: Blurred Lines



Is your agency's purchasing process leaving your employees confused? Do you have clear definitions surrounding how to initiate project-related or large overhead purchases, or do people feel like they're always crossing blurred lines with no clarity around the right way to purchase? Without a well-defined Purchase Order process, employees get very confused about how, when, why or even if they should use POs.

In many cases, with the hustle and bustle of agency life and the need to deliver work on time, purchases just get made – forcing agencies to deal with the ramifications when the vendor invoice comes in. How often does your agency get caught with its pants down because you have to pay a large vendor invoice that you didn't even know about? Even worse, how often do you realize you haven't sent a deposit invoice to your client to cover this large cash expenditure? UGH!

Agencies without a PO process, or with a poorly defined PO process, often find themselves in these situations, resulting in:

- Cash management issues
- Over budget projects
- Final invoices being sent to clients without all expenses included
- Unapproved, unbudgeted overhead expenditures

Without a good PO process – or with a process where POs are only created when a vendor invoice is received – it is nearly impossible for Accounting to accurately plan for large expenditures and effectively manage the ups and downs of agency cash flow. This leads to disgruntled vendors, as you are consistently paying them late, or forces agencies to get expensive short-term financing to bridge the gap between vendor invoices and client payments. If you're forced to get this short-term financing, the best case scenario is that it's lowering the markup on the outside expense; the worst case scenario, if there is no markup is that you're eating into your own agency's profit.

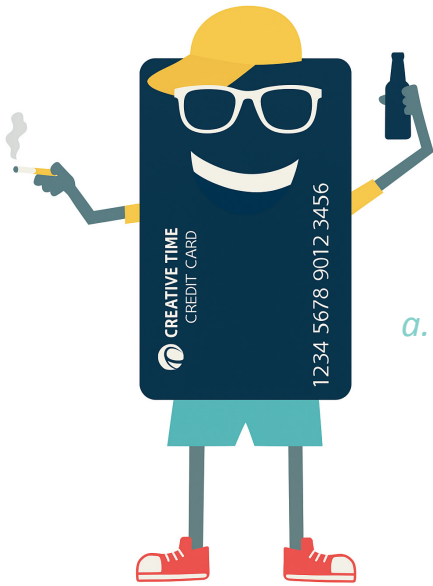
Not planning for your project-related expenses with POs means you're not able to efficiently track committed funds within your project budget, which can lead to spending more budget dollars in labor and expense than are actually available. This mismanagement of project budgets often catches PMs by surprise when outside expenses suddenly hit their projects, resulting in over budget projects with reduced margins.

In addition, if your agency isn't using POs to track project-related expenses BEFORE they come in, it can be incredibly easy to send a final invoice to a client without all final expenses being received – resulting in an inability to bill clients back for expenses. This is directly related to forgetting to bill back client-related expenses, as discussed above.

We see a lot of agencies who have project-related PO policies, but they often don't go the extra mile to create an Overhead PO Policy. This is less of an issue in small agencies as most large purchases are controlled by Principals, Executives or Accounting. However, in medium to large agencies, budgeting and overhead expense approval processes become critical to preserve agency profit; without defined overhead PO processes and approvals, you can easily spend much more on agency expenses than planned.

Purchase Orders are a powerful agency management tool that are often poorly used and inadequately controlled. When agencies don't have good policies surrounding POs, we've found that POs very often don't get created – or, even worse, they only get created when a vendor invoice is received, basically rendering the PO process inefficient and useless. Without a good PO process, your Accounting team isn't able to plan for future project-related or overhead expenditures, and your PM team isn't able to accurately manage committed funds within project budgets, landing substantial blows to agency cash flow and profit.

Credit Cards Gone Wild



With all the miles, points and rebates credit cards are offering these days, just about everything that CAN be put on a credit card IS put on a credit card. While this is not specific to agencies, and is a huge problem for many businesses, the saga of Credit Cards Gone Wild is definitely at the top of the list for broken agency processes.

a. *Too Many Cards, Too Many Users*

How many cards your agency has can be a huge area of concern; often, people think having too many credit cards is the biggest issue, however, too few cards can be an even bigger disaster.

Many agencies distribute too many cards to too many people, including those only making a few small agency charges a month, thinking it will alleviate any expense burden to the employee and make purchasing more efficient for the agency. But without good checks and balances, this creates even more problems for the agency's Accounting department, slowing down payment processing, delaying reconciliation and coding, managing accidental employee charges, and overall making it difficult to control and manage these agency expenses.

On the flip side, some agencies have too few cards because they're afraid of the above ramifications. Unfortunately, this can lead to its own set of problems as credit card numbers tend to get shared between employees to alleviate the bottleneck of only having a few purchasers. Without good checks and balances here, it is very difficult to keep cardholders accountable for everyone else's credit card charges, and often, this leads to even more rogue charges being made without anyone's oversight or approval.

We encountered one situation where there were 3 credit card numbers distributed across 35 event producers! It was almost impossible to find the responsible parties for rogue or inaccurate credit card charges because the cards were being used by just about everyone and no authorization forms or reconciliations were being done. Each month, Accounting had to go on a marathon manhunt to track down the person or people – or office dog! – who made every charge on each card, finally resolving to simply route a spreadsheet and let people fill in what they remembered purchasing. This often left Accounting holding the bag for charges that couldn't be verified.

b. *Untimely + Inaccurate Management*

When Accounting ends up holding the bag for charges that can't be identified or verified, that often leads to charges not getting billed back to clients appropriately – or ever!

Without good credit card processes, the responsibility of accurately coding charges to the right project or client often falls to Accounting rather than the purchaser who is familiar with the project and expense. This often leads to unverified client charges being miscoded as an agency operating expense or as an unreimbursable client-related expense – meaning the agency is forced to eat the cost rather than having them properly billed back to a client. It can also lead to loss of project margin if expenses aren't properly marked up before being billed back to clients.

Another major issue relates to the timing of when credit card charges are coded. Many agencies only upload/code charges to projects once a month after they've downloaded their statement – and in some cases, not until after they've reconciled and paid the credit card bill. While this may seem like less work for Accounting, it can cause other problems for them when Project Managers don't have real-time data to accurately manage these outside project-related expenses. Often, we see incorrect charges get caught too late or charges get coded to projects after final invoices have been sent to clients, which causes even more work for Accounting and PMs.

c. *Charging Personal Expenses*

We've all been there; you accidentally use the wrong credit card at the nail salon for that super awesome pedicure and forget to notify Accounting of this personal charge. Or, even worse, you might have had a former employee who took advantage of their corporate credit card for personal expenses. Having a corporate credit card is a privilege that comes with responsibilities for both the agency and the cardholder. Without a strong credit card review and reconciliation policy to hold cardholders accountable, this situation can become a costly agency problem.



Improperly Tracking Your Benjamins

Without good tracking, you cannot have good data. You can have a gut feeling all day long about what is affecting your financials, but if you're not properly tracking your benjamins and running reports with key insights, you won't be able to make solid data-driven decisions.

In some cases, not tracking this critical data or agency KPIs stems from not having the right tools to properly track or record the necessary information to gain these insights. However, much of this data can be extrapolated from your systems, then combined and configured into the right reports; you just need to know what data to pull and how to present it. It's not about pulling a zillion reports; it's about properly designing and reviewing reports that produce key insights that will affect change within your organization.

So, which benjamins are most agencies tracking improperly?

a. *Labor Income vs. Outside Expense Markups*

When agencies don't separate their Labor Income from their Marked Up Expense Income (we know, it's kind of an oxymoron) on their Corporate P&L, it is difficult to measure the margin being produced by billable employees vs. markups being made on outside expenses.

Take for example an agency that negotiated a really low client rate card but large amounts of markup on outside expenses. If that agency has not separated Labor Income from Marked Up Expense Income, they are unable to see the large profitability gap on the Labor Income side. In this scenario, the markup on the outside expenses is subsidizing the low labor rate, and without an easy way to identify labor vs. outside expense margin, this agency could be putting themselves in a very risky situation.

Additionally, if an agency's Labor Income and Marked Up Expense Income aren't separated by service line, it is also difficult to easily identify the margin of your different internal and external service lines. By not tracking Labor Income at the service line level, you cannot effectively see how much you're producing in Labor Income with the billable department headcount you have. When it comes to Marked Up Expense Income, you are unable to easily make the distinction in margin between your various outsourced service lines.

b. Agency Gross Income and Gross Margin

It's not as simple as just tracking your agency revenue and net profit. With all of the different agency capabilities and revenue streams, including fee/production labor, marked up expenses, pass-throughs and media, it's impossible to create a set of agency benchmarks based on revenue. Instead, Best Practice agency benchmarks are based on Agency Gross Income, and if you're only tracking Revenue, you will be unable to successfully use industry benchmarks to help manage and grow your business.

Very often, we see agencies include their Direct Labor costs as Cost of Goods Sold, which limits them to only being able to report Revenue and Agency Gross Margin/Profit (Revenue minus Cost of Goods Sold minus Direct Labor minus Direct Contract Labor). This eliminates their ability to report Agency Gross Income, which should be measured as Revenue minus Cost of Goods Sold, where Cost of Goods Sold is only equal to the net outside project-related expenses utilized to deliver their services or capabilities – and DOES NOT include Direct Labor or Direct Contract Labor.

c. Freelancers/Contractors

Mismanagement of freelancers and contractors is one of the biggest drains on an agency's benjamins. We see it all the time... agencies hire freelancers to help alleviate workload and avoid full time hires during seasonal or project peaks, but they're often not tracking the proper details, so they can't easily identify the effects on Agency Gross Margin/Profit.

Many agencies don't track freelancer/contractor costs by detailed capability or type in order to determine the margin and break-even point for bringing that capability in-house or for hiring a new employee. In most cases, agencies miss the break-even point, either hiring too early or too late, costing them valuable profit dollars.

Another huge area of concern with freelancers/contractors is how their income and costs are being recorded on your agency's financial statements. Freelancers/contractors who are tracking their time in your accounting technology are usually recorded as Labor Income; however, their costs may be getting coded to Cost of Goods Sold. When this happens, you could incorrectly inflate the margin you are making on your direct employee labor since the freelancer/contractor cost is not represented within employee compensation; in addition, this would decrease the margin you're reporting on your Cost of Goods Sold.

Without proper tracking in this critical, high expense area, agencies could be grossly miscalculating the overall benefit and profitability of utilizing outsourced freelance/contract labor.

d. Client P&L Tracking

Very often, agencies don't track everything related to delivering work for a client – including over budget labor, non-billable client development labor and expenses, unreimbursable expenses like working meals or shipping, etc. – against the client. This inaccurately inflates the Client P&L and misrepresents the overall effective hourly rate for that client. Agencies can't accurately analyze the health of a client relationship if they aren't properly tracking all of the time and expenses to manage or grow the client that they are unable to bill back.

Without insight into all of the labor and expenses related to a client, whether you can bill them or not, you can't properly analyze the effective hourly rate of the client to determine if they are a good fit for your agency.

Without the proper tracking of all these benjamins, it can be nearly impossible to get data from your Corporate P&L or Client P&L that allows you to make critical agency management decisions like increasing rates, hiring new people, firing clients, taking on a new capability/service, etc.

So many agencies end up running around like chickens with their heads cut off because they don't have the data they need to drive actionable insights to affect change within their agency. Or, they're spending too much time tracking their benjamins in the wrong reports, leaving them constantly solving symptoms instead of the problem at its root.



Billing: Show Me the Money

Hopefully we're not dating ourselves, but do you remember the line from Cameron Crowe's *Jerry Maguire*, when Rod Tidwell (played by Cuba Gooding Jr.) yells for Jerry to "SHOW! ME! THE! MONEY!?" This is a constant refrain we hear from agency Principals and Executives who are consistently discouraged when reviewing their agency financials. In many cases, the agency feels slammed with work, but the financials don't reflect the revenue and profit the agency should have for feeling that busy. Often, this can be traced back to mismanagement of revenue recognition, billing, or revenue and expense matching.

a. Inconsistent or Inaccurate Revenue Recognition Methods

Most agencies don't realize that there is more than one right way to recognize revenue, or, more importantly, that their revenue recognition should be aligned with their signed client contracts. Often, agencies only utilize one method of revenue recognition, and they don't take into account the various requirements of their client contracts.

We often see agencies just recognizing revenue whenever they bill their clients. While this may be correct under certain circumstances (e.g. time and materials progress billing) it definitely isn't correct for all circumstances (e.g. retainers or fixed bid milestone engagements). One area we see a lot of agencies struggling with surrounds percent complete revenue recognition. Many agencies try to apply the principle of percent complete revenue recognition, however, without tracking the proper details, they often end up mismatching revenue and associated direct costs, or misrepresenting the effort expended to justify the appropriate revenue amount for the period.

Without detailed estimates and time tracking by phased project architecture, it can be difficult to accurately determine how much of the project has actually been completed – so agencies generally rely on how far through the total budget (in hours or dollars) they are. But this doesn't properly take into account if you've spent more hours or dollars delivering a particular phase of the project than you estimated. When this happens, you end up recognizing more revenue for the work expended in that phase than you would have recognized if you had completed the work on budget. If you continue this throughout the project, you will recognize all the revenue before the work is actually complete, leaving you with weeks to months of direct costs with no matching revenue.

b. Mismatching Revenue and Costs

Many agencies are mismatching their revenue and project-related costs across accounting periods, leading to timing issues that misrepresent the agency's Gross Income, Gross Margin and Net Profit. When reviewing company financials of longer accounting periods (e.g. yearly or quarterly data) this mismatching may be less of an issue as it may even out over this longer period of time. However, within shorter periods (e.g. monthly) these swings in company financials can significantly misrepresent Agency Gross Income, Agency Gross Margin and Net Profit for that period.

Improperly accruing and deferring revenue is one of the main issues behind mismatching revenue and costs. We've seen many agencies that don't manage deferred revenue properly, or even at all! When a client pays a large deposit invoice and the agency recognizes the whole deposit as revenue instead of deferring the revenue until the work is earned (based on your revenue recognition methodology as described above), they are overstating their Agency Gross Income, Agency Gross Margin and Net Profit for that period. On the flipside, agencies that don't accrue revenue for work they have earned but not yet billed are understating these same company financial metrics.

Project-related expenses are another area where agencies often mismatch revenue and costs. For agencies managing high volumes of outside project-related expenses, deferring and accruing those expenses properly can be difficult, and when done incorrectly, can also severely affect an agency's Gross Income, Gross Margin and Net Profit.

We see it all the time: agencies recognize revenue on an outside expense for work completed before they've received the vendor invoice and do not accrue the cost appropriately, leading them to overstate Agency Gross Income, Agency Gross Margin and Net Profit. On the other hand, if they receive a project-related vendor invoice and don't bill it back or recognize the appropriate amount of revenue within the same period, they end up understating these same company financial metrics.

If you aren't properly accruing or deferring revenue AND expenses, your operational data and your financial data might tell you two very different stories. For example, if your operational data shows that your team logged 1,000 hours of billable work last month that should have equaled \$200,000 in revenue, but you forgot to defer an unbilled \$50,000 project-related expense, your Agency Gross Income would only show as \$150,000 for that period. This may lead to concern where there should be none – or, even worse, when you do take the \$50,000 in revenue for the expense later (without the matching cost), you might think you had a really great month, but the operational data might be telling you a different story. Mismatching revenue and costs can lead to lots of confusion about the financial health of your agency.

c. Managing Realization Gap: Show Me The Money That Could Have Been

Probably the biggest area of concern we have for agencies is the misunderstanding of Agency Realization and how severely it impacts an agency's bottom line. Agency Realization measures the ratio of billable hours to billed hours, showing you the percent of billable hours you actually got paid for.

Breaking News: Many agencies don't get paid for all the hours they put into projects!

Now, we all know this is true (we've talked about it time and time again on our blog); but what agencies AREN'T doing is measuring their agency-wide Realization Gap to accurately identify opportunity cost revenue, or how much they could make if they were getting paid for all their billable hours, either within the projects they're already working on or with additional work they could be servicing.

Instead, agencies tend to only look at the decreased margin by project, a.k.a. the difference between 42% and 39%. However, they misunderstand the gravity of the situation because that 3% margin could be an opportunity cost of \$20,000 gross dollars they could be charging to another client. Since the agency is already paying for the labor cost associated with this revenue, the \$20,000 – if actually earned! – would go directly to the bottom line.

Agencies who don't measure this Realization Gap end up making decisions based on inaccurate data – like thinking that they need more headcount when really they just need to focus on getting paid for the work they're already producing!

Managing proper revenue recognition, billing, matching and effective hourly rates is not always enough to affect change within your agency. Sometimes the best way to get through to the team managing the work is to show them the money that could have been.

We know we just aired all your dirty laundry and opened the Agency Kimono. You may be feeling a bit of a draft and are probably wondering how to get this buttoned up – quickly. Never fear! Our next article will provide solutions and actionable next steps for the first five broken operational processes; then, we'll follow that up with the final article in this series, which will cover solutions for how to address the broken financial processes discussed here. Stick with us!

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Vanessa Edwards is a serial entrepreneur, professional jet pilot, former agency owner and founder of Creative Performance Inc, a consultancy that empowers agency owners to achieve their cultural, operational and profitability goals. As a FunctionFox, Workamajig and Oracle PLM partner, she has helped over 100 marketing services organizations (agency + brand) through large-scale organizational change, complex technology deployments and strategic planning.



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