

Report Number 23984

Setting Income Goals

The following five (5) items are things you should consider when planning income goals:

1. **Be specific about what you expect from the business** using the reverse-income statement as a tool. (e.g., required profits = necessary revenues minus allowable costs.) Don't start with the costs and hope the profits will flow. Figure out what profit will make this venture worthwhile, then work backward to figure out what it will take to get there.
2. **Impose market and competitive discipline.** Do your research. Is the market big enough? What's different about your product or service? Do you have the technology?
3. **Specify the operating challenges.** Entrepreneurs should ask:
 - o What is the unit of business?
 - o How many units do I have to sell to achieve my profit goals?
 - o Will this volume support a cost structure that achieves my profit goals?
 - o What kind of people infrastructure do I need to achieve my profit goals?
 - o How sensitive will my profits be to changes in the assumptions I am making?
4. **Document assumptions.** For example, here are some of the fatal assumptions that e-businesses and dotcoms have made:
 - a. Customers will sign on because our site is cool.

- b. All we need is 5% market share.
- c. Our e-customers will be like our bricks and mortar customers.

5. **Plan milestones that are targeted events and goals** not arbitrarily chosen dates. Focus on converting assumptions to knowledge. At each milestone, revisit the assumptions and business model, learn from it and adapt accordingly?

Calculating Your Hourly Rate

Here is how you can calculate your hourly rate presented in a general format:

The basic formula is

$$\text{hourly rate} = \frac{\text{Required Revenue (for the year)}}{\text{Billable Hours (in a year)}}$$

You don't need to do this calculation at the 'year' scale. You might find it easier to think at the monthly level, but you need to make sure you take into account things which do not happen every month, like vacation, etc. For the rest of this document, we will keep things at the year level.

Required Revenue. If you're self-employed, your largest expense is probably the salary you need to pay yourself. If you're doing web development or consulting, you probably have other expenses like internet connections and phone lines (both land lines and wireless), printer toner or ink, as well as other office supplies. You'll need money for marketing and sales (producing promotional materials, mailings,

taking prospects out for lunch, pitch materials, etc), as well as for travel (gas money, cab/bus, fare etc). If you are renting office space, you'll need rent money, and, in almost every case, you'll need to pay taxes to the government.

Profit is another component of your required revenue that you need to think about. Some people just wing it, tacking on 20% for profit. We would suggest instead to consider the reasons why you need to make a profit. Remember that you've already calculated in the cost of your salary, which should provide you with the money you need to maintain the quality of life you desire. One good use of profit is to re-invest it in the company, purchasing new equipment, upgrading your skills, etc.

Profit can also be used to grow the company. You can use it to pay the salaries of staff you hire on while they ramp up their billable hours. It's also always a good idea to have money in the bank to cover expenses when billable hours are lower than required. You might also think of growing your company by hiring getting some office space and hiring employees to take care of non-billable tasks (ex. administration, sales, etc). However, these are not things that are paid for by profits. These are regular costs which will require you to increase your hourly rate.

The important idea here is to develop a good understanding of the costs involved in your business. In some cases, this will be a simple calculation, in others, quite complicated. But before you launch yourself onto this career path, you need to know what kind of money needs to be coming in order to remain viable.

Billable Hours. Calculating the number of billable hours might seem like an easy calculation:

$$52 \text{ weeks} \times 35 \text{ hours/week} = 1820 \text{ hours}$$

You've already thought of a few other things that you need to take into consideration that would change this number. First, you need to figure

in vacation time. Most people will plan to take at least two weeks. Others may be looking upon self-employment as a way to take more vacation time. That is possible, although more vacation time translates into fewer billable hours, which, according to our formula, means a higher hourly rate.

Another reality of freelance work is that simply earmarking hours as 'billable' does not mean that they will be so. You can't simply say, "This week I'm going to work 35 billable hours," and it will happen. You need to have the contracts in place. Rarely does the work come in smoothly either. Some weeks (or even months) might see very little billable work, while others will bring more than you can handle. That's the reality of freelancing.

Getting contracts (i.e. making sales) takes time as well. A lot of time networking, meeting with people, getting your name out there, pounding the pavement. This is all non-billable time. If possible, you should try to have as many contracts as possible lined up before setting out as a freelancer. That will provide you with some sort of revenue stream during your first few months of operation.

The problem of time lost to the sales process is compounded by the practice of spec work, where the freelancer has to do creative/strategic/planning work for free as part of the client's evaluation process. This places the freelancer in the position of having to do billable work for free in order to get the sale.

An example

Let's try plugging a few numbers into the formulas, just to get a feeling for them. For the sake of argument, let's say that after looking at your costs and profit goals, you decide that your required revenue is \$75,000. Remember that that number includes your salary, operating costs, taxes, etc. For our billable hours, let's assume that we are

willing to stick with two weeks of vacation, and that we expect to be able to bill 50% of our time. This translates into:

50 weeks x 17.5 hours/week = 875 billable hours

and an hourly rate of:

\$75,000

hourly rate = ----- = approx 86\$/hour

875 hours

This is the hourly rate should be charging in order to stay in business.

Why not simply charge the going rate?

Many people who go into business don't bother going through these calculations. They simply find out what the going rate is for the work that they do, and they charge that. They charge whatever they can get away with. This may work when there is an abundance of work and clients have lots of money to spend, but it's no way to operate a business.

First, by skipping the exercise of calculating required revenue and billable hours, the business person is missing a grasp of the fundamentals of their business. This is especially true of people who have never been self-employed or thought about the business side of things. As long as everything is going fine (i.e. contracts are coming in, bills are getting paid), there are no problems. The sales make themselves and the money is good. However, once the market eventually dries up, and contracts become scarce, the business person doesn't know how to react.

Second, the market price may be determined by larger companies who have more overhead, requiring higher hourly rates. As a business person, your billable price will be lower, and remember that it already includes your profit goals, which are in turned based on your future plans. If your hourly rate is lower then the market, leave it there. The

only reason to grab the extra money would be greed. Aside from the moral implications of this, your greed would most likely cause you to price your services out of the range of those people (i.e. small companies, non-profits, etc) who need it the most.

Of course, it might happen that your hourly rate is *higher* than the market rate. In this case, you have a problem, and you need to either decrease your required revenue or increase your billable hours to bring your prices in-line with the market. There are also situations where you may be willing to accept a lower hourly rate, that is, lower than the hourly rate you've set for yourself. For example, if you were working on a project spanning several months, allowing you to bill a higher percentage of your time, you might accept a lower rate. Having done the calculations, you'll know exactly how low you can go and remain viable.

Conclusion

This information is not meant to be a complete treatment of the financial aspects of the business. You have been looking at the situation at a high level, which is good for this kind of planning, but month-to-month cash flow is critical to a business person. In addition, many clients are looking for fixed-price contracts, and are not willing to sign an open contract.

How to Set Rates

1. Introduction

The question of how much to charge is a popular one in the minds of business people and it's a topic which crops up often on discussion lists. However, it's a subject which is difficult to discuss.

Nevertheless, the purpose of this guideline is to provide the business person with a number of ways to arrive at rates, and to do so without once discussing the actual rates of any particular competitor.

2. How Do You Set Rates?

This is the basic formula:

Determine the number of billable hours per year

Take annual salary and add an overhead factor

Divide salary + overhead + secret ingredient by billable hours.

We start with the number of billable hours in a year.

Normal Work Week: 40 hours

Year: 52 weeks

$40 \times 52 = 2,080$ Total Hours per year

Now we adjust the total hours to arrive at the billable hours. This compensates for the fact that some of the time we are sick or on vacation or taking the day off for July 4th or Christmas. Naturally, we would still like to be paid for those days, even though we can't bill for them. So we have to look at just the number of billable hours we really have. Traditionally, ad agencies have reduced 2080 to 1600 and used that as the standard number of billable hours. So we will use that figure. If you're self-employed and spend a lot of your time selling, then you might want to reduce this further.

And, if you want to get technical about it, we can do that, too. In other words, what percentage of your time is billable? If you can figure that out, then you can use that figure instead of 1,600. But, we can already tell you that the industry average is going to be right around 60% billable, which is only 1248 hours, or a little over half of your time. So if you're doing better than that, you're above average. In order to be profitable, however, we recommend that you set a goal of 80% which is 1664 hours, very close to the 1600 figure from above.

Now we need to take the amount of money you expect to earn this year, whatever you would say is your "salary" if someone asked you. Let's say its \$10,000 just to make our calculations easy.

Next, we must look at the real cost that you represent to your business. That is, not just your salary, but any associated overhead that the business incurs because you work there. This would include some personnel related expenses such as employer share of payroll expenses or self-employment tax, health insurance, disability, life insurance, and other "non billable" expenses that are vital to you and

unavoidable to your business. Other things in this category might include a car allowance, or typical mileage expenses, the prorated cost of your computer, scanner, desk, chair and other office equipment and furnishings as well as a prorated cost of your office space. You need to include this even if you are a one person operation and self-employed working at home and living with your parents! Otherwise you stand a very good chance of going broke. And if you have employees, you will need to add up their "contribution" to overhead to set their rates.

After many accountants worked long and hard on this in business, a rule of thumb was devised whereby you figure the employee's overhead at 100% of the salary amount. In other words, to get salary and overhead, just double the salary. So, in our example, we would double \$10,000 and arrive at \$20,000.

Now we divide \$24,000 by 1,600 billable hours and arrive at an hourly rate of \$15.00. This works "per 10 thousand". So, if you make say, \$30,000, just multiply by 3 and you'll get the correct figure of \$45.00 per hour, or for \$100,000 just multiply by 10 to get \$150 per hour.

Now let's look at some examples.

3. How Do Attorneys Set Their Rates?

Or, How My Accountant Says His Lawyer Calculates *His* Rate

"How much money do you want to make? How many hours do you want to work? Divide. That's your hourly rate."

This is a very simple method, offered somewhat for amusement. Let's see how we would do this if we were attorneys.

Amount to make: \$1 million

Hours to work: 1

Rate: \$1 million per hour

Right away, we can see why this method appeals to attorneys. But this is actually a quick and dirty way to arrive at a ballpark hourly rate:

1. Figure out how much the job is "worth".
2. Figure out how many hours you're going to put into it.

3. Divide.

That's the hourly rate you'll be getting.

This is helpful when dealing with hourly rates on the *other* side of the coin -- when you want to see how the hourly rate you actually earned compares with the rate you *think* you're charging the client.

4. How Does My Accountant Set His Rates?

What about my accountant? How does he set his own rates for his people?

He multiplies what he pays them by 5 to get the rate.

In our example, this would be:
 $\$10,000 / 2,080 = \4.80 per hour
 $\$4.80 \times 5 = \24 per hour

This is 1.6 times (or a little more than 1 1/2 times) what we got in the ad agency example. Using a multiple of 5 is good; you can use it as your method, as long as it does not make your prices uncompetitive. Consider it the upper range for your rates.

5. How Can You Set a Rate for Your Entire Business?

Or, How I Calculate It for My Business

In addition to figuring the hourly rate for each employee and each service offered to clients, you also want to know what it is costing just to keep the doors open.

In other words, you add up all your costs to operate on an annual basis. Then you divide by 2,080. This gives you the "pay rate" for the business itself.

This is very useful. For instance, suppose the annual costs are \$100,000. That's an hourly rate of \$48.08. That means the business is spending on the average, \$48 an hour or \$1900 a week or \$8,300 a month, whether there is a lot of work or no work at all. These are very useful figures to have in mind as one is setting sales goals and hourly

rates. You might want to calculate the figures for your own business. How much did your business spend? How much did your business bill?

6. So, You Think You're Worth How Much?

When you go about setting your hourly rate, you'll probably become much more aware of the rates other people are charging for their time. Plumbers, appliance repair people, attorneys, psychiatrists, and photographers are a few who come to mind. Occasionally you'll see hourly rates posted in various businesses or in the media. Here's a way to use those rates to help figure your own.

We all have an idea of how much we think we are worth and how much we think others are worth. You could compare your rates to the rates of just about any other service business.

So there you have it, five ways to figure your rates.

How do you price your product now?

Answers from businesses can vary from "less than our competition" to "the highest price my customer will pay". Either tactic has a negative side that can cost your company customers and profits. Because you are too busy to be rocket scientists in the pricing galaxy, we developed this information of steps to help you understand pricing.

Three Steps for Pricing.

The Three (3) Steps to determine the pricing.

1. Do Your Homework

Know Costs. There is no substitute for thoroughly understanding your product costs and the variability of those costs – that means the resources used to create, produce and market your product. Unless you know all your costs by product and by customer you could be losing, rather than making, money with each sale.

Understand Market Value. Realistically compare your company's product to your customer's expectations and perceptions. You must also understand your competition and trends in your target industry.

Set Objectives. Once you have a thorough understanding of your costs, it is time to explore two of the ways your company can set

pricing objectives. Generally, pricing philosophy is based on company goals such as:

Sales Growth. For a variety of reasons, such as immediate expansion needs, a company may set sales growth as an objective. When selecting this as an objective, it is critical to remember that higher sales do not automatically produce higher profits. In fact, sometimes the cost of expanding sales volume, such as increased costs of production, distribution or customer service, becomes so great that profits actually decrease.

Profit Growth. Frequently, corporate goals such as a targeted return on investment or a profit maximization philosophy necessitate a "pricing for profit" objective. Be sure you take both short and long-term profit goals into account when implementing this objective. Also, study the implications of each pricing change on the health of your business.

2. Select Your Strategy.

It's now time to select your pricing strategy based on your costs, company objectives and the perceived market value of your product. Although strategies can be quite complicated and detailed, the following list discusses basic options most companies find useful. Your choice depends on internal assessment of your company's objectives and an objective analysis of the mark in which you compete.

Cost Base Pricing.

Definition: Price is based on a product's total fixed and variable costs.

Example: Typical pricing in commodity markets. For example, a commodity type raw product such as steel is priced using a standard formula based on cost.

Caution: If you use this exclusively, you must be able to stay in business with a very low profit margin. In non commodity businesses, this option should be only one aspect of the total product pricing strategy.

Demand Based Pricing.

Definition: Price depends upon your customer's perception of your products' value and the level of demand for your item. Your product must provide a unique benefit to your target market.

Example: Your product has prestige appeal so it can be priced in a range well above the cost of production. For example, luxury cars and gourmet food have prestige appeal.

Caution: Success depends on your knowledge of your customers and your market. You must have an uncanny skill for accurately estimating customer demand to avoid disappointing sales results.

Competition Based Pricing.

Definition: Price is set in relationship to your competitor's prices. In some cases this may be below cost and is usually indicative of a product that has no competitive edge.

Example: You are caught in an industry "price war" where all products must compete on the basis of price or risk losing their market value.

Caution: Your company's long term goals may be sacrificed in the interest of competitive pricing. Also, you are at the mercy of the largest companies in your industry that can afford short term losses in order to play this expensive game of war.

Value Pricing.

Definition: Gives your customer more quality for less than they expected to pay.

Example: Used when you want to gain market share, position your product with customers, or obtain market acceptance of a new product.

Caution: Product quality must be consistent and your company must operate efficiently for this to be an effective strategy. Using this strategy means that you understand your customers and competitors very well. In addition, you may find it difficult to raise prices to more profitable levels once your initial distribution goal is achieved.

3. Test Your Pricing Theory

Pricing your products is almost as complex as rocket science, but quite as predictable. At best, your product pricing is based on information that can change daily or even hourly. For that reason,, it is critical that you test the validity of your pricing strategies with a small customer sample or market segment and evaluate your pricing periodically to adapt to changing market conditions.

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