Why Every Service Business Should Have Job Costing

8 min read

Key Takeaways

- Attempting to compare the gross profit earned from one job to that earned from another is like comparing apples to oranges.
- When you know your costs and you know your desired gross profit margin, then you can easily calculate what your revenue (price) needs to be to achieve your target gross profit margin.
- Job costing in a service business can help you identify which types of jobs or clients are the most profitable.

"Who are my most profitable clients? "Am I pricing my jobs right?" "Why am I losing money on some jobs?"

Sound familiar? If you don't know the answer to those questions, it's important you take time to really understand job costing.

It starts with understanding your profit margins.

Profit margins protect your business from financial challenges, enable business growth, and keep all your business's parts working as they should. But how do you control profit margins – especially when you're operating a service business?

To take control of your profit margins, you must first understand exactly what they are, and which parts of your business affect them the most. **Then you'll see why job costing is so essential for service businesses.**

What Are Gross Profit Margins?

Let's rehash the basics before we dive into the "*good stuff*".

Gross profit is the amount of money left over after you subtract expenses from revenue:

Gross Profit = Revenue - Cost of Goods Sold.

It is simply a dollar amount that changes from job to job- **attempting to compare the gross profit earned from one job to that earned from another is like comparing apples to oranges.** You could have two jobs: one with monstrously high costs and one with incredibly low costs that generate the same gross profit - For example...

- Job A: **$1,000,000** in revenue, costs **$900,000** and generates a gross profit of **$100,000**
- Job B: **$500,000** in revenue, costs **$400,000** and generates a gross profit of **$100,000**

However, when represented as a percentage your gross profit margin reveals exactly how much room exists between your business's revenue and costs.

By looking at gross profit margin as a percentage, you can more clearly see how much you spend on each dollar of profit you earn.

% Gross Profit Margin = (Gross Profit $ / Revenue $)100

Looking at it from this perspective, you will quickly see that "apple jobs" simply do not compare to "orange jobs". Considering the example, take a look at the difference in profit margins...

- Job A: $1,000,000 in revenue, costs **$900,000** and generates a gross profit of **$100,000** = **10% gross profit margin**
- Job B: $500,000 in revenue, costs **$400,000** and generates a gross profit of **$100,000** = **20% gross profit margin**

Although Job B is a smaller job and generates only half the revenue of Job A, its gross profit margin is twice as strong. Every dollar earned by Job A costs twice as much as each dollar earned by Job B.

Accurate Gross Profit Margins: That's Why Job Costing Is Essential

By looking at your gross profit margins, you can actually determine how strong or how weak your business is.

The key to knowing your accurate gross profit margins is having a thorough, accurate, and consistent way to **understand your business's true costs**. This is where job costing comes in.

Job costing is the process of allocating all of your costs (direct materials, direct labor, and indirect expenses) to specific jobs or clients.

This provides an accurate amount of your cost of goods sold so that you can track and evaluate your true profit margins per job or client.

Why Does My Service Business NEED Job Costing? 3 Reasons...

1. To Make Optimized Pricing Decisions

We'll cut to the chase- pricing is not only one of the most important decisions a business owner will make, but it is **THE** most vital component when it comes to making money.

It is crucial to look at your numbers in order to make strategic decisions.

This is where understanding job costing comes in. Once you know what your gross profit margins are, you can take control of them.

When you know your costs and you know your desired gross profit margin, then you can easily calculate what your revenue (price) needs to be to achieve your target gross profit margin.

But how *exactly* does this work? Your bookkeeper hands you your financial statements, and then what?

To see how a business owner might optimize pricing in this way, let's look again at Job B from above.

Let's say that we want to adjust the pricing (revenue) to achieve a better target gross profit margin of 60%.

First, we'll subtract the desired profit margin percent from 100%, which gives us 40%.

This means, to reach our targeted gross profit margin, we expect that 40% of each dollar earned will go toward your cost of goods sold (COGS).

Next, we divide our estimated costs ($400,000 in this case) by our determined COGS rate (40%): $400,000/0.40 = $1,000,000

So, now we can see that if we charge $1,000,000 for Job B, we would have $600,000 in gross profits, which equals a gross profit margin of the targeted 60%.

Of course, you can also find ways to improve gross profit margins by cutting costs, but this is a great way to set pricing for jobs or clients based on historical data.

2. To Identify and Replicate Profitable Jobs

Job costing in a service business can help you identify which types of jobs or clients are the most profitable.

When you start comparing profit and loss statements and gross profit margins across job types and clients, you will likely be surprised by what you find.

You might see that small jobs which don't generate enormous amounts of revenue are more easily streamlined, require less time, have the lowest costs, and generate the greatest profit margins. Or, conversely, you might realize that with the way your operations or costs are arranged that bigger jobs or clients result in your strongest profit margins.

When you identify the jobs or clients with the best profit margins, you can focus on replicating those types of accounts, processes, or sales.

3. To Identify and Improve or Eliminate Jobs That Are Costing You Money

Conversely, job costing can also help you identify and eliminate the types of jobs or clients that cost you money or have weaker profit margins.

As you can see in the Job A vs. Job B comparison the jobs that generate the greatest amount of revenue aren't always the most profitable. In service businesses, the jobs or clients that demand the most employee time (especially high-level employee time) tend to be the least profitable.

If you fail to charge enough of a price markup on these accounts to accommodate the additional direct labor costs, then you'll likely experience shrinking profit margins, despite the increased revenue.

When you determine which jobs or clients are least profitable, you can either eliminate them from your business or adjust your pricing models to improve profit margins.

3 Steps to Start Using Job Costing in Your Service Business

Although job costing in a service business can be challenging to get right, it can, nevertheless, be done.

To job cost in a service business, you'll need to determine what your costs are and implement systems that allow you to accurately track and allocate these expenses.

Here are the benchmarks you will need to work with your accounting function to determine before tracking expenses:

What Jobs/ Services Do You Want To Evaluate? → Identify Units.

Job costing allows business owners to evaluate their businesses at a granular level. To start job costing, first determine what types of "jobs" you want to evaluate.

This could be a literal job type (by individual contract, job size, or task type). You can also define the units you're evaluating as individual clients, types of clients, types of services, or service packages. Additionally, you should also look at the cost of internal jobs or tasks like payroll processing or weekly meetings.

What "Stuff" Do You Need To Get The Job Done? → Identify Direct Labor and Materials Costs.

Next, you'll need to identify and implement systems for tracking direct labor costs and direct materials costs. This includes all materials specifically used and the hours of employees dedicated to completing a job.

For example: In a construction firm, direct costs clearly include the price of building materials, equipment rentals, and laborers' hourly pay. In a cleaning business, this might include the cost *of cleaning solutions and single-use supplies in addition to the hours worked. In other types of service businesses, like a marketing agency or law firm, direct materials costs might be negligible.*

Direct costs differ in every type of service business, and you'll need to determine what you consider direct costs and how you track/bill these expenses.

Are There Any Hidden Costs? → Allocate Indirect Labor Costs and Other Overhead Expenses

Although indirect expenses are not directly connected to individual jobs, they still need to be accounted for and properly allocated.

For example: these indirect labor and other indirect expenses include equipment costs, software subscription fees, your monthly nut, and the general costs of doing business should all be allocated to jobs.

This can be done by having your bookkeeper totaling indirect expenses and dividing by the total number of jobs. Or, calculate a weighted allocation based on the work hours dedicated to each job. The second method for indirect cost allocation is clearly the most accurate, but it also requires a bit more work.

Make Use of Streamlined Technology for Cost Tracking, Coding, and Allocation

You can't have job costing in any kind of business without a robust bookkeeping and accounting system and the technology tools that simplify accurate time tracking and expense categorization.

When you're ready to start job costing, we recommend working with an experienced management accountant. A professional's expertise will help you identify and implement the tools your business needs to start job costing properly.

Plus, they'll teach you to understand unit economics, read your management reports, and show you how to take control of your business drivers to cut costs, optimize pricing, and achieve the strong profit margins that will grow your business.