



White Paper

Payroll: The Key to Activity Based Costing

Find out why activity based costing (ABC) is the best solution to define your costs, accounts and activities. In this paper, you will learn how a payroll oriented ABC will help you make more accurate managerial decisions.

If you want to know how your costs are structured and what opportunities exist for cost reduction, then Activity Based Costing (ABC) is the answer. ABC allows you to understand your costs at an activity level. This allows you to see a breakdown by type of expense for each activity (work phase or task). This breakdown is by a “production unit”, often referred to as a “cost center” (job or project). Hence, ABC is a three dimensional breakdown of costs by cost center, activity and account. This provides a level of detail that allows meaningful cost control decisions to be made.

Challenges in implementing an ABC system:

(1) *How should cost centers be defined?* This requires that products be broken down (grouped) in a way that they can be tracked with reasonable accuracy. In a nursery, tracking an individual planting seldom justifies the effort. However, tracking all 1 gallon plants as a group may be a reasonable goal. Or, tracking all similar production for a defined planting or harvest period may work best. In some cases, it will be by facility, such as by greenhouse or by location.

(2) *How should activities be defined?* Again, it is an issue of what can reasonably be tracked. First, it must be easy to identify the activity and easy to record. Activities can be defined very discretely, such as pre-plant, planting, watering, spacing, moving, and so on. Or, more generally, such as greenhouse, shade house, yard, and harvest. What is important is that activities are selected in a way that they are clear, reasonable and worth the effort to record ... and, allow you to make meaningful management decisions.

(3) *How should accounts be defined?* This is easier as it begins with the General Ledger's Chart of Accounts. But should each account be broken down further into more detail, particularly for non-labor expenses, such as type of fertilizer or type of pot? Using detailed sub-accounts provides a level of detail that allows you to better understand your costs and to make decisions accordingly. In the case of labor, it needs to be defined by type with overtime and overhead costs being separately recorded..

(4) *How should overhead costs be allocated?* Allocating overhead (indirect) costs to production based on each cost center's relative consumption of overhead services is often required, particularly where this fully loaded cost is required as a basis for determining standard costs and for setting pricing. Ideally, these costs should be allocated based on each cost center's relative consumption of overhead services.

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However, from a practical perspective, this is difficult and as a result some standard methods are applied, such as allocating based on direct labor hours, direct inputs costs, space utilized, total direct costs, and so on. On the other side, cost centers do not have control of these expenses and it is their contribution to overhead and profit may be even more important from an analytical and management perspective.

(5) *What type of data is required?* While financial information is core, physical quantities are equally important. Hence, an ABC system needs to support both amounts and quantities. Also important is that the data be on an accrual basis representing what is actually consumed by the cost center based on when it is consumed.

Why Payroll is important as a source of ABC data.

Labor costs are generally the single largest element of cost in companies where ABC is a valuable management tool. However, capturing labor usage in the detail required by an ABC system requires both a good method for recording employee/contractor time plus the ability to properly allocate the cost into the ABC system. Ideally, the same system would provide labor costs for both financial accounting and the ABC system. Given this level of detail, only an ABC oriented payroll system can provide the level of detail required.

Such a system needs time details and associated quantities broken down by cost center and activity with the type of labor (account) typically coming from the employee. In addition, it is generally useful to separately track overtime hours and cost based on just the premium paid or on the full overtime cost. Since the cost of labor should also include employer contributions (such as FICA, medical, 401k, etc) and non-productive time (such as vacation and training time), this needs to be calculated and recorded at the same level as the direct labor expense. Typically, this payroll burden is allocated based on direct labor costs and is a very significant element of cost.

An ABC oriented payroll system can also capture the usage of equipment associated with each employee and charge this out as another ABC cost detail. The charge out rate can come from the equipment record. For owned/leased equipment, the accounting is an internal transaction that has no net effect on the financial records. Generally, this means charging the using cost center for the equipment usage and giving the revenue to the equipment's cost center (an equipment service pool).

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Since two sub accounts (or related accounts) of the same account are used, there is no effect on the overall financial results of the company. By choosing different accounts for each type of equipment, the type of equipment can be detailed in the ABC system.

Conclusion. Since labor and equipment usage are typically the largest elements of cost and the most difficult to capture in an ABC system, an ABC oriented payroll system is essential to the success of an ABC system. Not only does such a system allocate labor costs but equipment can also be charged out at the same level of detail. Other types of cost, such as input supplies and facilities, can generally be tracked and expensed directly to the cost center. A good ABC system provides valuable insight into the business and supports management decisions that would not otherwise be possible.

Argos Software provides Payroll software as a component of its nursery management system. The system is modular with the “full” enterprise system including Sales Order Processing, Inventory Management, Purchase Order Processing, Production Management, and Accounting. Various other modules are available including Contact Management, Equipment and Facilities Management, Handheld Systems, EDI, Business Intelligence through Dashboards, and Automated Processing through our Task Agent. To find out more about this system, email us or call **1-888-253-5353 Ext 2**.

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