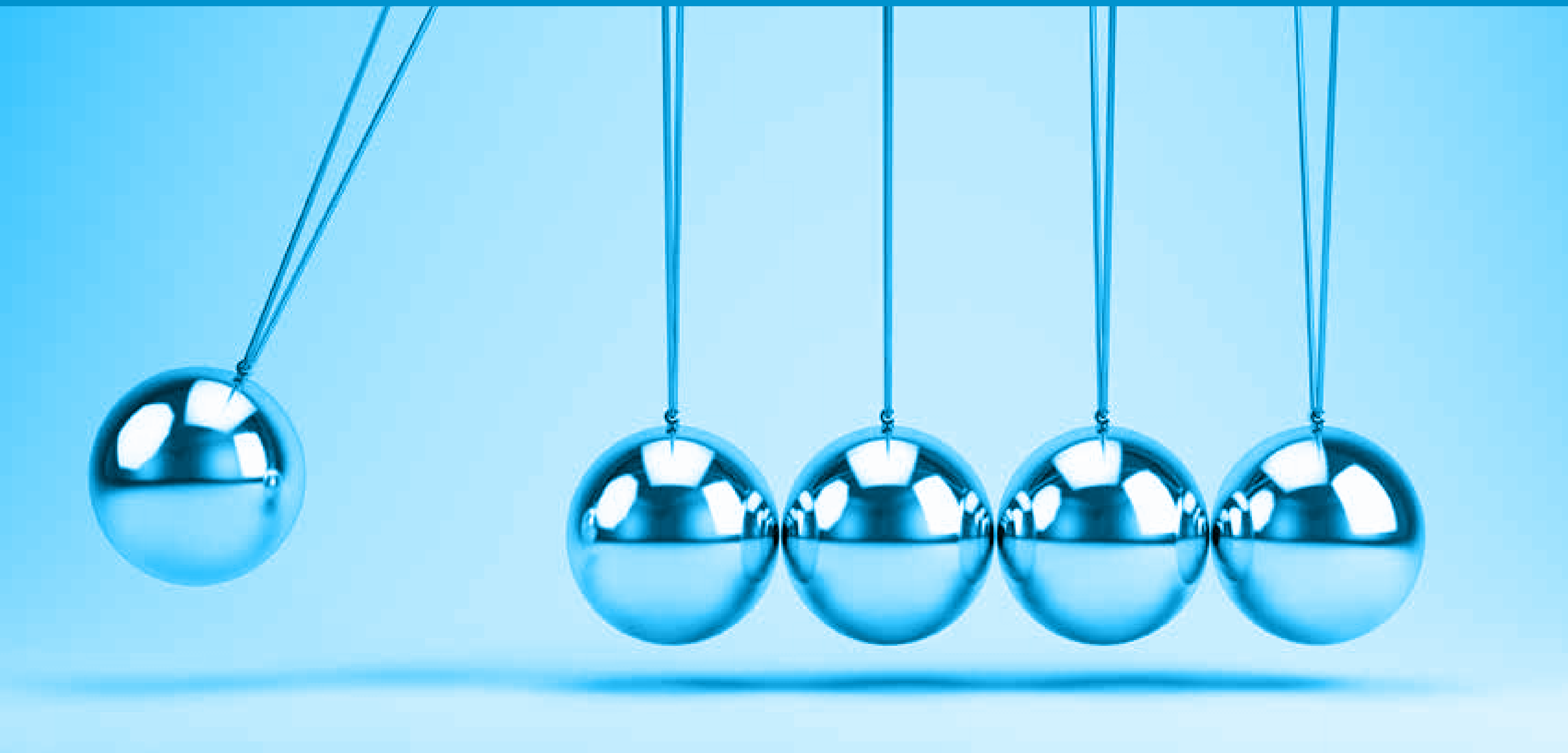
HOW TO IMPROVE THE FINANCES OF YOUR CREATIVE AGENCY



Introduction

You are a creative expert; that's why you own your own creative agency. But dedicated as you are, it's not your considerable expertise in your field that's going to make your agency a success and keep it that way. It's the profitability of the business that does that, and profitability significantly depends on managing certain numbers, or key performance indicators. These are the different types of measurements that keep track of how the business is doing and warn you when you need to make adjustments.

This booklet is designed for you—a business owner—in a creative agency, which includes marketing, branding, and design agencies but also architectural services. You know there does not need to be a conflict between creating great design and running a profitable business. But you might not know how to work the financial side of running a creative agency, or you might prefer not to be intimately involved with that side of things.

We provide Chief Financial Officer (CFO) services to companies that either can't afford a full-time CFO or don't need one. We work mostly virtually, so we are sometimes called virtual CFOs, fractional CFOs, or CFOs-on-demand.

But what does a CFO do, and why do you need one? That's probably your first question.

Think for a moment about the last time you were given monthly financial statements from your bookkeeper or annual financial statements from your accountant. You probably thought, This is great—but now what? What does this mean? Is this good or bad, and where do I go from here? Are the monthly financial statements accurate? I have certain financial goals—how do I reach them?

These questions about getting from where you are to where you want to go do not in any way diminish what bookkeepers and accountants do. Without accurate historical financial statements, you can't forecast the future. You first need to know where you are in order to know where you are going.

This is where virtual CFOs come in. So what, more specifically, do we do?

FIRST STEP: We look at your historical financial statements and ask questions about why your cash and profits are where they are.

SECOND STEP: We look at the future and ask where you want to be in three to five years. What will your sales be like, what will your profits be, and what will be the value of your company?

THIRD STEP: We create a road map to your financial success, a series of financial forecasts taking your current situation into account as well as your assumptions about what will happen in the future. We call this a series, because you will look at several scenarios. What happens, say, if you increase the number of billable hours for each designer? And what else needs to happen for you to do that? What processes need to change? How much more business do you need to bring in?

After setting up your road map, we look at the various levers you need to pull to produce those profits. A lever is like a gear; when you shift it, your business moves at a new pace, and the results will cascade. Suppose you have five design employees, and you increase each employee's number of billable hours by two, every week; that means 100 more hours a year. At $150 per hour, that brings in $15,000 for each employee and $75,000 for five employees. This is significant additional profit for a company with less than $1 million in sales.

But once your company hits the $1 million revenue mark and you have eight to ten staff, keeping track starts getting harder. It gets very difficult to manage everyone's time by just looking around to see who's busy. This introduces several other financial questions into your situation: What should our net income be? How are we doing in comparison to similar companies? How much should we pay people, and what should our organizational structure look like?

We try to help you answer these questions.

> **INTRODUCING THE CASE STUDY:** *A high-level designer we'll call Stewart. After working several years in a prestigious design firm, he went solo and started his own firm.*
> *Because of his reputation, he quickly obtained work, particularly in the industry he previously worked for. The firm grew, and he hired more staff, including a design director and a project manager. As an owner, Stewart soon found he was very, very busy. He also noticed the following issues.*
> - *He was the only one who really got new business in the door.*
> - *Even with a project manager, he still spent considerable time managing projects.*
> - *He also still spent a fair bit of time on billable work.*
> - *He was the main manager of the staff.*
>
> *The firm was busy and profitable but still had periodic cash flow issues.*
>
> *Because the firm was still quite small, Stewart was able to observe who was busy and who wasn't and therefore allocate work that way. There was not much in the way of time tracking.*

Cash

There is a saying that revenue is vanity and profits are sanity, but cash is king. You have probably experienced how much time and effort it takes to run a company that's short on cash. There is little time to plan, and you may also find few opportunities to increase profits. You may have to accept jobs at prices you don't like, just to get some cash in the door, and you may need to accept inferior supplier arrangements just so you can defer payments.

In short, you are spending your time bobbing and weaving.

You might run into some major concerns: you might lose a major client, you might not get paid on a large receivable, you might have an unexpected expense. All of these are normal issues to deal with if you have enough cash, but they can be crises with a low cash balance.

So how much cash should you have on hand? At a minimum, you should have a balance of 10% of your most recent historical 12-month revenue, but sometimes you need up to 30%.

So, if you have a company with $1 million in revenue, you should have between $100,000 and $300,000 in cash on hand.

Cash Requirements[1]

10%	30%
No clients bringing in greater than 10% of revenue	High concentration of revenue on one client
High recurring revenue	No recurring revenue
Zero accounts receivable days	High number of accounts receivable days
Strong pipeline	Weak pipeline
Low growth	High growth
No big purchases in the near term	Big purchases in the near term

CASE STUDY: *Together, Stewart and I identified further issues:*
- *He did not know the average billability for the firm, making it difficult to make accurate projections.*
- *Problems with pricing, partly due to a lack of data on how many billable hours were required and partly due to a lack of knowledge of what the market would bear.*
- *The firm was "top-heavy," with too many senior designers and not enough juniors.*
- *Some cash flow issues, partly due to lower than necessary profitability and partly due to high outstanding receivables.*

First steps in putting together an action plan:
- *We established a rolling 8-week cash flow budget. This type of budget takes a little time to update, but it does predict cash flow shortages and provides time to respond to a looming shortage.*
- *Such a budget also provides more discipline, as expenses are clearly visible. We quickly identified and rectified a few looming cash flow shortages.*

PROFITS

Profits are your revenue less all your expenses. This is pretty straightforward. So let's look at **revenue** first.

You can record revenue in several ways.

- **Keeping track of time and materials.** If you work 10 hours on a project, you bill for those hours. This method is good for the service provider, because the profit is very predictable. But the method is falling out of favour even so, because all the risk is transferred to the customers. "Hours worked" does not necessarily correlate to "value received."
- **Fixed fee.** This is the most common pricing method. Your agency and the customer agree to a fixed price that you both consider fair. For the agency, the fee will be based on an estimated number of hours, but if the hours exceed the estimate, the fee will not change.
- **Value billing.** This fee is derived from the perceived value received. For example, the fee for a marketing campaign for a large customer may be larger than that for smaller customer, because the value received is bigger for the larger customer. However, value billing can be difficult to implement and get right.

In light of all that, let's concentrate on fixed fee billing and take a closer look.

[1] Adapted from Jody Grunden: Digital Dollars and Cents, 2017

Even though your billable rate and number of billable hours don't show up on a customer invoice, the service you provide is still heavily dependent on billable hours. Your agency does not sell a ready-made product, but rather, services that require a specific number of hours of work from people with various levels of knowledge and experience.

Let's look more closely, then, at what goes into your **profitability.**

Availability

Availability refers to the number of hours each production staff member is available to bill each year. A standard year has 2,080 hours (260 days times 8 hours, although some companies have a standard 7.5-hour workday). But from that total you will have to subtract statutory holidays, vacation, and anticipated sick/personal days. The minimum number of vacation days is 10, but depending on the culture of your firm and the seniority of employees, it could be higher, which lowers the days available to work. A firm may also set aside time for summer hours, staff training, corporate events, etc.

Of this remaining total, we estimate that 70% is billable. The rest is used for administration, marketing, and general strategic thinking.

The 70% is also an average. The billable hours vary from position to position; junior designers generally have a higher percentage of billable hours, while intermediate and senior designers have lower percentages. Below is a sample calculation of available hours.

Billable Hours in a Year

52 weeks x 5 workdays		260
Less statutory holidays		(10)
Less vacation		(15)
Less sick days/personal days		(5)
Available days to work		230
Times 7.5 hours/day		1,725
Let's say 70% availability	equals	1,208
		or 1,200

Here we select 1,200 as an average number of billable hours for each person in a firm. Junior staff will work more, and the more senior staff will work less. Non-billable time includes items such as all sales and marketing activities, administrative tasks such as timekeeping and invoicing, and strategic non-client-specific activities.

Individual Billable Hour Expectations

Having calculated the average per-person billable hours in a firm, let's look at an example that demonstrates how to calculate those hours for a specific person on the way to achieving the company average. A junior designer should be expected to work, say, 1,380 billable hours in a year. This number should now be broken down into totals per month or, even better, totals per week.

In this case, given that some weeks are vacation weeks and others include statutory holidays, for a full workweek, a junior designer should be expected to work between 32 and 34 billable hours to accumulate 1,380 billable hours by the end of the year. You would apply the same type of calculation to intermediates and seniors, using their lower totals.

So how can you manage billable hours? One way of doing this is to have the right pyramid of seniors, intermediates, and juniors. The ideal pyramid will vary from firm to firm, depending on the type of work it is getting, but the principle is that if a junior can do the work as well as anyone else, he or she should do it. Have a look at the following table for an example of calculating billable hours for several different levels in the employee pyramid.

Firm Billable Hours

EMPLOYEE	NUMBER	AVAILABLE HOURS PER PERSON	BILLABLE RATIO	BILLABLE HOURS PER PERSON	TOTAL AVAILABLE HOURS	TOTAL BILLABLE HOURS
Owner	1	1,725	0.45	776	1,725	776
Seniors	2	1,725	0.58	1,001	3,450	2,001
Intermediates	3	1,725	0.68	1,173	5,175	3,519
Juniors	4	1,725	0.80	1,380	6,900	5,520
					17,250	11,816
				Firmwide billable utilization		**69%**

This is one example of a firm that has an average utilization rate of 69%.

Another way to manage billable hours is to provide a weekly sheet for each employee and then track how many of this person's hours are billable. This is better than looking for a certain percentage. A junior might be expected to bill around 1400 hours per year, while other more senior designers bill less; a tracking sheet helps you see how well they are keeping up the required weekly pace.

In managing billable hours, you want to increase the number of hours without reducing the quality of anyone's working life. The time that needs to be reduced includes time when staff is idle or pretending to be busy, not vacation time, holidays, or corporate events.

CASE STUDY: *When we started with Stewart's company, there was very little in the way of key performance indicators. Thus, the first order of business was to develop actual billability numbers.*

We started by having the staff record their numbers, then introduced the weekly tracking of time for each production employee. The owner and some senior designers decided upon an initial weekly expectation of hours for each employee. If junior designers met the target, no further communication was necessary. Many of the designers tended to think about design and only design; they didn't want to know whether they met a billability target.

The company also started using time-tracking software, which allowed the tracking of profitability on each project.

Billable Rate

Most contracts will be fixed fee, but you must still track your time. After all, you pay for every hour of your staff's time, so you really need to know how they spend that time.

Yet as you probably know, most people do not like recording their time—particularly not creative people. They may say they are thinking about a project but not actively working on it. Is that time billable or not?

Billable time can really only be the time spent sitting down working on a project. That is why the more senior designers do not have that many billable hours, because having fewer hours allows them some unstructured time. This is also why the ratio of billable revenue to salary is higher for junior designers.

How do you arrive at a billable rate, then? There are several methods. One is to look at industry benchmarks and, as much as possible, see what the competition charges. Another is to determine how much revenue is required from each employee and divide that by the expected number of billable hours. The following is an example of calculated billable rates at a firm for junior, intermediate, and senior employees, showing the ratio of revenue to salary in each case.

Standard Revenue to Salary

	Junior	**Intermediate**	**Senior**
Billable hours	1,380	1,173	1,001
Billable rate	$100	$150	$200
Revenue	$138,000	$175,950	$200,200
Salary	$50,000	$75,000	$100,000
Ratio	**2.76**	**2.35**	**2.00**

A third method of calculating a billable rate is to start at the most basic level, with the employee's salary, then add all benefits, and finally, add a burden rate for the other expenses. You can see an example of this method in the next table, again calculating for all three levels of the employee pyramid.

Billable Rate

Salary	**Junior**	**Intermediate**	**Senior**
	$50,000	$75,000	$100,000
Social security	4,580	5,120	5,560
Other benefits	1,000	1,000	1,000
Training	1,000	1,000	1,000
Total payroll costs	**$56,580**	**$82,120**	**$107,560**
Admin costs	30,000	30,000	30,000
Sales and marketing	20,000	20,000	20,000
Owner's salary	10,000	10,000	10,000
	$116,580	$142,120	$167,560
Profit @ 15%	17,487	21,318	25,134
Total costs	$134,067	$163,438	$192,694
Billable hours	1,380	1,173	1,001
Project loss @10%	(138)	(117)	(100)
Net billable hours	1,242	1,056	901
Billable rate (Total cost/Net billable hours)	$108	$155	$214
Say, a rate of:	**$100**	**$150**	**$200**

Some Suggestions for Improving Profitability

Profitability

Enhancers	Detractors
High billing rates	Pricing errors: low billing rates
Low write-downs	Costing estimate errors: high write-downs
High utilization	Low utilization
Right staff mix	Top-heavy: wrong staff mix
Clarity on project scope	Scope creep
Good record keeping: no timekeeping errors	Timekeeping errors
Quick and accurate billing	Billing errors and payment delays

Billing Rates
These are nominal billing rates. This means actively pursuing projects that pay a high per-hour rate, either because your firm has high pricing power or because the number of actual hours required is low, due to your knowledge and experience with a certain industry or project type.

Write-downs
There are two kinds of possible write-downs you can try to avoid. One is where you use a “top-heavy” staff with an average billable rate that the project will not ultimately pay. The other is when you underestimate the number of hours required.

The following is an example of a write-down with a top-heavy staffing level.

Project Revenue - Top Heavy Team

	Balanced team		**Top-heavy team**	
Fixed fee		$100,000		$100,000
Hours required	700		700	
Average billable rate	**$142**	$99,400	**$178**	$124,600
Profit (loss)		$600		$(24,600)

In this example, the firm will suffer a project loss, because they have staff with a higher billable rate than what the project pays.

The next table displays the resulting loss in an example where a firm has underestimated the actual number of hours required to complete a project.

Project Revenue - Underestimating Hours

	Planned hours		**Actual hours**	
Fixed fee		$100,000		$100,000
Hours required	**700**		**800**	
Average billable rate	$142	$99,400	$142	$113,600
Profit (loss)	$600		$(13,600)	

High Utilization
This comes from good management of your staff's time. Having staff track their time and using a good time management system are essential.

The right staff mix
This can be included as part of the write-down category.

> **CASE STUDY:** *We looked at the mix of staff at Stewart's company, discovering it was top-heavy, with too many senior designers. Because more work was coming in, new junior staff were added. With more business coming in, we needed to match the availability of billable hours with the contracted billable hours. This was easily done using an Excel spreadsheet.*

Clarity of Project Scope
Carefully and clearly define the scope of every project with your client. Set out the project goals and the schedule, phases, tasks, and resources it will take to achieve those goals. Also—and this is equally important—set out what is excluded from the scope of the project. Having a clear scope statement will prevent scope creep, which can involve your doing more than you were contracted to do, for the same fee.

CASE STUDY: *The time tracking introduced into Stewart's firm allowed us to determine the overall billability. At first it was low, because too much time was spent on "blue sky" projects. These types of projects involve brainstorming for ideas without necessarily having a clearly formulated plan or goal, and then paring the ideas down to something that can be worked with. If these projects do not involve paying clients, or if they involve work beyond the scope of what a client is actually paying for, the firm's overall billability decreases.*

The time tracking allowed us to reduce time spent on such projects and increase hours that were billable to contracted client projects.

Bringing It All Together

There are several different "gears" or levers that shift your creative agency toward greater profitability. These levers are what determine your profits.

- ✓ **Revenue capacity** (in hours)
  This indicates how many available hours the current production staff can bill.
- ✓ **Leads** (hours)
  This indicates potential new work in billable hours.
- ✓ **Conversion rate**
  This is the rate at which potential new work is won.
- ✓ **Standard billable rate**
  This is the firm's average rate.
- ✓ **Project loss**
  This is the average loss on fixed fee projects, i.e., the fee received less the actual billable time, times the average rate.
- ✓ **Production staff** (number)
- ✓ **Average annual billable hours**
  This is the available hours times the utilization.
- ✓ **Average annual salary** (including benefits)
  This is for production staff.
- ✓ **General and administrative costs**
- ✓ **Sales and marketing expenses**

What is important to increasing your profitability is that with small shifts in each of these levers, your profit can increase substantially.

The following tables give examples of how even small shifts in any of these levers can affect both revenue and expenses, to the great benefit of your firm's profitability.

Creative Agency Revenue

		CURRENT			FUTURE	
Lever				**Change**		
	Existing contracted revenue (hours)	7,500			7,500	
1	**Revenue capacity (hours)**	12,000		**5%**	12,600	
	Opening contract to capacity	62.5%			59.5%	
2	**Leads (hours)**	5,000		**25%**	6,250	
3	**Conversion rate**	70%		**5%**	73.5%	
	New contracted revenue (hours)	3,500			4,594	
	Total contracted revenue (hours) (existing plus new)	11,000			12,094	
	Ending contract to capacity	91.7%			96.0%	
4	**Standard billable rate**	**$175**		**5%**	**$183.75**	
	Standard revenue		$1,925,000			$2,222,227
5	**Project loss**	**10%**	(192,500)	**20%**	8%	(177,778)
	Net revenue		**$1,732,500**			**$2,044,448**

Creative Agency Expenses

		CURRENT			FUTURE
	Net Revenue	**$1,732,500**			**$2,044,448**
	Cost of sales				
6	**Production staff**	10			10
7	**Average annual billable hours**	1,200		**5%**	1,260
	Hours paid	2,000			2,000
	Utilization (billable hours over hours paid)	60.0%			63.0%
8	**Average annual salary**	$90,000		**0%**	$90,000
	Production payroll	$900,000			$900,000
	Gross Profit	**$832,500**			**$1,144,448**
	Gross profit percentage	48.1%			56.0%
9	**Admin costs**	$450,000		**0%**	$450,000
10	**Sales & marketing expenses**	$300,000		**25%**	$375,000
	Profit before tax	**$82,500**			**$319,448**
	Net profit percentage	**4.8%**			**15.6%**
	Actual billable rate (revenue/billable hours)	**$144.38**			**$162.26**
	Effective rate (revenue/hours paid)	**$86.63**			**$102.22**

CASE STUDY: *Over a period of six months, the average utilization of billable hours in Stewart's firm increased from 60% to 70%.*

In the end, what did he accomplish with the assistance of a virtual CFO?

The outcome of pulling the suggested levers and shifting into a higher gear was that **Stewart increased the firm's annual revenue by $500,000 while improving profitability.**

As the owner of a creative agency, you may strongly prefer to concentrate on the actual creative side of your company instead of letting the financial side use most of your time and energy. Yet you know the finances need regular tending if your agency is going to grow and increase in profitability and value. A virtual CFO is the answer to that dilemma.

When your virtual CFO has analyzed your financial situation and helped you set your company's three-to-five-year goals, you will have a road map to increased financial success. As you pull the identified levers, you can shift your business into a higher gear, with cascading results. Your financial needs will be taken care of, and you can again concentrate on what got you here in the first place—your expertise in creativity and design.

Notes

About Henrik Leborg CPA, CA, MBA

Henrik Leborg brings 20+ years of operational and financial management experience as a CFO in a variety of industries, including business services, software and manufacturing.

Since 2015, he has operated Gravity Consulting, where he helps businesses improve their profitability, cash flow, and business value. He has worked extensively with creative agencies and software development companies.

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