

Keeping a Handle on Deposits

12/18/06

This is probably a good problem to have – I just don't want to mess things up as I go forward. Our company is growing. We spent a lot of time focusing on sales and marketing this year, and the results are showing. There is a bunch of new business coming in the door. On new contracts we take a deposit up front, which allows us to insure the client is committed, and cover the cost of materials we have to order, plus our few weeks of work.

My problem is this. Bank deposits are growing – that's the good news. My fear is that I'll accidentally spend that money on the wrong things. We still have to pay for people to do the work, out of that deposit money. I know this is a problem in my industry. I've seen lots of other companies that end up robbing Peter to pay Paul – spending too much because they thought they were doing well, then having to use deposits from the next job to cover payroll for the last job. I don't want to end up like that. How can you help?

Money comes in today, for a sale that's just been made. Materials get ordered tomorrow, but you don't get a bill for a month, and if you're managing cash flow, you wait another 30 days after that to pay for it. Work starts anytime from next week to 3 – 6 months from now, and you use part of that deposit to pay for the payroll, once you start work – if the

money is still sitting around. Then you work for awhile, and then it's time to bill the customer for some more money – either to catch up on what you've already overspent, or to keep you ahead of the game. The last ¼ of the work gets paid 6 months to a year down the road, sometime after you complete all the work; it's called retainage – what the customer holds back to be sure of satisfaction. That last ¼ probably is a big portion of your profit, and covers some of your final bills. And it could come in more than a year after the initial deposit. No wonder it's hard to keep track of where you are in the game of doing work and making money. And it all starts with the deposit check.

Keeping deposits separate, and using them for what they were intended, can be a big problem in any business. In part, the solution is how you set up your bank accounts and how you account for the deposits and other progress payments. In part, the solution is to know how much you can afford to spend on other things, as you grow. And part of the solution is being able to see whether sales really are doing as well as you expect, which is different from feeling like you're flush because there's money in the bank at the moment.

My first recommendation is that you set up a separate money market account, into which you put all of your client advance

payments. This will help you to keep from co-mingling money you've earned with money that you have yet to earn. Remember, a client down payment is not something you've earned, yet. You've just gotten the right to do the work, and made a promise that you will follow through.

As you do the work, you can withdraw money equal to the work you've done, from the money market account, and deposit it in your checking account. This procedure should help you to keep the money straight. The one thing you will have to do is figure out what a client pre-payment is really supposed to cover. For example, if you have materials you have to order, how much of the client pre-payment goes to materials, vs. going to payroll for the job.

Once you have things set up structurally, with a separate money market to keep track of pre-payments, you can do the same thing with your accounting system. A client pre-payment is actually not an asset. It's a liability, from an accounting point of view.

Here's why that is the case. You have the client's money. You've promised to do the work. If you don't do the work you've promised to do, the client has the right to demand his or her money back. Therefore, you're only holding the money for the client until you deliver what you

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12/18/06

promised. That means you are liable for doing what your company said it would do. You haven't actually earned the money yet, and you are on the hook for delivering the work. That's a liability.

Talk with your accountant about setting up a liability account on your balance sheet, for pre-paid work. If you do different kinds of work or different kinds of projects, you may want to set up several accounts, one for each type of work, to help you keep things straight. When you get a client pre-payment, it gets deposited in the money market account at the bank, and recorded as a deposit in the liability account. As you complete work, order and pay for materials, spend money for payroll on that job, you can deduct money from the liability account, and deposit it into your working checking account.

Here's an example of how this might work. Let's say that the customer gave you a \$10,000 deposit on a \$30,000 job. Of that \$10,000, you intend to spend \$3,000 on materials, and the rest will go for payroll. The whole \$10,000 gets deposited into the money market account you set up. As \$3,000 in materials are ordered and paid for, you withdraw, or transfer money out of the money market account and deposit it into the checking account. That leaves you \$7,000 in the account, to pay for labor, and additional materials, travel

costs, or anything else you might normally charge to the job.

Let's say that in 4 weeks you start work on the job. Payroll for the job, the first week, is \$2,800. You transfer that amount from the money market account to the regular checking, or perhaps, to your payroll account, if you have that separate.

Don't forget to gross up your payroll, to cover benefits costs. You can probably do a quick calculation to figure out how much to mark up your payroll, probably in the range of 20% - 30%, depending on how much you pay in benefits. Don't forget to include social security, etc. Let's say that you decide to use 20% as your markup on payroll, to cover benefits. $\$2,800 \times 120\%$ (salary plus benefits) = \$3,360. Withdraw \$3,360 from the money market account, deposit it into checking. That leaves you with \$3,640 in the money market account to pay for upcoming labor and materials on this job.

Once the \$3,640 is spent, which at the present rate, will be likely to be gone after the next week of work, it's time to go back to the client and ask for the second progress payment. Not sure you're ready to ask for that second progress payment? This exercise will help you to figure out if your billing / charging system is actually working. One of the biggest problems in most companies is that the deposits

and pre-payments don't match the work flow. This will help you to figure out if you are having that problem.

Sound complicated? Not as complicated as trying to unwind things, once you've overspent. If you can't afford to do the work on an upcoming job, because you have nothing left, then you'll be out of business. That's even worse than spending a little bit of time figuring out how to keep track of your money.

Now let's talk about what you can afford as you grow. This is where your budget comes into play. Having even a rough budget will help you see if your planning assumptions work, or not.

Figure out your cost of goods sold, for materials and labor, for a typical job, and for your business overall. Divide cost of goods sold by revenue, and you have your cost of goods sold percentage. Subtract cost of goods sold percentage from 100%, and you have your gross profit percentage. If you don't know how to do this, or you're not sure you're right, get someone to help you. These are critical numbers and ratios you have to know, and manage, if you're going to make money.

Then figure out your overhead costs. These are the expenses you have to incur on an ongoing basis – things like lights, rent, phone, office payroll, marketing

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12/18/06

costs, sales payroll. If you know how much you have to cover each month, regardless of how much money you bring in, you can figure out how much revenue you need to bring in to break even.

Once you know your overhead costs, divide them by your gross profit percentage (look back a couple paragraphs to figure that one out). This will tell you how much revenue you need to earn each month, to stay afloat. Bring in more, and you make a profit. Bring in less, and you lose.

Remember, when you're calculating what you're going to bring in for the money, do not calculate deposits. Calculate work you expect to perform, and materials you expect to order. You can use deposits and other sold work commitments, to help you figure out what work you'll do during the upcoming month. But, unless you expect to use up all of the deposit during the month, to pay for work performed and materials ordered, don't count on that deposit money to help you break even.

Now you can figure out if you really have enough sales. Use the above calculations. If you are breaking even, or even better, if you have more money coming in than you need, that's good. If, on the other hand, you were about to use deposits to cover the shortfall, you have to go out and

get more sales. Focus on this first!

You can only free up so much cash by buying carefully, and managing your operations crews better. When a company is short of cash, unless you're spending wildly, the only way out is to get more sales, and more profitable sales. You can do this one of two ways. Get more profitable jobs by raising your rates. Look for customers who better value what you do, and are willing to pay more for the work.

This article may bring up some challenges, as you think about how you manage the company's income. Pay attention, and figure out a system that you can work with. If it seems complicated, stick with it until you figure it out. Bringing in work, handling deposits, and paying for work, in the right order, isn't simple. It's why so many businesses get it wrong and eventually run out of funds and go out of business. Don't let that happen to your business. Learn to play the game of business well! The consequences could be disastrous, if you don't. The rewards are significant, if you do!

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