# *How to make more profit from the same number of clients*

**A practical White Paper by Chris Lang, DBA Expert**

It's remarkable to think that many creative agencies believe the best way to make more profits is to win more business. Its not unusual for owners to complain to new business people 'If we can just land a couple of really good clients then we are made', believing that winning big brands will propel them into the next level, and through the reputation this attracts clients will be falling over themselves to let them handle their business.

While all that may well be true, there is a much easier way of looking at this issue, and it starts by taking a realistic view about the clients you have and the way you charge for your services.

There are a number of basic factors that determine if your agency will be profitable or not, and they are nothing to do with the quality of the work, your location or your Facebook page. It's down to the dull financial metrics.

This paper will explain how using some simple financial models in conjunction with a job costing system an agency can make more from its existing portfolio, and through the efficiency that it achieves it can then step up a gear to be taken seriously by those clients that generate the biggest fees.

### Utilisation

Utilisation is the amount of time that staff spend on fee earning work. This is key to the profitability of the agency because it is the skills of the people that the agency sells in order to generate profits. The amount of time available for fee earning work varies considerably depending upon the role of the individual, because employees spend time on a wide range of activities including company meetings, working on new business pitches, travelling or being absent due to illness.

The more senior the person the less time they are likely to spend on fee earning work, but they compensate for this gap by virtue of the new business they help to bring in to the agency. On average, Design Agencies perform at an utilisation rate of around 78% (this can range between 66% for Senior Managers to 84% for Studio Operators). In reality a Visualiser may be expected to spend 90% of his time on fee work but a Managing Director is likely to spend most of their time running the company.

Utilisation is a key element of calculating charge out rates.

### Charge Out Rates

Charge out rates can be a delicate issue when you negotiate with a new client (or renegotiate with an existing one- especially during a procurement-led process. There are various ways of calculating the necessary formulas, but the basic principals are built around a common set of formulas:-

- **Number of Working Hours /Year**
- **Number of Chargeable Hours**
- **Salary Rate**
- **Overhead Rate**
- **Net Profit Margin**

### Number of Working Hours in a Year

For most businesses working a standard 37.5 hour week (average 7.5 hour day) the total number of available weekdays is 260. Deducting the standard 20 days leave, plus the 8 public holidays the remaining balance is 232.

232 days of 7.5 hours a day means there are 1740 working hours a year.

### Number of Chargeable Hours

While it would be ideal to get every available hour to be fully chargeable in reality the most that can be expected (for a typical Visualiser) is 90%, so the maximum number of hours is 1,566. Applying the same process to each employee will give you the total number of chargeable hours available.

### Salary Rate

This is worked out by taking the annual salary (including Employers National Insurance) of an employee and dividing it by the number of chargeable hours that employee is available, e.g.

A Visualiser on an annual salary of £54,810 including

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Employers NI, available to work the maximum chargeable hours of 1,566 would have an hourly rate of:-

£54,810 / 1,566 = £35.

Employee salary costs are the major drain on a business, and creative agencies often set aside around 50- 60% of their income simply to cover gross payroll (inclusive of Employers NI).

In order to work out how much to charge clients it is necessary to calculate the individual hourly salary rate, together with the running costs the business as well (known as the Overhead Rate).

## Overhead Rate

Overheads are all the business costs that are in addition to the salaries of fee earners, i,e.

- Rent and business rates
- Insurances
- Business services
- Utilities
- Consumables etc.

It also includes the cost of un-billable employees such as bookkeepers, office managers and new business executives.

In order to charge clients for these costs an hourly amount is needed to add to the charge rate. This is calculated by adding up all the overhead costs and dividing it by the total number of chargeable hours as worked out previously.

For Example: If the total annual overheads of a small agency (employing around six chargeable employees) is calculated at £90,000 and the total number of chargeable hours is 9,000 then the Overhead Rate will be £10 per hour. This is the amount that must be included with each billable hour in order for the company to cover its costs.

By adding this to the Salary Rate we will then get to a cost per hour for each employee.

Therefore a Visualiser with a Salary Rate of £35 will also require an Overhead rate of £10, so the total cost rate will be £35 + £10 = £45

This is the amount the company needs to charge clients in order for it to cover not only the employee's salary but also the other costs of the company. Obviously the aim of the game is for the company to make a profit so this needs to be added to rate in order to arrive at the charge rate.

## Net Profit Margin

Covering the salary costs and the overhead costs in any billing is necessary, but obviously the aim of the game is for the company to make a profit so this needs to be added to rate in order to arrive at the correct charge rate.
Most design companies will be trying to make a 20% net profit margin. This means that the rate in the example would amount to 80% of the final charge rate.

An easy way to then get to the final charge rate is to take the rate shown and divide it by 80 to get 1%, which can be multiplied by 100% to get the charge rate.

In our example this would be £45 / 80 = 0.5625 x 100 = £56.25

The profit per hour is therefore £11.25 which is 20% of £56.25

## Marking Up Third Party Costs

There are no hard and fast rules about marking up third party costs. It often depends on the size of the cost and the relationship with the client. Some clients will specifically exclude the marking up of costs, especially the procurement departments of big multi-national companies, while others are only interested in the overall cost. However, wherever possible marking up by at least your target net profit margin is a good starting point.

## Estimating

The more realistic the estimate the more likely the company is to make decent profits. It is a starting point to calculate how much a client should be charged for a particular project but also it's a learning experience as well. If you are about to estimate for a project but you know a similar project went well over budget you will know that you need to charge more this time in order to maintain your profit margins.

Estimating also means you think about each task in a project and try to fully understand the length of time the task takes in order to make sure you are charging the client the right amount for the whole project.

The estimate will also give you the reference point for when you come to reconcile the project. Again this will feed in to the company's learning on how much to charge clients for project.

## Employee versus Freelance Resource

The use of external staff allows the company flexibility in its cost base, as normally they will only be used as and when required. However in general freelancers cost more than employees and there may be issues with consistency which may require more supervision.

For example a freelance Visualiser may cost £300 a day, which is £40 an hour but you will only be able to charge the client at the same rate as the equivalent employee, i.e. £56.25. Once you take into consideration the Overhead Rate calculated above (£10) your hourly profit is only £6.25.

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On the other hand often freelancers are highly skilled and they may take less time to complete a task than an employee. You would still charge the client the same amount but the cost will be less as the amount of time spent working on the task is shorter.

The key will be to ensure that freelance resources are deployed sparingly, and only when absolutely necessary. Estimating their time accurately using a resource management system will minimise the risks of over-servicing.

## Project Financial Reviews

An understanding of when projects have gone over budget can really make a difference to the profitability of the company. For example if any client changes have occurred that were outside the original brief but have not been charged for this is effectively giving money away. If costs are being checked against an estimate it is much more likely that these will be discovered at the time allowing you to flag the issue and re-estimate to the client.

It is worth noting at this stage that even the small costs build up if you don't keep track of them properly. If you're continually couriering work to and from clients or suppliers but not estimating and charging for these then you will put your profit margin at risk.

It is very important to review the costs of each project when it comes to an end, but a more efficient agency will also review during the course of it. This allows companies to recognise where they have done well financially and to put in to place processes for when things have gone badly.

Using a job costing system will make this process easier, because the margin of error between a profitable project and one that loses money is very thin: Quoting at the right charge out rate, using Freelance resources sparingly and providing accurate estimates through a job costing system will prevent valuable profits from going to waste.

## Cost Control

Cost control is not a fixed entity. Many overhead costs such as rent, rates, insurance, will be repetitive. Others such as travel, stationery, new business costs, telephones etc., are likely to vary from one month to the next. The Overhead rate has to allow for fluctuations in demand, and the best way to manage this is to prepare an annual budget.

A well-considered annual budget is a must and producing monthly management accounts to compare actual costs versus the expected costs is very important. The source of cost overspends can often be down to inexperienced employees. They won't have the knowledge or skill to ensure spending does not escalate out of control and if no monthly checks are taking place it is likely the only time this will be noticed is when annual accounts are being produced, often months after the end of the financial year. <u>Too late to do anything about it.</u>

Another method that can be employed to try to control costs is to share the budgeted amounts with the people mostly likely to be spending on that particular cost. Not only does this mean costs are likely to be reviewed on a regular basis but also gives a sense of ownership to employees thereby empowering them and making them feel more like they're part of a team and the company's money is a team effort.

In the end agency efficiency is determined by the attention to detail that a creative business applies to managing the client relationship. While the details of charge out rates, correct overhead absorption, proper estimates, careful use of freelancers and third party costs may seem overcomplicated its easy to see how agencies can allow valuable cash to drain away from a business simply because they don't pay enough attention to these details.

Through using an integrated job costing and accounting system, agencies can instil good business practice into everyday business processes. The agency will be able to turn its vision for the future into reality

But the greatest advantage of all is the feature that seems the most trivial: Simply by turning a portion of the time lost by fee- earners on repetitive administration into billable time, an agency can recover a major portion of annual net profits. All of this is achievable without winning any more business.



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*Chris and his team have worked with many companies over to past 5 years to help improve their financial performance, not only by processing day-to-day data but also improving processes and commercial awareness throughout the company. This approach ensures high quality information and therefore better decision making at the top level.*

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