LABOUR COSTS / ACCOUNTING FOR LABOUR.

Introduction

Labour cost is classified as direct and indirect. They form the labour cost which in turn forms a significant percentage of the total cost of production in a manufacturing or service organization and there is need to exercise maximum care to minimize these costs.

Minimizing costs does not mean reducing cost but means getting optimal and efficient productivity from the employees.

Purposes of Labour Cost

- To calculate the correct gross and net wages for each employee.
- For financial accounting purposes.
- For management accounting purposes (i.e. stock valuation)
- Decision making and control purposes

Elements of Labour Cost.

Labour Cost can either be direct, or Indirect they include.

- Basic Wages.
- Overtime premium
- Bonus payment
- Idle time
- Labour turnover.

Remuneration Methods.

Basic wages can be determined using various methods that include:

i. Fixed salary per month.
ii. Time based systems.
iii. Piece works systems.
iv. Bonus / incentive schemes.

Fixed Salary per month
Mainly applies to permanent workers who receive a fixed salary every month.

Time based systems
Wages are determined by the number of hours worked. If an employee works more than their basic hours then an overtime payment might be made.

Formula.

Total Wages = (No. of hours worked × Basic Hourly rate) + (Overtime hours worked × Overtime Premium)

Example:

James is a direct labour employee who works a stand 40 hours per week. He paid basic rate Rs. 15 per hour. Overtime paid at a time and half in a certain week James works for 50 hours and due to his improved efficiency he is entitled to a bonus of Rs. 100
Required.

a) Basic pay for standard hours.
b) Basic pay for overtime hours.
c) Overtime Premium
d) Classify amount paid to James as Direct / Indirect labour cost.

PIECEWORK SYSTEMS.
In this case wages depend on the level of output achieved and is expressed as follows:

Basic earnings = Unit Produced x Rate of Pay per unit

i) Straight Piece Work.
The basic rate per unit remains constant irrespective number of units produced

ii) Straight Piecework with guaranteed minimum wage.
Employees paid on number of units produced bill one is guaranteed of a minimum wage since there are occasions when production doesn’t take place due to unavoidable circumstances e.g. power failure shortage of material machine breakdown etc.

Illustration.
Sam is paid Rs. 10 for each unit produced she is guaranteed a minimum wage of Rs. 1500 for 40 hour week in a series of 4 weeks she produces 130, 150, 170 and 180 units. Production overheads are added at rate of Rs. 5 per direct labour hour.

Required.

a) Calculate Sam’s pay per week.
b) Production overhead cost per week
c) Total Conversion Cost.
d) Unit Conversion Cost.

iii) Differential Piecework.
Employees’ basic rate of pay per unit changes as the level of activity changes. The rate per unit increases on additional units produced. It doesn’t provide security for a guaranteed wage but it can enhance earning by providing higher rates for higher production.

Illustration.
X Ltd operates a differential piecework system and the following weekly rates have been set.

<table>
<thead>
<tr>
<th>Weekly Production</th>
<th>Rate of pay per unit (Rs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 – 1000 Units</td>
<td>2.00</td>
</tr>
<tr>
<td>1001 – 2000 Units</td>
<td>3.00</td>
</tr>
<tr>
<td>2001 – Above Units</td>
<td>5.00</td>
</tr>
</tbody>
</table>

Required.
How much would be paid to following employees for a week.

• Peter 1500 Units
• Mercy 2400 Units
Advantages of time rate over piece rate.
- Quality of output is better since there is no hurry to produce more unit.
- Employees feel secure and they are assured of some pay at the end of the period if time is determining factor.
- Does not lead to hard negotiations when rates are being revised.
- More appropriate when quality of output is more important than quality.

Disadvantages time rate over piecework.
- No incentive for employees paid on a daily rate to improve performance as more efficient are equally compensated as less efficient.
- Quality of output is much lower and supervisory cost are high since employees need close attention.

Bonus / Incentive Schemes

Bonus paid to employees to increase efficiency and productivity. The term “Productivity” is a measure of efficiency with which output have been produced. An increase in production without an increase in productivity will not reduce unit cost.

If productivity is improved, it will enable a company to achieve its production targets in few hours of work and therefore at a lower cost.

Illustration.
Suppose than an employee is expected to produce 4 units every hour he works. If during a 40 hour week the employee makes 175 units in 35 hours.

Required
Compute efficiency or productivity of employee using

a) Unit produced
b) Hours worked.

Characteristics of bonus / incentive schemes

i. Employees are paid more for efficiency.
ii. In spite of the extra labour, the cost per unit of output is reduced and profit earned per unit of sales is increased
iii. The morale of employees increase due to the receipt of extra reward for extra effort.

Conditions of a successful bonus scheme

i. The objective should be clearly stated and attainable by employees.
ii. Rules and conditions of the scheme should be easy to understand and not liable to misinterpretations.
iii. Allowance should be made for external factors outside employees control which reduce productivity such as machine breakdown or raw materials shortage.
iv. Only those employees who made the extra effort should be rewarded.
v. The scheme must be properly communicated to the employee.

Types of Incentive Schemes

i. High day rate system.
ii. Individual bonus scheme.
iii. Group bonus scheme.
iv. Profit sharing schemes.
v. Employ share ownership plan.
vi. Value added incentive schemes.

i. **High Day Rate System.**

A system where employees are paid a high hourly wage in expectation that they will work more efficiently than similar employees on a lower rate in a different company.

**Advantages.**
- a) Simple to calculate and easy to understand.
- b) Guarantees employees a consistently high wage.

**Disadvantages.**
- a) Employees cannot earn more than fixed hourly rate for their extra effort.
- b) Employees may prefer to work at normal rate of output.

ii. **Individual Bonus Scheme.**

A remuneration scheme where individual employees qualify for a bonus on top of basic wage with each person’s being calculated separately.

**Illustration.**

X Ltd operates a premium bonus scheme for employees of 75% of time saved compared with standard time allowance for a job at the normal hourly rate. The data relating to a certain job completed by an employee is as follows.

Allowed time for a job 4 Hours.
Time taken to complete 3 hours.
Normal hourly rate of pay Rs. 8.00

Required: Total pay of employee for job.

iii. **Group Bonus Scheme.**

Many a times when individual effort cannot be measured and sometime the employees need to enhance the collaboration between the employees so that they work towards their organization goals as a team. In such cases group bonus schemes are administered which are incentive plan which is related to the output performance of an entire group of workers a department or even the core factory.

**Advantages**
- a) Easy to administer because they reduce clerical effort required to measure output and calculate individual bonuses.
- b) Employees are motivated to work as a team thereby increasing their cooperation among each other.
- c) Creates healthy working atmosphere reducing accidents spoilage waste e.t.c.

**Disadvantages.**
- a) Increases in fighting among employees especially those jobs with many processes.
- b) Demotivates some of employees especially those who see fellow workers as lazy.
- c) The employee’s group demands allow efficiency standards as a condition of accepting the scheme.

iv. **Profit Sharing Scheme.**

In this scheme employees participate in sharing profit of company. If the profit for a given period surpass a predetermined limit. This scheme makes employees feel part of the company via profit sharing and are motivated to work hard to enjoy fruits of hard work.
Advantages.

a) Employees feel part of company reducing disturbances like strikes and always work hard to surpass profit limit.
b) The company will only pay what it can afford out or actual profit.
c) This type of bonus is also paid to non production personnel

Disadvantages.

a) Profit limit may be too high discouraging employees to work hard i.e. maybe too optimistic and unrealistic.
b) Company can have many employees and may be what each employee get can be too little to impact motivation on them.
c) There may be other factors outside control of employees which hinder effort to surplus profit limit.

v. Employee Share Ownership Plan.

These are share options given to employees who work for a certain period of time. The employees are eligible to purchase the shares at a discounted rate, which they can sell (if they wish) at the market price. This method can reduce labour turnover since most employees remain to become shareholders of the company

Advantages.

a) Employees are motivated to work hard for company since they become stakeholders / shareholders.
b) Through share ownership employees can earn extra income in form of dividends.

Disadvantages.

a) Benefits are not certain as market value of shares at a future date cannot realistically be predicted in advance. Exercise price of options may be higher than market price of shares.
b) Benefits are not immediate as scheme must be existent for a number of years before members can exercise their right.

vi. Value Added Incentive Schemes.

Alternative to profit sharing as a business performance measure and can be used as basis of incentive scheme.

Formula is as follows.

Value Added = Sales – (Cost of Materials + Services).

Recording Labour Cost.

Daily time sheet or weekly time sheet or job cards, depending on the circumstance. Labour cost of piece workers is recorded or a piecework ticket or on an operation card

Idle Time / Unproductive Time.

This unproductive time paid for i.e. workers are paid but no goods have been produced e.g. when there is power failure, machine breakdown, training etc. Idle time has a cost because employees will still be paid basic salary / wage for these unproductive hours therefore should be a record of idle time. Idle time can either be avoidable or unavoidable.

Avoidable idle time.

Due to production disruption due to shortage of raw materials, insufficient job schedules. etc. N.B. Cost of paying for hours of avoidable idle time that simply ought not to have been incurred and should be written off in income statement.
Unavoidable idle time.
Uncontrollable cost of the business e.g. unexpected fall in demand for a product, sickness of employees, strikes by suppliers’ etc. affecting production. N.B. Unavoidable idle time of direct workers may be included in the cost of product as production overhead all other idle time is treated as period cost.

\[
\text{Idle Time Ratio} = \frac{\text{Idle Time}}{\text{Total Attendance Time}} \times 100
\]

LABOUR TURNOVER.
A measure of the proportion of people leaving relative to the average number of people employed over a period of time. This rate should be kept as low as possible. Management might wish to monitor labour turnover so that control measures might be considered if turnover rate is too high since business is losing experience and valuable staff at a fast rate.

Labour turnover is calculated for any given period by using this formula.

\[
\text{Labour Turnover Rate} = \frac{\text{Replacement}}{\text{Average No. of employees in the period}} \times 100
\]

The labour turnover percentage calculated can be compared with past figures, targets and industry averages. It provides an indication of whether an unacceptably high number of people are leaving the organization.

Illustration.
1) At 1st January a company employed 42200 employees at 31st Dec employee number 45600 during the year 2400 chose to leave the company.
Required.
Labour turnover rate for the year.

2) A company ahs 42000 staff at begin during year there was a major restructuring and 15000 staff company to work for another company 3000 new employees joined Co. in the year.
Required.
Calculate labour turnover rate for 2006

Causes of Labour Turnover.
Can be divided into two
- Avoidable
- Unavoidable.

Avoidable.
i) Poor remuneration.
ii) Lack of training opportunities
iii) Lack of promotion prospects.
iv) Poor working conditions.
v) Bullying in work place (Harassment).

Unavoidable.
i) Illness, death.
ii) Retirement
iii) Relocation, redeployment
iv) Family matters.
v) Natural Calamities.

**Cost of Labour Turnover.**

Every time an employee leaves an organization will incur costs that are associated with replacing employee. These costs are known as replacement costs.

- Advertising cost.
- Cost of selection.
- Training new employees.
- Reduced efficiency until new employee reaches required skill.
- Loss of output due to delay of new labour becoming available.
- Wastage before employee comes up to par.

A high labour turnover rate tends to lower performance of employee who remain in the organization such employees may worry of extra burden of training new members and temporary new duties imposed upon them.

In order to keep labour turnover rate to a minimum organization should aim to prevent employees from leaving such preventive measures come with there own cost as preventive cost which include.

- Pay competitive wages and salaries it remuneration is poor.
- Improve poor working condition.
- Offer good training opportunities.
- Promotion prospect within organization.