Charge out rates and profit

Having correctly calculated cost rates allowing you to recover the cost of your business from your projects in that year (see our video recording), our thoughts now turn to making money on these same projects.

In order to make money, you need to apply a profit margin on top of the cost rate, giving the total you charge to clients. However, it is vitally important that you understand the difference between a mark-up on your costs and the profit that will then be achieved by this mark-up. They are not the same thing. We will run through a basic example:

Our cost rate has been set at £50.00 per hour.

Cost Rate PH	£50.00
We mark this up by 20%	£10.00 (£50.00 * 0.20)
Charge out rate (billable rate)	**£60.00**

We have marked-up the cost by 20% but this does not mean we make a 20% profit. Profit is calculated as mark-up divided by amount invoiced as shown below.

Cost Rate PH	£50.00
We mark this up by 20%	£10.00 (£50.00 * 0.20)
Charge out rate (billable rate)	**£60.00**
Profit	**16.67%** (£10.00 / £60.00)

If we mark-up cost rate by 20% we achieve a profit margin of 16.67%.

Many clients say they are trying to achieve a certain profit margin (say 20%) but they never achieve this because they mark-up by the percentage they want as profit (20%). As shown above, they are not calculating profit correctly and end up making a lower profit margin.

Using the example above, if you wanted to achieve a 20% profit, the mark-up the cost would need to be higher, at 25%. The correct calculation for this would be:

Cost Rate PH	£50.00
We mark this up by 25%	£12.50 (£50.00 * 0.25)
Charge out rate (billable rate)	**£62.50**
Profit	**20%** (£12.50 / £62.50)

Whilst the above calculation is effective if you can bill every manhour to a client on a time-charge basis, it is not so effective on a fixed fee basis.

If you are bidding for a project on a fixed fee basis, we would recommend that you work out a resource schedule for the project first. Now apply your cost rates to the resource that you

have estimated. It is not enough to simply apply a mark-up as you will have other costs you need to add to this amount before you can apply your mark-up.

Some of the additional costs you may need to consider:

- Any non-reimbursable project costs, e.g. travel to site or internal printing
- A contingency to allow for the risk of a lump sum bid against a time charge bid. This contingency will vary in relation to how experienced you are at delivering this type of work and how confident you are in your original resource estimate.
- Inflation (but only if the project is likely to go beyond your annual salary review date or financial year). You may need to compound this if the project is particularly lengthy.

We can see the effect these additional costs can have below:

Cost Rate PH	£50.00
Non-reimbursable expenses (1%)	£ 0.50 (£50.00 * 0.01)
Contingency (5%)	£ 2.50 (£50.00 * 0.05)
Total cost before inflation	£53.00
Inflation (2.5%	£ 1.33 (£53.00 * 0.025)
Total Cost	£54.33
Mark Up (25%)	£13.58 (£54.33 * 0.25)
Charge out rate	**£67.91**
Profit	**20%** (£13.58 / £67.91)

As you can see our charge out rate has gone up to £67.91 on a fixed fee basis. Note, in the example, inflation is not calculated until you have added all the other costs to the original hourly rate. This is because inflation is likely to apply to these costs as well as the cost rate.

The quoted add-ons included above are examples, you may have your own ideas of what you would like to add to your cost in a fixed fee charge. This may vary depending on the project. The percentages shown are intended as an example used to demonstrate the method and differences; you should decide which percentages are appropriate to your business.

It is important that you add your extra costs when calculating a fixed fee, as without them the business is likely to make less profit. In the example we have shown an overall cost of £54.33 against an employee cost of £50.00 per hour. The difference of £4.33 will come out of your profit if you do not apply these add-ons costs.

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