RETHINKING YOUR BILLING RATES

How to optimize your billing rates using the data you already have.

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EXECUTIVE SUMMARY

When you're a professional services company, you live by the almighty billable hour. It's how you pay for your wages, your nice office, and every non-revenue-producing activity (businesses development, training, team building, etc.).

Companies either determine their billing rates through careful analysis and diligent consideration – or they use gut feel and follow "what the other firm is charging." Far too often it's the latter. Walmart didn't just invent the price of a $1 can of soda, they chose it carefully, after being reasonably certain this price would maximize profitability. It should be no different for your organization. Why are some managers so cavalier about valuing the cost of an hour of professional time worth hundreds of dollars?

When you better understand your billing rates, you'll make smarter decisions. You might lower your rates to obtain a competitive advantage, or raise them because you're not as profitable as you need to be. It's possible you'll create a mix of new types of rates based on employee role, project, or client.

What matters is that you go through the process.

INTRODUCTION

In this article we will discuss how to choose the right billing rate for your firm through basic data analysis. We will then cover key methods of increasing your profit margin. We conclude by discussing the key data you'll need in order to make these key business decisions.

Let's first define "billing rate" to remove any ambiguity:

billing rate. The price paid to your company (by your customer) for one hour of worked time. This is the rate you must charge in order for you to justify your time and the project you're working on.

So how do you establish the right rate for you? ***It starts with the data.***

"BUT... we don't charge by the hour. We do lump sum per-project or per-month fees."

Great! **But you still need to use hourly billing rates!** Use them to calculate the equivalent hourly fees for work, as if it had been done as fee-for-time. The only way to know if your lump sum or retainer is appropriately priced is to compare it to the equivalent hourly billing for the same work.

A DATA-DRIVEN APPROACH TO DETERMINING YOUR BILLING RATES

Conventional wisdom for determining hourly rates has been 3x or 4x wages: "Once for the wage, once / twice for your overhead, once for your profit." This has worked for some organizations, but there has to be a more methodical way to ensure maximum profitability with confidence.

But first, consider this: What is the driver? Do your *labor rates* determine how much you need to bill, or does the *billing rate that you can sell* determine what wages you can offer your staff? Different firms in different regions and industries will answer this question differently.

Wages & Benefits	***Overhead***	***Management***	***Profit***
Wages & Benefits	Share of fixed Variable	Salaried Managers	Profit
$50/hr	$45/hr	$25/hr	$50/hr

Billing Rate: $170/hr

If labor rates drive your billing rates, then you must take into consideration these various aspects when establishing individual billing rates for your staff members:

- **Full Wage** – This is your employee's salary, including compensated time off. (Note: You are paying them this amount regardless of the number of hours they bill.)
- **Taxes & Benefits –** This includes all federal, state, and local taxes, as well as bonuses, retirement contributions, etc.

- **Overhead (portion of fixed)** – Things that are relatively fixed for the company as a whole. Examples: office improvements, debt service, 401(k) administration fees.
- **Overhead (variable)** – Things that directly scale with each new person added. Examples: Administrative & IT staff, travel budget, workers' comp insurance, etc.
- **Management Burden** – There are client-facing employees whose billings don't quite cover their wages. (Often these are salaried owners and senior managers.) They're being supported by the surplus generated by highly-billable staff.
- **Net Profit** – If the employee bills a suitable minimum number of hours, all of the cost items above will be covered, and a profit margin will remain.

This standard method of pricing seeks to first determine the cost of providing a service, and then to add an additional amount to represent the desired profit. To determine cost, you need to figure out direct costs, indirect costs, and fixed costs. Add up your labor and overhead costs, add the profit you'd like to earn, then divide by the total hours that you are going to bill for. This is the minimum you must charge to pay your expenses, salaries, and earn a profit. Market conditions might also impact this (in a positive or negative way).

There are times when a hot labor market squeezes your wage costs from below, and the prevailing rate in your industry doesn't allow you to raise your billing rates to compensate. Alternatively, if your business is wildly successful and you're turning away business, you can temporarily raise rates and experience better-than-expected margins while waiting for your labor market to catch up. Over time, these fluctuations should even out, but it is critically important to be able to navigate these trends using your existing data.

In the end, your goal is to create the highest sustainable billing rate (based on your competition and your ability to sell your services), resist pressures of wage inflation, and sustain profit.

UNDERSTANDING OVERHEAD

Rather than throwing every non-salary item into a single bucket called "overhead", it's extremely useful to separate fixed from variable overhead. This lets you better predict the expense burden on each employee if your headcount fluctuates over time.

Here's how you calculate fixed overhead: Add up your total expenses in these categories for the past six months and divide by six to get your average monthly overhead burden. For the current month, divide it by the number of employees you have. This is the fixed overhead burden on each person.

fixed overhead. These generally don't change when you add or remove a few people. They include your rent, utilities, insurance, IT contracts & licenses, payroll & 401(k) administration fees, lawyer & accountant fees, your leases on phones and servers, and your marketing expenses.

Here's how you calculate variable overhead: Add up the total of these expenses for the past six months. Divide this by six, and divide that by the average number of employees you carried during that period. This is your per-person variable overhead. Moving forward, simply apply this amount to each person.

variable overhead. This includes all items that would immediately go down if you reduced headcount. Travel, personal computers, mobile phone contracts, IT consumables, 401(k) matching, mileage, parking & transit reimbursement, and office supplies & coffee.

Be sure to recalibrate your overhead estimates once a year to be sure you are keeping up with any major changes in your business.

THREE WAYS TO INCREASE PROFITABILITY

Once you are comfortable with your billing rates, it is time to focus on increasing your margin.

For example, you know that your senior account executive costs your organization X dollars a year. So, how do you drive more revenue (and profit) from the work your employee performs?

The best way to increase your margin without impacting your billing rate is to improve utilization rates. Start with this 3-step plan:

1. **Use utilization data to increase profits**
2. **Evaluate your time-off benefits**
3. **Deal with fixed and variable overhead costs**

1 Using Data To Increase Profits

A DATA DRIVEN APPROACH TO IMPROVING UTILIZATION

Do you have access to real-time utilization rates? Are you able to bucket your efforts as being billable or non-billable and track accordingly across all personnel and all clients and/or projects on an ad hoc basis? Can you proactively plan which resources should be doing what work and monitor progress at all times?

The increase you seek in your company's utilization rate will only be as good as your ability to measure it.

Let's examine the math:

COSTS: Bob earns $100K annual salary, which equates roughly to $50/hour. His taxes, benefits, and overhead push that figure to $175,000 annually.

BILLINGS: Bob is billed out at $150 per hour. He bills 6 hours per day on average, 5 days per week.

That's $150 x 30 hours/week billed x 50 weeks billed: $225,000 in billings.

MARGIN: The effective margin on Bob is currently $50,000 per year ($225,000 - $175,000).

WHAT IF we increased Bob's billable time by half an hour per day?

Now we're billing $150 x 32.5 x 50 = $243,750. Margin is now $68,750.

So by making Bob's day just 6% more billable, his margin is raised by almost 40%. You could attach a $10,000 bonus to that utilization improvement and still be ahead — and many firms do exactly this.

2 Evaluating Your Time-Off

Limiting time-off can be a helpful factor in improving utilization, and thus margin. It may sound tempting to offer an employee an extra week of vacation in lieu of a raise, but one week off is an automatic **2% cut in billable potential**, which at their billing rate may be a lot more expensive than the raise or bonus you had in mind.

If you can **limit excessive time off taken by your billable staff**, it's far easier to raise and maintain levels of utilization. This is not to say that employees should be denied PTO that they are owed or discouraged from taking time off for illness. Quite the contrary — you should provide employees with opportunities to improve health, create a healthy workplace environment and culture, and (this is the hardest part) force sick employees to stay out of the office, no matter how important they are to the organization.

3 Dealing With Fixed And Variable Overhead Costs

Another margin-increasing strategy is to reduce variable overhead costs. Reducing variable costs starts with shopping around to reduce your per employee health insurance costs, workers' comp premiums, or software license fees to widen your margin.

You'll also grow your margins by better amortizing fixed overhead costs. Laws of efficiency often favor the larger firms. For example, the costs to manage a 401(k) plan are almost the same whether you have 10 or 50 employees.

When you grow your firm, you spend fixed overhead dollars more efficiently.

BLENDED RATE VS. INDIVIDUAL RATES

Up to this point, we've been talking about determining individual rates for employees of your firm, but there are other ways to charge your customers.

A blended rate is a single rate presented to your clients, across your entire firm. This calculation starts with an analysis of total payroll and overhead expenses, then moves on to an analysis of chargeable staff hours. Next, a target profit percentage must be determined. Finally, all of these components are put together to determine an hourly rate. It's called a "blended" rate because the calculation is based on company-wide financial data. It represents a blend of all employee hours, all payroll costs, and all overhead expenses.

BLENDED RATES	
ADVANTAGES	DISADVANTAGES
✓ Simplicity of explaining to clients. ✓ Appearance of lower overall rate when comparison-shopping. ✓ Less client worry about who's doing the work.	✗ Very difficult to determine what your single firm-wide rate should be. ✗ Perception by clients that you're overcharging for junior staff. ✗ Harder to react to individual pay raises and promotions.

INDIVIDUAL RATES	
ADVANTAGES	DISADVANTAGES
✓ Better match of each rate to skill, seniority of employee. ✓ Easier to determine based on individual wage.	✗ Clients focus on top rates, making the firm appear more expensive overall. ✗ Clients obsess on how much junior/senior staff time they're getting.

YOU NEED TO BE ABLE TO NEGOTIATE RATES

You should be able to create **custom rate cards** that you might negotiate for individual clients, projects, or for charitable projects. If you're stuck with software that can't automatically calculate fees based on your custom needs, you won't be able to strike flexible deals with clients, which could hurt your sales efforts.

It's essential that you can specify a rate for each person that varies with each client or project they are working on or even which task they are performing. Billing rates can also be specified per task performed, and you can manipulate this task-based rate depending on which project or person is involved.

TIMESHEET DATA: THE COMMON THREAD

Your invoices depend on billable time. And your clients demand accuracy in documenting that time. Understanding utilization requires knowing the ratio of billable to non-billable time. And you can't optimize your margins without exploring all of these data points.

What timesheet data can you access right now? What would you like to be able to access? How does your utilization rate look this month across each employee and in aggregate, company-wide? How is your planning going for next month? The month after?

Take a look at your timesheets from last quarter. Which clients were the most profitable? Which projects took longer than they should have? Did this prevent your team from taking on other work? If so, what were the opportunity costs? Were you overstaffed? Could you have billed your clients more? Hidden just below the surface are the answers you need to bill the right amount — and to run a more profitable business.

ClickTime makes it easy for businesses to track, manage, and plan employee time and budgets. Visit www.clicktime.com to learn more!