Mastering digital agency accounting

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Keeping a digital agency's financial house in order is no small feat, from managing client budgets to steering the ebb and flow of project-based revenue.

However, digital agencies can thrive with the right accounting practices in place – and the sooner you lay that foundation, the better.

In this guide, we'll explore the fundamentals of accounting for digital agencies, including managing fluctuating cash flows, implementing stronger client billing processes, ensuring tax compliance and much more.

You'll leave with some excellent tips and best practices to apply to your agency's finances. But first, let's take a step back and explore the financial challenges digital agencies often find themselves facing

What are digital agencies, and why are they unique?

Digital agencies come in numerous different shapes and sizes. Some are boutiques specialising in a particular niche or service offering, while others are full-service agencies providing a thorough suite of digital marketing solutions.

This can include a wide range of services, such as:

- Search engine optimisation (SEO)
- Pay-per-click (PPC) advertising
- Branding
- PR
- Graphic design
- Social media marketing
- Content and strategy
- Web design and development
- Email marketing
- Cyber security
- And more

Regardless of their size or focus, virtually all digital agencies share one common trait: the typically project-based nature of their work.

Unlike businesses that sell physical products or provide recurring services, digital agencies typically operate on a project basis.

While this could involve some form of recurring services or subscriptions, each client engagement is focused on specific deliverables and campaign goals. It could involve launching a new website, running a targeted PPC campaign, or creating a series of branded content assets.

This agency model introduces several unique financial considerations that bring nuances to the table in the form of accounting, tax, etc.

Let's take a closer look at some of the key challenges running an agency is associated with:

Key accounting challenges for digital agencies

From handling irregular income streams to complying with rather varied HMRC rules, agencies face financial challenges that can quickly mount up and consume your time and resources.

Challenge 1: Irregular revenue streams

One of the first challenges digital agencies face is irregular, project-based income. Because agencies rely on winning and completing projects, revenue can fluctuate greatly.

One month, you might be flush with cash after wrapping up a big project, while the next might be leaner as you work to land new clients and kick off new engagements.

Without a steady, reliable income stream, agencies need to be extra diligent about budgeting, forecasting, and maintaining a healthy cash reserve to weather any dry spells and ensure you can pay your overheads.

Challenge 2: Upfront costs and resource investment

Another common challenge is the need to sometimes invest resources upfront before any revenue is generated.

Many digital agency projects require substantial labour input and sometimes third-party costs (think software subscriptions, stock photos, etc.) before the client sees any results or ROI.

For example, let's say an SEO agency lands a new client who wants to improve their organic search rankings.

Before making progress, they might have to invest dozens of hours researching the client's industry, analysing their current website, identifying target keywords, and developing a strategy.

All of this work happens before the client sees any tangible results or has much incentive to start paying their invoices.

Careful financial planning and client management are essential to ensure these early-stage costs don't put the agency in the red.

Challenge 3: Complex client billing and budgeting

Digital agencies also face complex client billing and budgeting. With clients often requesting a varied menu of services and deliverables, creating accurate and detailed invoices can be time-consuming.

You need a reliable way to track employee and contractor hours across different clients and campaigns, manage project budgets, and generate clear, itemised invoices.

Without a clear system for recording billable hours and expenses, it's all too easy for things to slip through the cracks, leading to lost revenue, or worse, disputes.

Challenge 4: Scope creep and change requests

Another pressing challenge in the agency world is scope creep. This involves a client requesting additional work or changes to a project that go beyond the original scope of the work agreement.

While small changes here and there might seem innocuous, they can quickly add up, costing you both time and money.

To mitigate scope creep, you need clear processes for handling change requests and communicating with clients about the financial implications of added work.

This might involve creating a formal change request document, requiring client sign-off on changes, or building a contingency buffer into your budgets.

Solutions to digital agency accounting challenges

Now that we have a baseline understanding of the challenges agencies face, let's explore some specific accounting strategies, and best practices you can employ to combat them:

Solution 1: Planning for income variation

Managing the cash flow of irregular project-based income can be a real headache, especially for agencies handling large yet sporadic projects. Here are some top tips for overcoming the pitfalls:

- **Build a robust cash reserve:** Aim to sock away enough cash to cover at least 2 to 3 months' worth of business expenses. This cash cushion will help you keep the lights on while you work to bring in new project revenue. Make it a habit to sweep a percentage of each invoice payment into your reserve fund until you hit your savings target.
- **Get clients paying upfront:** Structure your project agreements to include an upfront deposit or retainer whenever possible. This could be a percentage of the total project fee or a fixed amount based on the initial scope of work. Getting some payment in advance helps cover those early labour and third-party costs and reduces the risk of cash flow issues down the line.
- **Stay on top of accounts receivable:** Don't let unpaid invoices pile up. Set clear payment terms with clients from the get-go and be proactive about following up on overdue bills. It may feel awkward to pester clients about payment, but remember – you've done the work and deserve to be paid promptly.

Solution 2: Build cashflow forecasts

Every agency owner should get used to building cashflow forecasts. That means keeping up with your bookkeeping, monitoring key financial metrics (like profit margins and cash burn rate), and regularly forecasting your income and expenses.

Rolling cashflow forecasting

One helpful exercise is to create a rolling 12-month cashflow forecast. This involves estimating your expected monthly income and expenses based on your current project pipeline and historical financial data.

By mapping out your cashflow in advance, you can identify any potential gaps or shortfalls and take proactive steps to address them (like ramping up your sales efforts or securing credit).

Expense tracking and control

Another key aspect of effective cash flow management is diligent expense tracking and control. When income is unpredictable, it's all too easy to let spending get out of hand.

But by closely examining where your money is going and looking for opportunities to cut costs, you can free up more cash to reinvest in your business. Some expenses to keep a particularly close eye on include:

- Salaries and contractor fees
- Office rent and utilities
- Software subscriptions and tools
- Marketing and advertising spend
- Travel and entertainment expenses

By regularly reviewing your expenses and seeking out areas where you can trim the fat, you can create a leaner, more resilient agency that's better equipped to handle the ups and downs of project-based work.

Solution 3: Establishing effective client billing practices

Another key piece of the financial puzzle for digital agencies is client billing. Haphazard or inefficient billing practices can lead to confusion, frustration, and even lost revenue. Here are some billing best practices to keep your agency's finances shipshape:

- **Clearly define project scope and pricing upfront:** Before you begin any client work, make sure you have a crystal clear agreement outlining what services will be provided, what the key deliverables are, and how much it will all cost. If possible, break down pricing by individual service or milestone. The more specific you can be, the less room there is for misunderstandings.

- **Choose the right pricing model:** Agencies typically use one of two pricing models: flat project fees or hourly billing. Each has pros and cons. Flat fees provide clients with predictable costs, but they can expose an agency if a project takes longer than expected. Hourly billing ensures you're compensated for all time spent, but it can be tough for clients to budget for. Choose the model that makes the most sense for each project and client.

- **Automate time tracking and billing:** Manual time tracking and invoice generation are recipes for errors and wasted time. Invest in cloud-based software that lets your team easily track their hours by project and client. Look for a solution that integrates with your accounting system and automatically generates invoices based on logged billable hours. The less manual data entry required, the better.
- **Incentivise early payments:** One way to encourage clients to pay their invoices promptly is to offer a small discount for early payments. For example, you might offer a 2% discount for invoices paid within ten days of receipt. Just be sure to clearly communicate these terms on your invoices and build the discount into your pricing.
- **Use recurring billing for retainer clients:** If you have clients on a monthly retainer, consider setting up recurring billing to automatically charge their credit card or bank account each month. This can help ensure a steady stream of income and reduce the administrative burden of manual invoicing.

In all cases, clear communication and expectations around billing go a long way in building strong, long-term client relationships.

Mastering the tax system

Taxes are a fact of life for any business, and digital agencies are no exception. However, given the project-based nature of agency work and the frequent use of contractors, staying compliant can be particularly tricky. So here's what you need to know:

Understanding your tax obligations

Here are the basic tax processes you'll need to build and manage processes for:

- As a limited company, your agency will be subject to Corporation Tax on its profits.
- You'll need to file a Company Tax Return each year, typically due nine months and one day after your company's accounting period ends.
- If your agency is VAT-registered (more on that in a moment), you'll also need to account for VAT on your income and expenses.
- You must operate payroll and make the appropriate PAYE and National Insurance contributions if you have employees.

Registering for VAT

If your agency's VAT-taxable turnover exceeds the current registration threshold of £90,000 per year (from April 2024), you'll need to register for and start charging VAT.

Once registered, you'll need to:

- Add VAT to your client invoices
- File regular VAT returns with HMRC (typically quarterly)
- Pay any VAT owed to HMRC
- Reclaim VAT on eligible business expenses, which can help offset some of the additional cost

It's important to note that once you're registered for VAT, you must charge it on all your invoices.

Staying on top of tax deadlines

Here are some key dates to keep in mind for your taxes:

- **Corporation tax:** Due 9 months and one day after your company's year-end, along with your Company Tax Return.
- **VAT:** Returns and payments are typically due quarterly, one month and seven days after the end of each quarter (e.g. for the quarter ending March 31, the deadline would be May 7).
- **PAYE and NICs:** Payments are due monthly by the 22nd of the following month (or the 19th if paying by post),
- **Self assessment:** If you're a company director, you'll also need to file a personal self assessment tax return each year, due by January 31.

Navigating IR35 for contractors

Many digital agencies rely on freelancers and contractors to provide specialised services or bolster their in-house team.

The setup is usually simple for freelancers who operate on a short-term or ad-hoc basis and aren't fully dependent on your work for their living. However, for full-time or long-term contractors, off-payroll working rules, known as IR35, can create administrative headaches. HMRC can be strict about IR35, so you have to take it seriously.

In a nutshell, IR35 is a set of tax rules designed to combat "disguised employment" – that is, when a contractor works in a way that's more akin to a full-time employee but doesn't pay the same income tax and National Insurance contributions as a regular employee would.

Under IR35, agencies are responsible for:

- Determining the employment status of contractors they work with (i.e. whether they fall "inside" or "outside" of IR35)

- Deducting the appropriate taxes and NICs from their pay if they're deemed to be inside IR35
- Paying these deductions to HMRC
- Providing a "status determination statement" to contractors explaining their IR35 status

Misclassifying a contractor can lead to hefty penalties. Tread carefully and seek expert advice if you're unsure about a particular contractor's status.

Working with an accountant for tax compliance

Proper tax compliance is complex, so it's no wonder that many digital agencies work with an accountant or tax advisor to ensure compliance. Accounting for agencies, including accounting for PPC agencies and accounting for creative agencies, takes the stress out of compliance so you can focus on growing your business.

A qualified accountant can provide invaluable guidance, from VAT registration and IR35 to tax planning and financial forecasting.

If you're looking for a digital agency accountant, finding one with experience working with digital agencies like yours is essential.

Look for one who specialises in creative industries and has a track record of helping agencies tackle their unique challenges, like the team at Cottons.

Alongside a full suite of accounting services, we're able to help you identify areas for cost savings, create realistic budgets and forecasts and develop a long-term financial plan to support your business goals.

The case for outsourcing your agency's accounting processes

At this point, you might be thinking: "This all sounds great, but who has the time to manage all these financial tasks on top of actually running an agency?"

And you'd be absolutely right. That's where outsourcing your accounting functions can give you and your agency time to live, breathe and grow.

Outsourcing accounting is becoming increasingly popular among agencies of all stripes and sizes, and for good reason. Here are just a few of the benefits:

- **More time to focus on your business:** As an agency owner, your time is your most precious resource. Every hour you spend wrangling invoices or trying to make sense of a balance sheet is an hour you're not spending on billable client work, business development, or strategic planning. By handing off your accounting tasks to a trusted external partner, you can free up your time to focus on the activities that really move the needle for your agency.
- **Access to specialised expertise:** Unless you have a background in accounting yourself, chances are you don't have the same depth of financial knowledge as a trained accountant. And that's okay! By outsourcing, you can tap into the expertise of professionals who eat, sleep, and breathe this stuff. They can provide valuable guidance on everything from tax planning to cash flow forecasting, helping you make smarter financial decisions for your agency.
- **Scalability and cost savings:** Hiring a full-time, in-house accountant can be expensive, especially for smaller agencies. With outsourcing, you can access top-notch accounting talent without the overhead of a full-time salary and benefits. Plus, you can easily scale your accounting support up or down as your agency's needs change. Whether you just need a few hours of bookkeeping help each month or more comprehensive CFO-level support, outsourcing gives you the flexibility to pay for only what you need.

Of course, outsourcing your accounting decision is a decision that shouldn't be made lightly.

It's important to do your due diligence and find a partner you can trust – one who understands the unique needs of digital agencies and has a proven track record of helping businesses like yours succeed.

At Cottons, we pride ourselves on being the go-to accounting partner for digital agencies.

With years of experience working with agencies of all sizes, we deeply understand your unique financial challenges and are committed to helping you overcome them.

Our team of specialist accountants will work closely with you to develop a bespoke financial strategy that supports your agency's long-term growth and success.

From bookkeeping and tax compliance to financial planning and strategic advice, we offer a full suite of accounting services designed specifically for digital agencies.

Contact the team at Cottons today to learn more about our dedicated digital agency accounting services.

Ready to find out more?

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