

Profit Pricing for the Costing of a Service

Last Verified: 2005-10-06

Successful business people know and understand the basic concepts of costing and pricing. This is particularly true in the service industry. This article is intended to provide a guide and an understanding of the main factors to consider when establishing your costs, your prices, and your profits.

Using a simplified approach to cost accounting, you can attempt to identify the associated costs of offering the service. The total cost of producing or offering a service is composed of three parts:

- the material cost;
- the labour cost; and
- the overhead cost.

Direct Materials + Direct Labour + Direct Overhead = Total Cost of the Service

Direct Material Costs

The direct material cost is made up of your cost for the parts and supplies that are used on specific jobs. Once the list of these has been developed, a check with a supplier will give an up to date material cost. The shipping and other handling costs for the parts should be included in this cost.

Direct Labour Cost

The direct labour costs include those wage and benefit costs identified with a specific job. The labour cost is calculated by multiplying the number of direct labour hours required by the direct labour cost. It is very important to accurately determine the amount of direct labour hours involved to complete the service. The direct cost of employee benefits such as Worker's Compensation, holiday pay, E.I., C.P.P., etc., can either be calculated as part of the labour or the overhead costs. It is important that they are included and not forgotten. These are also usually expressed as a percentage of the wage cost.

Overhead Cost

Overhead costs include all job related costs other than direct materials and direct labour, and may or may not include employee benefits, if you have already included them in the labour costs. Overhead is the indirect cost of the service and is made up of indirect materials, indirect labour, and other indirect costs related to the service. To figure the portion of overhead related to particular services or jobs, an overhead rate is calculated as follows:

O/H Rate = Total Overhead Cost/Total Direct Labour Cost

OR

O/H Rate = Total Overhead Cost/Total Direct Labour Hours

The first method is the most common method where a specific service is performed, such as machine or auto repair shops and the rate is expressed as a simple multiplier of direct labour. The second method is more suitable for services such as secretarial or janitorial services and the rate is simply an hourly rate that is allocated to billable hours. To calculate total overhead costs, small business should not depend solely on historic information, but should be using projections of your next six months to one year costs. These should more accurately reflect the costs of inflation and the future direction of the business. Once these individual costs have been calculated, the total cost of the job can be calculated by adding all three costs together.

Pricing

Once this has been done, it is important to calculate a profit factor into the price of the service. To this point, all you have done is covered your costs. The economy, prices charged by competitors, etc., will all have an impact on how much you can charge for your service. A number of pricing alternatives exist. Two examples of this are: 1) By applying a profit factor (%) to each of the three costs separately or 2) By applying a profit factor (%) to the total cost at the end.

Example:

Material Cost = Material Cost + Freight & Handling Costs
= \$18 + \$2
= \$20

Labour Cost = Direct Labour Cost per Hour X Hours Required
= \$5 per hour X 2 hours
= \$10

Overhead Cost = Overhead Rate X Direct Labour Cost
= \$100,000 (Total Overhead)/\$50,000 (Total Direct Labour) = \$2 (Overhead Rate)
= \$2 (Overhead Rate) X \$10 (Labour Cost)
= \$20

	Cost (\$)	Profit (%)	Profit (\$)	Total (\$)
Total Material	= \$20	X 10%	= \$2	\$22
Total Labour	= \$10	X 30%	= \$3	\$13
Total Overhead	= <u>\$20</u>	X 30%	= <u>\$6</u>	<u>\$26</u>
Total	= \$50		\$11	\$61

Summary

The total cost of producing a service is composed of the total material, the total labour, and the overhead costs, and is used as the basis for setting prices and profit. Given regulations, competition and the economy, you must have a pricing strategy that keeps you competitive and profitable.

Source: U.S. Small Business Administration
Prepared: Government of Saskatchewan

For further information regarding starting a business, contact the

Canada-Saskatchewan Business Service Centre
#2 - 345 3rd Avenue South
Saskatoon, Sask. S7K 1M6
Phone: **306-956-2323** Toll-Free: **1-800-667-4374**
E-mail: saskatchewan@canadabusiness.sk.ca
Web site: <http://www.canadabusiness.ca/sask/>

DISCLAIMER

Information contained in this document is of a general nature only and is not intended to constitute advice for any specific fact situation. Users concerned about the reliability of the information should consult directly with the source, or seek legal counsel.

business infosource is a proud partnership between:



Western Economic
Diversification Canada

Diversification de l'économie
de l'Ouest Canada

Canada

