Pricing IT Services

A Complete Guide

Contents

Introduction

Do you know how much it costs you to perform one hour of service?

If you're basing your pricing solely on a market-driven strategy, you're playing a dangerous game. For example, if your costs are $75 per hour but your market only supports $50 per hour, either your costs are too high or you're in the wrong market.

There is no easy way to establish the "going rate" for comparable services, because all services are differentiated by other forces, such as individual processes, brand equity, and features. If you're going to price your services simply based on the competition, you'd better ensure you're making an exact apples-to-apples comparison, which is easier said than done and not something we recommend.

Consider instead, a model where your pricing is based on how much it truly costs you to perform one hour of service. In this eBook, we show you how to calculate your full hourly overhead burden–so you can set the right price for your IT services.

Let's get started.

Common Pricing Questions:

- How can we tell if we are making money?

- Should we be charging more for our services?

- How can we justify charging our clients more?

Start with Billable Staff

The first step to making an informed decision about pricing your IT services is to calculate your billable labor burden. Your employees cost more than just the hourly rate or salary you pay them. Think about all the additional costs you have to incur for each employee, from payroll taxes and workers' comp to healthcare, paid time off, and more.

An employee with a $40,000 annual salary can end up costing you closer to $60,000. Not accounting for this differential when pricing your services can be a serious mistake.

Everything reflected on your billable employees' W2s, as well as any costs above and beyond gross compensation, is your full labor burden.

These costs should not be left out of the equation. Such costs include:

- Federal Insurance Contributions Act (FICA)

- Federal Unemployment Tax Act (FUTA)

- State Unemployment Tax Act (SUTA)

- Disability

- Workers' compensation

- Healthcare

- Sick leave

- Paid time off (vacations, holidays)

- Profit sharing, pensions, 401k, and other retirement plans

- Additional bonuses
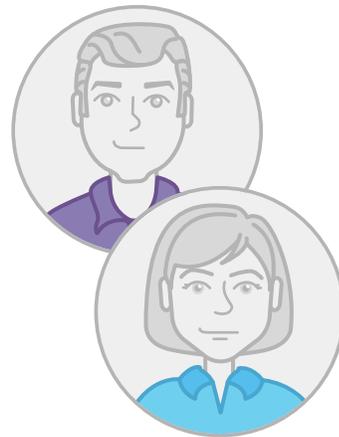
Once you've added up all your billable employee costs, **it's time to account for your overhead.**

Calculate Your Overhead

Your next step is to account for your overhead, or the ongoing expense of operating your business. Your overhead includes both your annual indirect labor costs and other recurring business expenses, such as rent and taxes.

Start with your indirect labor, or the cost of your non-billable staff.

Nontechnical employees with annual salaries, such as admins or marketing/sales professionals, should be included in this category. These employees are still a burden on the business; they just don't bill by the hour.

Next, total all your annual recurring business expenses. These expenses include all of the costs on your income statement, outside of direct labor and direct materials. These costs may include, but are not limited to:

- Rent

- Utilities

- Insurance

- Business taxes

- Interest paid on loans

- Marketing/advertising expenses

- Industry trade association dues

- Equipment and recurring software fees

- Office supplies/maintenance
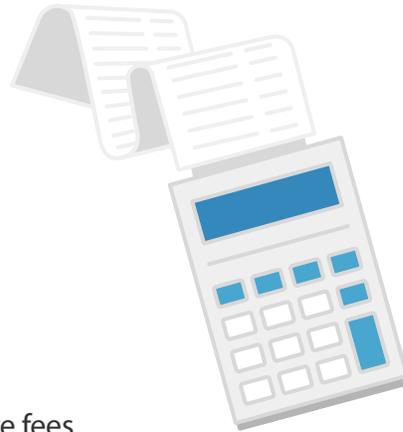
Once you have calculated your indirect labor costs and business expenses, add these two figures together. **The result is your annual overhead burden.**

How Many Hours Did You Bill Last Year??

Before you can calculate how much it costs you to perform one hour of service, you must first calculate your total annual billable hours. In other words, you want to account for the number of service hours that were directly billed to your clients to generate revenue.

Don't forget to account for any employee's paid time off (sick days, holidays, vacations). These hours should not be included in your total because while the employee got paid, the time was not billed to your clients. You'll also want to include billable hours worked by employees who perform both billable and non-billable work (like the business owner), as well as short-term or contract employees who do not work a full yearly schedule.

Once you've determined the total number of hours billed to your clients, you're ready for the final step.

Your Final Answer

Take your billable labor burden from chapter 1 and add it to your annual overhead burden from chapter 2. The result is the true annual cost of your service delivery. Divide this number by your total annual billable hours from chapter 3 and you have arrived at your full hourly overhead burden.

Need an example?

Let's Assume:

- You have 3 billable staff working an average of 1,960 hours per year (5,880 total annual billable hours)
- Your billable labor burden is $250,000 per year
- Your annual overhead burden is $150,000 per year

To calculate your full hourly overhead burden, follow these steps:

1) $250,000 (billable labor burden) + $150,000 (annual overhead burden) = $400,000 (true cost of your service delivery)

2) $400,000 / 5,880 (total annual billable hours) = $68.03 (full hourly overhead burden)

You must charge $68.03 per hour to break even.

If you want to determine how much you must charge per hour to achieve a desired return, simply multiply your full hourly overhead burden by your desired margin on labor. This calculation will tell you how much you must add to your hourly overhead burden in order to achieve your desired profit.

Continuing with the example above:

1) $68.03 (full hourly overhead burden) x 50% (desired margin on labor) = $34.01

2) $68.03 + $34.01 = $102.04

If you desire a 50% margin on labor, you must charge a minimum of $102.04 per hour.

Conclusion

Finding the true hourly cost of running your business isn't just an exercise in computational skills. It's an important part of pricing your IT services to ensure you're earning your desired margin while still providing value to your clients.

Making an informed decision about pricing your offering to achieve your desired margin on labor starts with a thorough understanding of your overhead burden. With this calculation, you'll be able to determine a true measure of profitability and know with certainty if you should be charging more or less for your services.

Hate Math?

We've made it easy to crunch your own numbers with our interactive overhead burden calculator.

Start Here »

Conclusion Page 2 Continued

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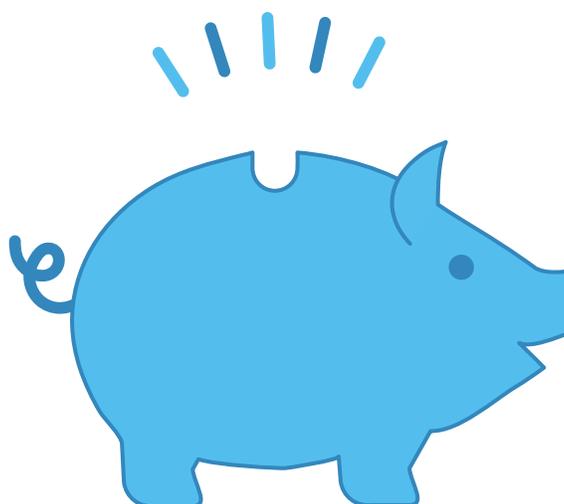
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