Module 3

The Right Price

A. Introduction to Pricing

B. Costing for a Service Business

Module 3: The Right Price

The right price is what enough people are willing to pay for a service.

Objectives:

By the end of this session, you will

- describe how to use information from the income statement to better manage your clinic
- know the steps to cost products or services
- calculate how services and products relate to each other in term of overall profitability of the clinic
- use financial ratios to better understand the profitability of your services

A. Introduction to Pricing

On one hand, for a clinic to be competitive in the market, its prices need to be right. That is, it needs to charge what people are willing to pay for a service. A business owner, on the other hand, must be aware that the price of the services has to cover the costs incurred to provide the service **as well as** some level of profit. There are many factors that affect the selling price of a service.

The three major variables are

- competition
- your business's costs
- your profit objective

The right price has to be low enough to attract customers and high enough to make the service profitable. Pricing is part art and part science, and there are several factors that go into the development of an optimum price:

- labor costs
- material costs
- indirect costs

Labor is the cost of work directly applied to a service. Work not directly applied to the service, such as cleaning up, is an overhead, or indirect, cost. Benefits also can be included as part of the labor cost.

Material costs relate to the cost of materials used directly in delivering the service.

Indirect costs (or operating expenses) represent the costs of doing business that are not readily identified with a direct service. These costs include rent; office supplies; utilities; transportation; advertising; depreciation; taxes; clerical, secretarial, and administrative support; and insurance.

B. Costing for a Service Business

Service business prices are driven by the need to balance billable time with available time.

- Like any other business, a service needs to have a target profit objective.
- Rates per service hour must be set to cover the costs of all personnel (billable and non-billable), the costs of all administrative activities, and the target profit.

Service businesses sell time. Skilled labor hours form most of the direct costs; material costs are often insignificant. The challenge for a service business is to correctly price time.

Service businesses include doctors, lawyers, and accountants, all who offer professional services. The price for services is usually expressed in terms of an hourly rate called the rate per service hour.

Direct costs per half hour	+	Charge to cover indirect costs and provide a profit	=	Rate per Service half hour

Example

Dr. Tsagaye works at a medium-sized clinic that provides general services to the local community. The clinic has two doctors including Dr. Tsagaye. Each doctor is paid birr 75,000 per year. There are two nurses who work at the clinic, and each is paid birr 40,000 per year. There is a clinic administrator who greets patients, prepares bills, and collects fees. He is paid birr 25,000 per year. Building rent is birr 40,000 per year, and utilities, office supplies, and other expenses amount to birr 30,000 each year.

Dr. Tsagaye knows that on average he spends half an hour with each patient. What should he charge clients for each half hour of service?

Step 1: How many service hours will the clinic provide this year?

Determine the number of service hours that the clinic expects to provide this year. At certain times of the year, there may not be much work. Even when you work 50 hours in a week, not all of those hours can be billed to clients. Also remember everyone gets a vacation, holidays, and sick leave.

Let's assume the following:

Number of doctors	X	Average service half hours per week	X	Weeks worked per year	=	Service half hours per year
2	X	80	X	48	=	7,680

Remember: Service firms must strive for the maximum utilization (billable time) of their capacity (total time).

Step 2: What will be the clinic's total costs this year?

Estimate the clinic's total costs for this year. Look at last year's records for help.

	Dr. Tsagaye's clinic
Two doctors at birr 75,000 per year	150,000
Two nurses at birr 40,000 per year	80,000
One secretary	25,000
Building rent and utilities	40,000
Cost of materials	30,000
Expected total costs for this year	325,000

Step 3: What about a profit?

If you base the rate per service hour on costs alone, there will be no profit left over. The clinic owner(s) must now decide on the target profit. If the profit (and price) is too high, the clinic may lose some of the patients who will go to other clinics that are cheaper. As the bookkeeper you should be aware that the clinic owner has to set a target profit. In our example the Doctor wants to make a profit equal to 50% of the salary, 37,500 for the year.

Step 4: What is the labor rate per service half-hour?

Now you are ready to calculate how much you should charge your clients per half-hour for the doctor's time:

Dr. Tsagaye's Rate

Total costs 325,000	+	Profit 37,500	=	Rate per service half-hour 47.20
Number of service half-hours 7,680				

Allocating costs to service areas—Operating expenses (or indirect expenses)

Establishing the rate of professional labor is one way to establish costing and pricing of services, as was presented above.

Another method is to look at the three components that contribute to costing including labor, material, and indirect expenses (operating expenses) on the basis of the different services and products your clinic provides, as opposed to only the physician's time in a generic sense.

Proportional allocation method to distribute indirect expenses

This method allocates a different proportion of general operating costs to different services and products depending on the proportion of sales these items are to your overall revenue. For example, if you offer two services, one of which represents 70 percent of your total sales, then you would allocate 70 percent of your general operating costs to this service. A second service represents 30 percent of your total sales. Therefore 30 percent of the general operating costs will be allocated to this service.

To simplify you can group similar services together. For example, categories can include laboratory, x-rays, and tuberculosis. The percentage of sales will be the same proportion of costs that you would allocate to that category. The total for all products and services will be 100 percent.

To understand how to allocate indirect expenses across several lines of service you need to follow two steps:

1. Calculate the percentage of revenue for each service line:

$$\frac{\text{Line of service revenue}}{\text{Total revenue}} \quad \Big| \quad \text{Percentage of total revenue}$$

2. Calculate the amount of indirect expenses that should be allocated to each line of business:

$$\frac{\text{Percentage of total revenue for a line of service} \times \text{Total indirect cost}}{\text{Amount of indirect cost to allocate to the line of service}}$$

Exercise: Calculating allocation of operating expenses—The proportional method

Instructions:

1. Calculate the percentage of revenue for each service line (Revenue / Total revenue = Percentage of revenue).

2. Calculate the amount of indirect expenses that should be allocated to the line of business (% of revenue x Total indirect cost).

Lines of service **ABC Clinic** Total revenue = 40,700/month Total indirect costs = 17,200/month				
	Injection services	Laboratory services	Delivery services	Doctor consultation
Revenue	11550	19200	3200	6750
Percentage of revenue				
What is the allocated cost using the proportional method?				

Cost of Materials

The kinds of materials and products you need to consider when pricing the clinics' services include supplies used to deliver services:

- drugs
- syringes
- plaster of Paris
- sutures
- elastic bandages
- laboratory test kits and stains
- x-ray material

When factoring in the costs of materials and products, include their shipping and handling costs.

	Item	Purchase price	Additional costs	Total purchase price
1				
2				
3				

The formula for optimal pricing

	Line of service	Cost of labor per half-hour	Allocation of operating costs	Cost of materials	Selling price
1					
2					
3					
4					

Then consider additional external factors, such as the price of competition, perception of the customer, purchasing power of the customer, and the economic and political climate.