What Are Cost Centers?



To be successful, businesses must track costs and income streams to build an accurate business plan and budget.

An important factor influencing budgets is the cost center, something that the business needs to spend money on that doesn't directly generate revenue of its own.

A better understanding of cost centers provides insight into how businesses are organized, along with how to read accrual-based accounting financial statements. Read on to learn more about what cost centers are, why they are important, and how they work.

What Are Cost Centers?

Cost centers refer to roles or departments, also known as business units or service centers, within a company that cost money but do not generate revenue. These include administrative, service, and support services.

These parts of the organization cannot be eliminated to save money because they are an essential part of keeping operations running as smoothly as possible.

Cost centers are listed separately to keep their resource usage easier to monitor.

Cost center managers are responsible for making sure their cost centers run efficiently and within budget.

Cost centers may be roles, such as human resource staff or janitorial services, or they may be entire departments, such as the warranty department, the marketing department, or the IT department.

The number and size of cost centers a company may have will depend on industry and company size.

For instance, small companies may have a cost center for bookkeeping or office management, where there is a single person who manages everything.

But, for a large multinational corporation, there may be separate cost centers for the human resource department, the administrative staff, and the accounting department.

The wages of each employee in those departments will be included in the cost center budget, for the cost center they work.

> *Cost centers can be thought of as responsibility centers that influence the profitability of a business.*

Why Cost Centers are Important

Cost centers are important because they add value to the company. Without them, it would be difficult, if not impossible, for the rest of the company to generate profit.

Improved Customer Experience

Customer service departments help customers resolve complaints or other issues, locate products, and understand company policy and warranties.

Providing excellent customer service increases company value and house to build a loyal customer base.

Research and Development

Research and development departments seek to find innovative solutions to consumer issues and create new products.

Maintenance

Maintenance workers, janitorial staff, and IT departments work to make sure that all of the company's equipment is running efficiently and that facilities remain safe and clean.

These workers ensure you can generate profit and keep your staff healthy.

Data Analysis and Business Strategy

Market and data analysis departments make it easier for you to understand consumer trends and industry changes.

These departments provide information that helps you see how effective your current business strategy is and changes that you need to make moving forward.

Administrative Task Management

Those working in your office, managerial accounting, and human resource departments ensure that your company is submitting reports and forms accurately and managing budgets, and office organization and payroll.

They also complete many other important administrative tasks necessary to keep the business running

How Cost Centers Work

Cost centers have their own categories in the general ledger so that accounting teams can track costs and resource allocation.

Each cost center within your company should have a manager who is held accountable for the department budget and the staff assigned to that cost center.

Cost centers work to:

- Define management responsibilities
- Define cost center processes
- Use monitoring to lower costs
- Assign budgets
- Help your finance and accounting department understand your business

The financial accounting department assigns cost centers based on your business needs and how you spend your money.

They often have a broader perspective of budgeting needs than individual cost center managers and therefore help structure resource allocations for improved efficiency over time.

Ideally, cost centers are created with a set of parameters that includes the scope of work and details about managing accounts, products, and vendors. Be clear about your purchase order process is, what vendors are approved for ordering, and how invoices are handled.

The manager of a cost center needs to be held responsible for managing the budget of their cost center.

This responsibility needs to be listed in their management objectives. It's best to avoid assigning a manager multiple cost centers without good reason.

Cost center managers need to have a clear idea of the cost center's primary goal so they can effectively manage the budget they're given to reach those goals.

Cost centers need to have clear budgets and their managers need to track that spending. This allows the managers and finance and accounting department to understand the resources that each cost center uses, how the resources are allocated within the cost center, and what changes need to be made for the next fiscal year.

By tracking your cost centers for staff and efficiencies, overspending, and other challenges, you can lower your overall cost.

The data you collect from your cost center structures can help guide reorganizations and inform future budget allocations.

Communicating your cost management techniques and goals with your managers

helps greatly.

Examples of a Cost Center

The best example of a cost center is the human resources department. The human resources department doesn't generate revenue because it is an administrative department.

However, it is crucial in ensuring an organization runs smoothly because they are responsible for entering and storing employee information, managing employee complaints, processing new hires, handling employee outreach, promoting employees, and terminating employees.

The human resources department may also play a role in recruiting, training, and payroll.

When organizing your human resources cost center consider the:

- Duties the department will be responsible for
- Number of employees you will need to manage the assigned duties
- Pay rate and benefits cost for each position in the department
- Cost of office equipment and software
- Different vendors the department will have access to
- Projected Department maintenance cost
- Overall projected budget for the department

The human resources manager needs to be experienced in the department so that they can efficiently guide and help the staff as needed. Ideally, they should be able to balance employee needs also managing costs.

Other examples of cost centers include:

- **Customer service department:** Staff in this department address customer complaints, manage warranties and rebates, and work to improve the overall customer experience.
- **IT department:** This department ensures that software, hardware, and networks are working correctly, securely, and are updated appropriately.
- **Janitorial:** Works to keep the building safe and clean so that staff and visitors can be productive

- **Project managers:** These people plan, budget, schedule, and monitor projects to ensure they're completed correctly and as efficiently as possible.

None of these departments generate profit, but they are crucial to business function and play a role in cash flow and investment decisions.

Cost Centers vs. Profit Centers

Where the cost center costs a business money but doesn't generate direct profit, the profit center focuses on generating revenue for a company.

Profit centers are subunits within a business that are responsible for profits, with a focus on maximizing revenue and profit.

Profit centers are more complex because they focus on revenue, profit, and costs. Each profit center is backed by cost centers to ensure the business continues to operate.

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