THE CPI TOP TEN:

Broken Agency Processes Solutions - Financial

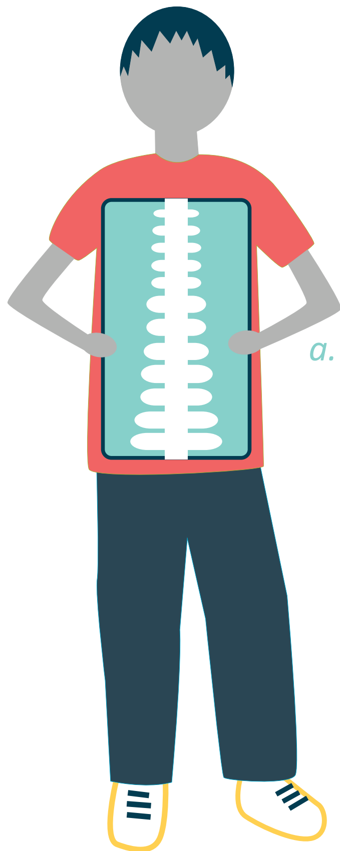
By Vanessa Edwards

Welcome back to the 4th and final installment in our CPI Top Ten Broken Agency Processes series. Writing these articles has been a bit of a cathartic experience for us, and we hope you've had the same experience while reading them.

This article, Solutions to Financial Challenges, is perhaps our most in-depth and involved article; it covers some very deep financial topics, and is pretty accounting heavy! So, Project Managers – beware! While this is all excellent information for anyone in an agency to know, it is first and foremost important for your agency's Finance department to understand everything written in this article.

So let's get started!

Broken Agency Process 6
Bill Backs Breaking Your Back?



We see many agencies losing piles of money by not promptly and accurately billing back their project-related expenses to clients. Some agencies struggle with not remembering to bill back expenses, while others don't mark them up properly; even worse, some agency Project Managers don't understand their client contract parameters to know if expenses are supposed to be included in the contract or billed on top. However it happens, the inaccurate billing back of project-related expenses to clients can cost agencies thousands of dollars – so how do you stop the bleeding and make sure you're recouping all these costs?

a. *Managing Freelance Labor*

First and foremost, agencies should look at how they're handling their freelance labor. Someone in your agency needs to be in charge of managing a list of approved freelancers with agreed upon rates; this list should prevent people from choosing their best friend vs. the best person for the job, and also allows you to control margins by pre-negotiating rates based on the function being performed by the freelancer. Make sure all freelancer hours are being mapped to appropriate agency functions and billed back to your clients at your agency's gross rates, not at some other rate. It's important that your Finance department is involved in reviewing and approving freelancer rates and margins to guarantee project profitability.

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Once this pre-approved list has been completed, the next important thing is to make sure your Project Managers are scoping freelancers properly within their project estimates. Whether a PM knows they will be using freelance labor when they are initially scoping their project or they decide to outsource mid-project due to capacity issues, PMs need to make sure they are not giving away project profitability by miscalculating freelancer budgets.

If a PM is scoping freelance labor from the start of a project, as mentioned above, it is critical that they are not managed as a pass-through expense or as a standard vendor, like a printer, which usually only allows a 15 to 20% markup. Unfortunately, many PMs forget this and either pass the freelancers through with no markup, or only markup the freelance labor by 15 to 20%, which is often significantly lower than marking up the freelancer's rate to agency gross rates. If you're using a pre-approved freelancer list and mapping to your agency rate card, when you scope the hours appropriately, you can feel confident your project margins will be preserved.

As you're scoping these freelancer hours, don't forget that managing freelance labor can often take additional oversight from your Creative Director, Copywriter, Technology Director, etc. When you know you will be utilizing freelancers from the start of a project, it's important to scope additional hours for whoever is providing creative or tech oversight to manage these freelancers. This doesn't have to be a huge amount of additional hours; we're only talking about an additional 10 to 15% of the freelancer's hours for this extra oversight. Remember: your Creative Director (or whoever) should already have oversight hours scoped to provide supervision throughout the project; we're just adding a few more hours for the complexity of guiding an external resource through your creative process. We often see PMs struggle to remember this when scoping projects, which can cause them to go over budget later or risk the quality of a deliverable if this oversight does not occur.

There are many situations where a project has been scoped to be done with internal resources, however, based on agency capacity and workload, the agency makes a decision to utilize freelance labor for pieces of a project. This requires PMs to re-scope on the fly, which is often done incorrectly and usually costs the agency a great deal of profit. Many PMs make the mistake of using gross budget dollars to quote out work to the freelancer, giving away all of their margin! In addition, they also forget to account for the additional oversight hours required to supervise the freelancer through the creative process. D'oh!

For example, if you have a budget of 40 hours at a $125 hourly gross rate ($5,000) for copywriting within a brochure project, when you outsource this work to a freelancer, you should calculate the oversight hours needed and remove them from the gross budget first; e.g., if you allocate 10% of the copywriting budget to creative oversight at your Creative Director's $200/hour rate, that would give you 2.5 hours ($500) that need to remain internal, leaving you with a $4,500 gross budget.

Next, to determine the maximum amount of hours that you can give the freelancer without reducing project margin, divide the remaining budget of $4,500 by your agency's $125 hourly gross rate for copywriting; this gives you 36 hours left that can be allocated to the freelancer. At the freelancer's net rate (say $50/hour), this equals $1,800 that represents the maximum net budget you should outsource to your freelancer.

But, before you go telling the freelancer that they have $1,800 to spend on this project, the PM should request a quote from the freelancer, as it is possible they are faster than your internal team and can get the work done in less than 36 hours. Why give away margin if you don't have to?

If the freelancer can't do the work within the 36 budgeted hours ($1,800), the PM should work with Finance to get the reduced margin approved. For example, if the freelancer quotes $2,250 (or 45 hours at their $50/hour rate), this would result in a reduced agency gross rate of $100/hour for this work ($4,500 gross budget/45 hours). In some cases, when an agency is at capacity, it can be better to do the work at a reduced margin than not do the work at all; however, this decision should be made by your Finance team, not the PM.

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b. *Billing Back Expenses*

If your agency's problem lies in not billing back the correct expenses to clients, the first step is making sure your Account and Project Managers clearly understand what expenses are included within the scoped budget of the project and what expenses need to be billed on top. Common examples of outside expenses that are often billed in addition to contract amounts are shipping, printer proofs, fonts, stock photography and travel.

When PMs are unfamiliar with their contracts, they can make mistakes like including expenses that should be billed in addition to the contract amount within the price of the project. They also may forget to get pre-approval from their client for outside purchases to be billed in addition to the contract; in many cases, this lack of client approval can leave the agency holding the bag, forced to pay for additional hard costs, and ultimately reducing project and client profitability.

One way to easily identify expenses that need to be billed on top is to open separate projects within your project management/accounting tool specifically for these out-of-contract expenses. This usually reminds PMs and Accounting that these expenses need to be billed separately from the project. If using an integrated system, like Workamajig® or Advantage, you could create a separate Task or Component specifically to identify these out-of-contract expenses within your project; however, without rigorous management, it can still be easy to forget that these expenses should be billed on top of the project budget.

c. *Budget Management Tool*

Another solution is to launch a strong budget management tool, ideally one that includes gross labor as well as gross AND net expenses to create, manage and track all of your project costs. Most importantly, when used properly, this tool will help you manage all of your outside client-related expenses to ensure proper billing back to your clients; this can easily be accomplished with an integrated solution like Workamajig or Advantage. Most of these tools have a great Purchase Order functionality that can be instrumental in properly marking up and billing back the appropriate project-related expenses. In addition, they have Item Rate Sheets that allow you to define standard or client-negotiated markups for certain types of purchases, e.g. printing, illustration, photography, equipment rental, etc. and even freelance labor! These can be setup by Finance to be used as a guide for PMs when scoping projects to ensure appropriate margins on outside expenses.

Even with these Item Rate Sheets, we find that there is still confusion surrounding Markup vs. Margin of outside expenses. Finance often thinks in Margin, while Project Managers often think in Markup. It is critical for your team to understand the difference and know when to best use each one. It's also critical for them to be able to convert Markup to Margin and vice-versa, so they can always be speaking the same language.

Markup should be used when you want to add dollars on top of the net cost of an expense; Margin should be used when you want to derive the amount of profit between the net cost and the gross amount of an expense. The most important thing to note is that if you try to calculate Margin by using Markup, you will undershoot the Margin. For example, if you want a 30% Margin and you multiply your net cost of $100 by 130%, e.g. $100 x 1.3 = $130, you are only actually getting a 23% Margin, e.g. ($130-$100)/$130 = 23%. To properly calculate a 30% Margin, you have to multiply by 143%, e.g. $100 x 1.43 = $143, or ($143-100)/143 = 30%.

Since these calculations can get complex, it is a great idea for Finance to create a cheat sheet for Project Managers to convert your most commonly used Markups and Margins, e.g. 30% Margin = 43% Markup; 30% Markup = 23% Margin; etc. Some technologies only manage in Markup or Margin and don't always have both calculations available to the end user.

Another great solution for not forgetting to bill back your project-related expenses at the appropriate amount is to institute a PO policy and Vendor Reconciliation process, which we will cover in detail in the next section, Purchase Orders: Blurred Lines.

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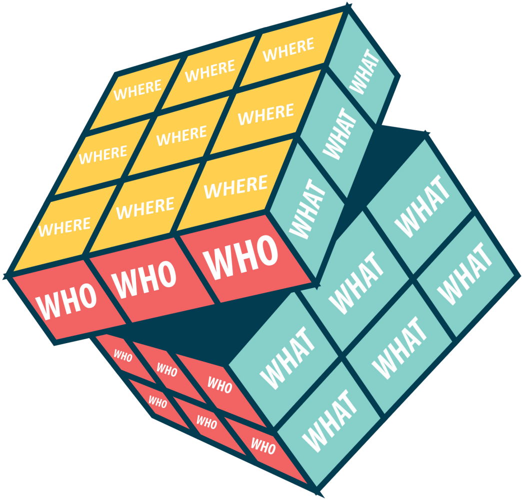
Broken Agency Process 7
Purchase Orders: Blurred Lines



As discussed above, implementing a Purchase Order policy with clear processes is critical to effectively managing outside expenses. If your agency has no PO policy at all, your first step is to adopt one! If your agency has a poorly-defined or poorly-followed PO policy, your first step is to fix it!

So, what is a good PO policy? At its simplest, a good PO policy has clearly defined processes for when POs need to be created (timing and threshold), what critical information needs to be captured (item definitions) and what needs to be relayed to vendors (e.g. terms and conditions), who can and can't create POs, who has authority to approve POs and for what dollar amounts, and when and how to reconcile vendor invoices to POs. This PO policy should be well documented and trained to those employees deemed as purchasers for the agency. It's often not enough to write it down and train it once; we recommend refresher training annually for all purchasers to ensure accuracy of data and reduce expensive out-of-pocket errors.

a. Approved Purchasers + Approvers

As previously discussed in this article series, agencies often have too many people making agency- or client-related purchases. The first step to a good PO policy is clearly defining and limiting agency purchasing to a core group of employees. This may come as a shocker to some, but not everybody in the agency needs to be able to buy things for the agency! Centralizing purchasing to an approved cross-discipline group of employees (who are well trained!) is the best way to go. So, who should these employees be in your agency? This is heavily dependent on your agency size and structure, but we recommend most client-related purchasing be done by integrated Project Managers or SME Producers, e.g. Event, Broadcast, Video, Photo or Print Producers.

In addition to defining a group of purchasers, it's also important to define a group of approvers who have responsibility for reviewing and approving POs based on predefined purchase limits. Your PO policy should include these purchase limits by person or role so the purchasers know when they need to route a PO for approval vs. when they can approve it themselves, since you may decide that for efficiency's sake, your purchasers can also approve POs up to a certain dollar threshold. Every agency needs to define these limits for their employees based on the type of work being purchased and the seniority and experience of their purchasers.

Keep in mind, before any client-related PO ever gets approved, the approver needs to confirm that the purchase is within an approved estimate or statement of work, or has been pre-approved in writing by the client. PO approvers should also verify the accuracy of the PO, confirming the proper item and department coding, proper markup (if applicable), and that the correct vendor terms and conditions have been included.

Lastly, when dealing with sizeable client-related POs, we recommend including a second level of PO approval; usually, this is a senior Accounting team member who is often considering the cash flow ramifications of these large purchases, not just whether they are within the project budget. This allows them the opportunity to ensure these large purchases get deposit invoiced, if required.

b. PO Timing

Many agencies do have pretty good policies about who can create and approve POs, but we see them dropping the ball on when the PO is created. Unfortunately, they often initiate the work with the vendor before creating the PO, and in some cases they don't even create the PO until they receive the vendor invoice. Your PO policy needs to clearly define that POs must be created and approved before work is initiated with or outsourced to a vendor or contractor. Ignoring this important piece of the policy defeats one of the main purposes of POs to the agency – the effective management of cash flow. And, if using an integrated system like Advantage or Workamajig, you'll lose the secondary purpose of POs – accurately managing project budgets with committed outsourced funds.

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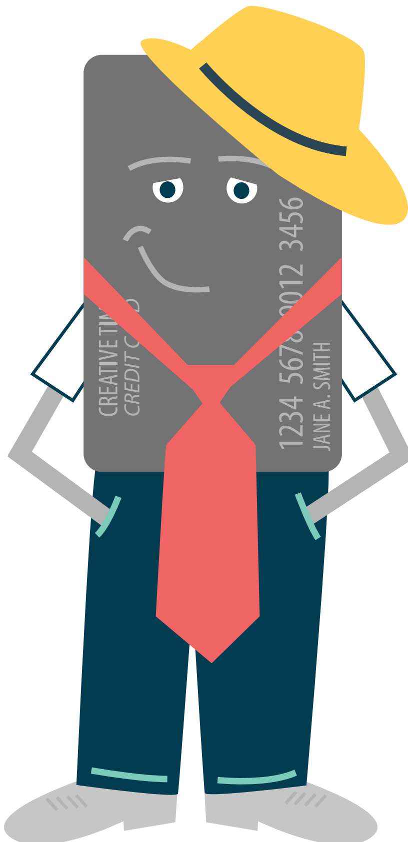
One of the most critical pieces to a good PO policy is a clear reconciliation process that provides guidelines for how to properly reconcile vendor invoices against POs and how to handle discrepancies, both big and small! In order to provide this guidance, we recommend creating a Vendor Invoice Reconciliation Form that the purchaser fills out, attaches to every vendor invoice and submits to Accounting. This form should capture information like PO number and approval status, PO amount, amount of this vendor invoice, whether or not this is the final vendor invoice or if there are more invoices to be received, what to do if the vendor invoice is over/under the PO amount, and signature lines for discrepancy approval.

This creates clear communication between purchasers and Accounting prior to the entry of AP to avoid errors in coding or payment. Without this level of communication, Accounting departments may attach vendor invoices to the wrong POs or wrong projects, or even worse, pay vendor invoices that have not been vetted or confirmed as delivered by the purchaser. In scenarios where the vendor invoice exceeds the PO amount, this reconciliation is even more critical because certain decisions that will affect project margin and agency profitability need to be made; in cases where the discrepancy is sizeable, senior leadership needs to be involved in approving the decision for the agency to either charge the client above and beyond the SOW or have the agency eat the expense.

Accounting should review the agency's Open PO Listing + Aging on a monthly basis and work directly with purchasers to close any outstanding open POs where all services have been delivered and vendor invoices have been received and reconciled.

A few words about agency-related POs: we have found that the drawbacks of managing agency-related POs tend to outweigh the benefits for small agencies. However, medium to large sized agencies can benefit from agency-related POs, especially if they are managing monthly and annual departmental budgets. If your agency wants to include agency-related POs in your PO policy, you will need to create a slightly different process for creating, approving and reconciling. In smaller agencies, Accounting usually owns the procurement of all agency-related purchases, however larger agencies often benefit from having approved departmental purchasers for their agency-related expenses. You may need to set a different group of approvers and PO limits for agency-related POs, as well as a different escalation process for reconciliation discrepancies.

You may need to create a PO policy from scratch or you may just need to clean up and clarify your current policy; either way, incorporating these recommendations will help your team effectively manage both agency- and client-related expenses, ultimately leading to higher net profit for your agency.



Broken Agency Process 8
Credit Cards Gone Wild

If your agency is struggling with the saga of Credit Cards Gone Wild, we recommend that you examine how many corporate (company-paid) credit cards your agency has (or how widely distributed your corporate credit card numbers are) and consider drastically changing your credit card count and policies. We are firm believers that not everyone needs a company credit card, or access to company credit card information.

Before you can solve your credit card dilemma, it's important to analyze what your problem is. Review your agency's corporate credit card processes, looking at:

- How many corporate credit cards do you have?
- Who's using those cards? How many people have access to those card numbers?
- Who's responsible for coding and reconciling your corporate credit card charges?
- How long does your credit card reconciliation process take?
- How often do you end up with charges where you can't track down the purchaser?
- How often do you miss an opportunity to bill back credit card charges to clients appropriately?

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a. *Approved Credit Card Purchasers*

Our number one solution for agencies with credit card problems is to limit your corporate credit cards to your agency's most senior leadership (e.g. Principal, CEO and CFO) as well as responsible individuals making daily overhead purchases (e.g. Office Managers and Executive Admins) or project-related purchases (e.g. Project Managers and Event Producers). It's not only about how many purchasers you have; it's also important to think about who has access to make corporate credit card purchases and at what dollar amounts.

From here, make sure nobody is sharing credit card numbers as this defeats the entire purpose of limiting cards and causes even bigger issues with accountability and reconciliation down the road. Instituting a limited number of cards AND purchasers allows you to limit the number of accidental personal purchases on company cards, improve coding accuracy and client bill backs, and ultimately better control agency spending as a whole.

For the corporate credit cards you do hand out, make sure the owner of the card is responsible for approving and coding all charges that were made on their card. Ideally, Accounting downloads non-pending corporate credit card transactions weekly and distribute to the cardholders for approval and accurate coding. Waiting to do this until the end of the card's billing cycle makes it very difficult for cardholders to remember what they put on their card a month ago. For those agencies with many project-related expenses on corporate credit cards, downloading and coding weekly is critical to assure Project Managers can effectively manage budget to actuals and ensure charges get billed back appropriately to clients.

Limiting the number of approved purchasers for your corporate credit cards can be an effective way to reign in your agency's credit card issues. If an employee who isn't an approved purchaser needs to make a purchase on behalf of the agency, they can either work with an approved purchaser to get the necessary approvals and make the purchase, or they can follow your Purchase Order process (as detailed above). Or, if they receive pre-approval, they can also use their personal credit card and submit a detailed Expense Report with receipt backup to receive reimbursement for agency-related charges.

b. *Credit Cards and Travel*

Many agencies feel the need to hand out corporate credit cards to anyone that travels for the agency, which in some cases can double or triple your agency's corporate credit card count. A better solution is to setup a dedicated corporate credit card for all agency travel arrangements and utilize a centralized internal booking process with clear guidelines. For larger agencies, consider using an external booking tool, which will automatically follow your stated policies and guidelines, linking directly to your dedicated travel credit card. This leaves traveling employees with only minor incidentals, meals and baggage fees/upgrades that they must cover personally to be reimbursed for. Using these types of travel-only cards creates an environment where employees have to spend as little as possible on their personal credit cards for agency travel.

c. *Managing Expense Report Purchasers*

If you're switching from having a large number of corporate credit cards to fewer cards, you're likely to see an increase in employee Expense Reports. For this transition to work properly, you need to set the expectation with your employees that their Expense Reports should be filled out when the expense is incurred or, at the latest, within 30 days of the expense. Since we know that late Expense Reports are a huge problem for agencies, we recommend that you implement a cut-off period for Expense Reports and don't accept submissions for charges made more than 60 days ago. The flipside of this employee responsibility is for agencies to make sure that they have a strict policy surrounding Expense Report approvals and reimbursements that get employees paid back within a reasonable and timely manner on a consistent basis. This means that agencies can't wait until they're paid by the client to reimburse employees for project-related expenses as that puts a financial burden on the employees and could even cost them interest; this burden should be owned by the agency and managed through deposit billings to clients, where needed.

We've referenced this already, but just to make it crystal clear: any agency with corporate credit cards NEEDS a well-defined corporate credit card process with clear policies and procedures. This process should include the review of all charges by approvers (usually a direct manager), as well as an Accounting review of the charges to ensure the accuracy of coding and validation of client-related bill backs. In addition, you should have someone with strong fiscal responsibility, ideally your COO or CFO, in charge of the overarching monitoring of your corporate credit card process who can enforce your agency's policies and guidelines, including the consequences for misuse of a corporate credit card.

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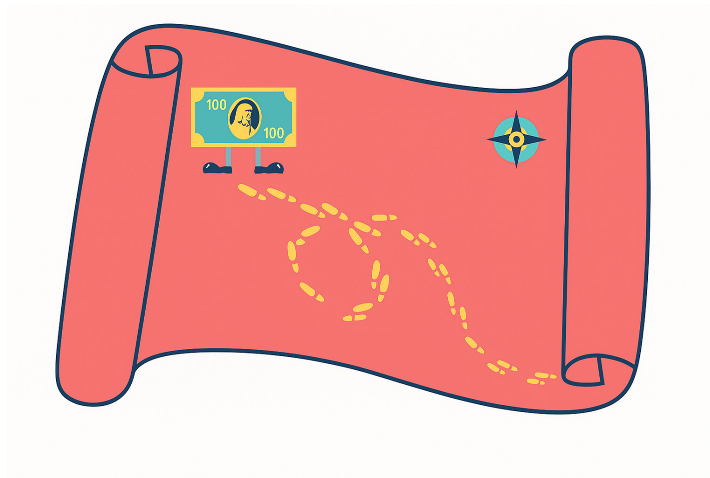
Corporate credit cards are a necessity when running any business and when managed properly, can become an efficient and effective way to quickly handle the payment of agency-related expenses. Just use these famous words spoken by a true master, Spiderman's uncle, with all corporate credit cardholders: "Remember, with great power, comes great responsibility."



Broken Agency Process 9
Improperly Tracking Your Benjamins

Properly tracking your Benjamins leads to better analysis, giving leadership the ability to make true data-driven decisions to aid in guiding agency operations, growth and profitability. Unfortunately, many agencies are limited by the tools they are using; agencies will get the best data with an integrated Accounting and Project Management system, like Advantage or Workamajig, where the transactional data of time entry, vendor invoices, expense reports, and credit card charges drive the General Ledger data. An integrated system, when setup and managed properly, automatically connects the data accurately, avoiding the manual translation or missing communication that often occurs between many Project Management tools and the agency's Accounting software.

Unfortunately, deploying an integrated software properly is a large investment and often cannot be afforded by smaller agencies. Rest assured, there is still value that can be derived from properly tracking your Benjamins in a non-integrated Accounting tool.

a. Labor vs. Marked Up Expense Income

One of the keys to valuable data is making sure you can break out your Labor Income (Agency Fees) from your Marked Up Expense Income. Ideally, these categories would also be broken down by Service Line, which is very easy to do within an integrated tool, however, may be a struggle for agencies utilizing a software like QuickBooks. By separating Labor Income from Marked Up Expense Income, it is easier to separate the money you are making on the billable employees you have from the money you are making by marking up outside expenses. This allows you to easily calculate average Effective Hourly Rates for your agency, as well as get a good pulse on how much revenue you're producing compared to the billable hours your team is logging. Without separating these, the margin from expenses can hide an agency's low Effective Hourly Rate (aka Realization Gap).

In order to get the most value from Service Lines, we recommend not only setting up Labor Income accounts by Service Line, but also matching Marked Up Expense Income and Marked Up Expense COGS accounts by Service Line; this allows you to see the average markup by Service Line. It is critical not to include reimbursable expenses (pass through expenses) in these accounts as it will decrease the average margin in these Service Lines; rather, reimbursable expenses should be tracked in separate Reimbursable Income and Reimbursable COGS GL accounts to ensure the agency is getting paid back for ALL reimbursable (pass through) expenses.

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b. *Unreimbursables*

It's also extremely important to track Unreimbursable COGS, which include client-related investment expenses that you can't bill the client for. Unreimbursable travel and working meals are expenses that are often not initially budgeted within projects, however come up as an opportunity for investment by the agency in the client relationship. These expenses should be pre-approved by agency leadership and should be coded to an annual non-billable client admin project as they represent continued investment in the client relationship. In certain integrated systems like Advantage and Workamajig, tracking Unreimbursable expenses allows you to more accurately measure Client P&Ls and Client Effective Hourly Rate, giving you visibility into the true cost of the client engagement.

These non-billable client admin projects MUST be managed by PMs just like any billable project and reviewed monthly to ensure that these projects do not become dump buckets for hiding time or reimbursable expenses that should be billed back to clients.

All these words are great and everything, but what does this really look like in practice? How should these ideas be reflected in your financial layout? Here's a sample agency P&L layout (non-technology specific) based on our best practice recommendations; if you're using an integrated software like Workamajig or Advantage, you might have a slightly different layout based on how the tool automatically manages Deferred Revenue, Accrued Revenue, Deferred Project Expenses, and Accrued Project Expenses. Also, depending upon your capabilities, your agency's Service Lines may be slightly different than this sample.

It's critical that you do NOT include Direct Labor or Direct Contract/Freelance Labor within your Agency COGS, as this limits you from being able to use your Agency Gross Income to benchmark your agency within the industry. Given the wide variance in agency capabilities and the corresponding margins on outside expenses, it is almost

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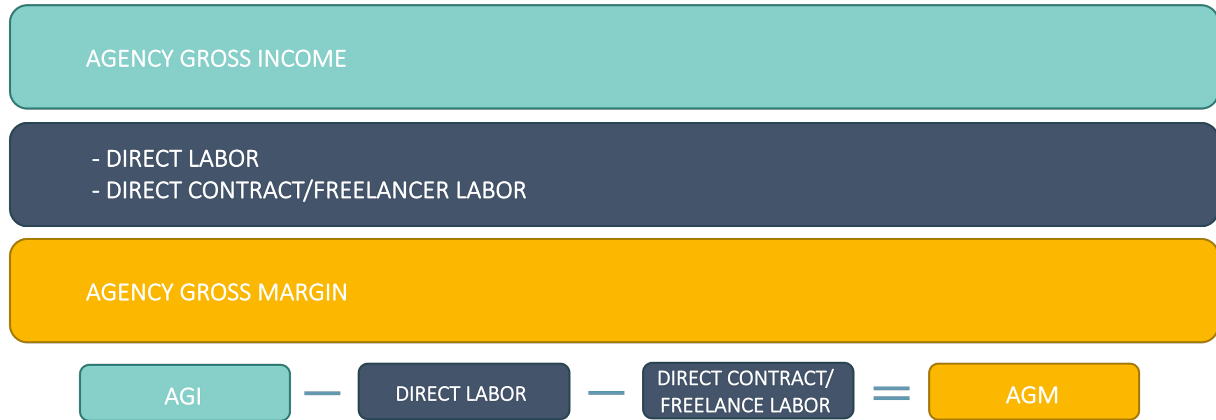
impossible to do industry benchmarking based on agency Revenue. Therefore, we recommend always using Agency Gross Income as your benchmarking standard.

However, we think it's equally important to measure Agency Gross Margin, which is Agency Gross Income – Direct Labor – Direct Contract/Freelance Labor. Most technologies will only give you either Agency Gross Income OR Agency Gross Margin, but not both. If your technology only allows you to get one of these, we recommend not putting Direct Labor or Direct Contract/Freelance Labor in COGS so your system will automatically give you Agency Gross Income. From here, you can then easily calculate Agency Gross Margin manually by exporting to Excel.



At a certain agency size, there is a large value to tracking Departmental P&Ls as well as Service Line P&Ls. However, only an integrated technology is likely to give you access to both so you can easily see accurate Departmental P&Ls as well as the revenue generated by Service Line, which includes revenue produced by cross-departmental resources. Integrated agencies above 50 employees that are growing rapidly should definitely consider tracking both Departmental and Service Line P&Ls.

Tracking your Benjamins following the best practices outlined above will give you substantially improved insights into the financial health of your agency, including the ability to easily identify contractor/freelance labor overspending, calculate billable hours unable to be billed to clients (Realization Gap), find reimbursable expenses not being billed back to clients and ascertain margin by outsourced Service Line; ultimately pinpointing where the agency is really making (or losing!) money. Once you have this information, you know where to start looking to identify the process or technology issues that need to be changed or improved to directly impact your bottom line.

Broken Agency Process 10
Billing: Show Me the Money

When it comes to "showing you the money", we're really trying to solve two problems:

1. the mismatching of revenue and costs that gives us incorrect financial statements, which can lead to poor decision making and ultimately a hit to agency profit;
2. the need to fix the agency's Realization Gap (those billable hours that don't get billed to clients), which in most cases, has a substantial impact on the bottom line.

In order to solve the first problem, it's important for agencies to understand their contracts in detail and to choose the appropriate method of revenue recognition that matches their contract. Once you have nailed down which revenue recognition methods are right for your agency, you must implement them consistently; for larger agencies, the only way to ensure consistency is to document the methods and make sure your Finance department is well trained on these methods.

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As we mentioned in Part II of this series, the type of revenue recognition that is right for you depends on your client contracts; for example, Time & Materials contracts have different revenue recognition processes than Retainers or Fixed Bid engagements. Regardless of the contracts, it's ideal to recognize revenue as it's earned. For Time & Materials engagements, this is very easy, as you bill the actual labor and expenses that occurred in the month.

a. Time & Materials

When properly recognizing revenue on Time & Materials engagements, make sure you date the billing within the period that the work was completed; for example, a Time & Materials invoice for work done in January should be dated January 31st. However, some agencies struggle to get their end of month billing done in a timely fashion, and may not be able to invoice all of those transactions on an invoice dated in January. Some other agencies may not bill until the project is complete, which may not be for a few months.

So, if you're going to invoice January work in a later month, you need to make sure you accrue revenue in January for work completed in January, to allow for the revenue and direct costs to be properly matched in the month of January. In order to avoid having to do a lot of manual accruals, we recommend doing your Time & Materials billing immediately following completion of month-end time entry; ideally, this will allow you to complete these invoices in time to include a January 31st date.

b. Retainers

Retainer revenue recognition must also be based upon your specific Retainer contracts. Most Retainers do not designate a specific number of hours, but rather define a set number of people that are either designated at a specific percentage or dedicated full time to this Retainer.

Revenue recognition for a traditional Retainer is usually amortized evenly over the period of the contract, due to the fact that the agency cannot accurately predict when the work will be completed and/or if they will spend significantly more or less hours to complete the Retainer than is identified in the contract.

A reconcilable Retainer, however, is based on a contract that states exactly how many hours are being purchased by the client, which often is comprised of dedicated or designated resources; any work above or below the contract value will be billed in addition or credited back to the client. While this may be billed evenly in installments over the contract period, the revenue recognition should be based on the work completed to date, similar to the Time & Materials method above.

c. Fixed Bid

For Fixed Bid projects where your client contract states that you do not get paid until you provide specific deliverables, and where you don't have a strong cancellation clause allowing you to bill for all work completed to date if the client cancels, then you should use milestone-based revenue recognition. In this case, you wouldn't recognize any revenue until the deliverable was completed and accepted by the client.

Unfortunately, while this is GAAP compliant, it is less accurate for matching your revenue and direct labor costs in the same period, making it a less ideal method for financial analysis. To gain the best information out of your operational and financial data, you want these to be as closely linked as possible – meaning, you want your revenue to reflect what you have earned in that month with the direct labor costs that you had in that month. To do this, we recommend using percent complete revenue recognition – but one of the major caveats to using this method (among others) is that you need to have a strong cancellation clause allowing you to bill for all work completed to date if the client cancels mid-project.

Percent complete revenue recognition is the ideal method for ensuring you can get the best comparison data out of your operational and financial reports while staying GAAP compliant. The key to this is being able to accurately determine percent complete through a project, which can be difficult to do/prove without an integrated software, a well-trained Project Management discipline and a strong Finance lead. If percent complete revenue recognition is managed poorly or not managed at all, you may have even worse financials than before, almost assuring that you won't be GAAP compliant.

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Effectively matching revenue and expenses while using the percent complete revenue recognition method can be a little tricky. Integrated systems (like Advantage and Workamajig) can really help with this as they have easy ways of managing Accrued and Deferred Revenue, as well as Accrued and Deferred Expenses. However, if you're using a system like QuickBooks, you have to get a little inventive with journal entries to manually accrue and defer revenue as well as expenses – but don't forget to manually reverse those accruals and/or deferrals in the appropriate period!

Most importantly, you need to AVOID taking revenue without accruing the associated expense, even if you do not have the vendor invoice! On the flipside, you need to AVOID booking expenses to the P&L without taking the appropriate revenue, even if you haven't billed the client!

Knowing when to accrue vs. defer revenue and expenses is the most critical component to accurate matching within the percent complete revenue recognition method; if you don't get these pieces right, your AGI, Gross Margin or Net Profit may be over- or under-stated in that period. In longer periods (e.g. annual reporting), these over- or under-statements may even themselves out; however, when reviewing data in shorter periods (e.g. monthly), these swings can be very misleading and can cause a leadership team to try to solve the wrong problems within their agency.

The second problem we discussed is finding the money that "could have been" – your Realization Gap. As we discussed in Part II of this series, Agency Realization measures the ratio of billable hours to billed hours, showing you the percent of billable hours you actually got paid for. In contrast, your agency's Realization Gap identifies your opportunity cost revenue, or how much the agency could make if you were getting paid for all your billable hours, either within the projects you're already working on or with additional work the agency could be servicing.

Realization Gap analysis is the complement to your agency Utilization analysis. Many agencies focus solely on agency Utilization and Revenue reporting, and are missing the core component of agency Realization, which ultimately connects these two metrics.

Often, we see agencies with high Utilizations but low monthly Revenues – their team is logging crazy billable hours but the agency doesn't have the Gross Margin to show for it. Assuming the agency is following proper revenue recognition methods, the difference between their current monthly Revenue and what they should be earning is their Realization Gap.

You are already paying everybody to do the work, so as you fix your Realization Gap and start billing for these hours, the Revenue can fall straight to the bottom line. Increasing agency Utilization without fixing the Realization Gap just allows you to do more work that you're not getting paid for.

Unfortunately, your Realization Gap can be hard to access without an integrated system. However you can manually calculate the total over budget transactions for all completed projects within a period to see all of the dollars you could not invoice to your client. The key to this is that you can only get this number when the projects are completed and final invoices have been sent, assuming you have good tracking in an effective project management tool.

Not only can an integrated system help to identify this Realization Gap, but with proper setup, we can easily break it down by client, project, function, person, and reason. And, if Write Offs (over budget billable transactions) are managed monthly by project phase, you can also see an accurate monthly Realization Gap report showing you all the money that could have been.

Our best practice would be to run this report three different ways: grouped by department and by reason; grouped by client and by project; and grouped by client and by reason. By reviewing these reports, you can identify the reasons behind why a department is going over budget, which clients have the biggest effect on your Realization Gap, and why certain clients are less profitable than others.

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While this reporting is extremely valuable, it's what you do with it that really matters. By consistently reviewing these reports, you can identify problem areas within your agency that likely need a process facelift. With well-defined Realization Gap reasons, you can effectively see the money that specific process issues are costing your agency, e.g. mis-scoping or over servicing, allowing you to focus your efforts on the worst offenders. This also allows you to track the progress you have made in these areas, which can be shared with the team and ultimately used to increase accountability.

Analyzing your Realization Gap at this detailed level allows you to solve the root problems once and for all – ultimately increasing agency profitability!

We know – that was pretty heavy stuff! Congratulations on making it to the end of this article, and to the end of our CPI Top Ten Broken Agency Processes series! As we alluded to at the end of our last article, now that you've read through all of our solutions for the most common agency broken processes, you should prioritize the solutions that will provide the most value to your agency right away. Then, develop a plan for implementing the right solutions for your agency.

When developing your specific plan, you may want to customize some of our solutions to be more effective within your agency's culture. And of course, in order to be successful, you need both leadership buy-in and designated resources to help you tackle each solution. Once you have this necessary support, you will need to work hand-in-hand with your agency's leadership to affect change and successfully implement the plan.

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