



Labor Cost Improvement

Understand & Improve Labor Cost

Labor cost is, in nearly all cases, the most expensive part of running a business. In order to understand labor cost a manager should first understand the key cost factors: Indirect & direct labor and value added & non-valued added activities. Understanding these factors will provide company leadership with more insight to better manage operations and overall labor cost.

Indirect Labor Cost

Indirect labor cost represents what is paid by a company that is not directly related to the production of goods or services. Supervisors, inventory analysts, equipment runners, maintenance personnel, and dispatchers are examples that fit into this category but are necessary to

make the production possible or more efficient. Indirect labor costs are not usually identifiable with a specific task or order. In this article, we will focus on direct labor cost because of the broader opportunities to manage and lower overall labor costs.

Direct Labor Cost

Direct labor cost represents what is paid by a company that is directly related to the production of goods and services. To calculate the direct labor cost for a unit of production one must know the amount paid to the employees and the units produced for the same period by those employees. If you are calculating the direct labor cost for a service industry, replace the

number of units with number of customers.

This provides a high-level understanding of labor cost, but does not really give management the information and tools needed to truly drive efficiencies, incentivize supervisors and employees, and manage labor cost to its lowest levels. To achieve this, management must first put focus on direct labor with emphasis on eliminating or reducing non-value added work.



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To gain a thorough understanding, Direct Labor should be broken down into process steps and non-value added work should be identified. Breaking down direct labor and separating the value added and non-value added tasks are best done through data collection and observations. Deploying Industrial Engineering methods by conducting time and motion studies utilizing electronic data collection devices to capture and analyze the data is recommended.

Prior to beginning this activity, the work processes should be defined as best as possible with work steps broken down to small increments. By doing so, the observer can better document the actual work being performed, the time it takes to perform the steps, and identify non-value added activities, such as travel, waiting or delays, excessive motion, over-production, defects and rework, etc. The observer should also look for "best practices" that can be shared with the work group that result in a more efficient and safe work process.

A company that has an industrial engineer (IE) on staff is best equipped to support this activity. Managers and supervisors may also support this, but often get side-tracked with the demand of the daily work at hand. In addition, managers and supervisors may not

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view the work process from a third party, un-biased perspective, and in some cases not see opportunities that would be found with an experienced outside perspective.

In cases where a company does not have an IE on staff or the work processes are too large and time consuming to complete the effort, an IE consulting firm with broad experience across industries such as CapRock is recommended. Gains made in reducing non-value added work tasks and increases in efficiency often result in labor cost savings of 20-25% at a minimum. The pay back on the investment for this type of activity is generally in months, not years



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