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DEPARTMENT OF COMMERCE

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SEM-VI

Subject
Cost and Works Accounting-III

Chapter 1
Standard Costing

Chapter 1st

Standard Costing

INTRODUCTION

Standard is the desired level of performance for evaluating whether the actual performance is upto the expected level. All management officials are interested not only in understanding what costs are but also how satisfactory and productive they are. The standards provide incentive and motivation to work with greater effort and vigilance for achieving the standard, which increases ultimate efficiency and productivity too.

Standard Costs are the pre-determined cost calculated in advance of production on the basis of a specification of all the factors affecting costs.

Standard Costing is a useful technique of exercising control in the areas of cost of production by comparing actual cost with the standard cost ascertainment variances, finding out the causes of variances and taking corrective action under the techniques of standard costing, the effective use of standard cost, increases cost consciousness among management and employees and business profits by providing a suitable base for performance evaluation. Thus, Standard Costing helps managerial planning and control in a significant manner.

STANDARD COST

The word 'Standard' means a criterion. Thus, a Standard Cost is one which is pre-determined and used as a criterion for measuring the efficiency with which actual cost has been incurred. Standard costs represent 'planned' cost of a product. They expected to be achieved in a particular production process under normal conditions.

A Standard Cost is a planned cost for a unit of product or service rendered. Standard costs are highly detailed scientifically predetermined costs of material, labour and overhead chargeable to a product or service. Standard costs represent excellent target costs that should be obtained. Standard Cost expresses what costs should be under attainable good performance.

Definitions

Following definitions crystallize the concept 'Standard Cost'.

i) The Institute of Cost and Management Accountants (U.K.) defines Standard Cost as, "a predetermined cost which is calculated from management's standards of efficient operation and the relevant necessary expenditure. It may be used as a basis for price fixing and for cost control through variance analysis".

STANDARD COSTING

Definitions

Following definitions crystallise the technique of 'Standard Costing'.

i) According to CIMA, London, Standard Costing is : "the preparation and use of standard costs, their comparison with actual cost and the analysis of variance to their causes and points of incidence".

ii) Brown and Harward defines Standard Costing as : "a technique of cost accounting which

compares the standard cost of each product or service with the actual costs to determine the efficiency of the operation so that any remedial action may be taken immediately".

Meaning

Standard Costing involves the setting of pre-determined cost estimates in order to provide a basis for comparison with actual costs. A Standard Cost is a planned cost for a unit of product or service rendered. Standard Costing is universally accepted as an effective instrument for cost control in industries.

OBJECTIVES OF STANDARD COSTING

The basic objectives of Standard Costing technique can be outlined as follows:

- i) To provide a formal basis for assessing performance and efficiency.
- ii) To control costs by establishing standards and analysis of variances.
- iii) To enable the principle of "Management by Exception" to be practised at the detailed operational level.
- iv) To assist in setting budgets.
- v) To assist in assigning responsibility for non-standard performance in order to correct deficiencies or to capitalise on benefits.
- vi) To provide a basis for estimating.
- vii) To provide guidance on possible ways of improving performance.

TECHNIQUES OF STANDARD COSTING

- i) Pre-determination of technical data related to manufacturing operations, processes, products and their efficiencies, wastage, losses, machine utilisation etc.
- ii) Pre-determination of standard costs in full detail under each element of cost, i.e., Material, Labour, overheads.
- iii) Pre-determination of standard profit margins.
- iv) Pre-determination of standard selling prices.
- v) Comparison of actual performance and costs with standards.
- vi) Analysis of variances-cost, sales and profit along with reasons for deviations of actuals from the standards.
- vii) Presentation of variances to management for taking appropriate action and remedial measures.
- viii) Revision of standards where necessary.

FEATURES OF STANDARD COSTING

- 1) Standard Costing is one of the cost control techniques and not a method of costing like job costing, or process costing.
- 2) Standard means a criterion or a yardstick against which actual activity can be compared to determine the difference between the two.
- 3) Standard cost is the cost that should have been under a given set of operating conditions.
- 4) It is a pre-determined cost computed before the cost is incurred (i.e. in advance of

production).

5) It is based on engineering specifications of all the factors affecting cost.

6) It is computed for a specific period of time.

ADVANTAGES OF STANDARD COSTING

i) Effective Cost Control:

The most important advantage of standard costing is that it facilitates the control of cost. Control is exercised by comparing actual performance with standards and taking action on the basis of variances so revealed.

ii) Help in Planning:

Establishing standards is a very useful exercise in business planning which instills in the management a habit of thinking in advance.

iii) Provides Incentives :

The standards provide incentives and motivate to work with greater effort. Schemes may be formulated to reward those who achieve or surpass the standard. This increases efficiency and productivity.

iv) Fixing Prices and Formulating Policies :

Standard costs are a valuable aid to management in determining prices and formulating production policies. For example, prices may be fixed by adding a standard margin of profit in standard cost. Similarly, standard costing furnishes cost estimates while planning production of new products.

v) Creates Cost Consciousness :

Standard costing creates cost consciousness among executives which increases efficiency and productivity.

vi) Facilitates Co-ordination:

While establishing standards, the performance of different departments such as production, sales, purchases. etc. is taken into account. Thus, standard costing facilitate co-ordination between different functions of different departments. vii) Eliminates Wastes: By fixing standards, certain wastes, such as materials wastage, idle time, lost machine hours, etc. are reduced.

LIMITATIONS OF STANDARD COSTING

The following are the Limitations attached to Standard Costing System.

i) Fixation of standard is not possible for every type of work or operation.

ii) Wrong standards may result in wastage i) iii) of time, money and energy.

iii) A business may not be able to keep standards up-to-date. In other words, a business may not revise standards to keep pace with the frequent changes in manufacturing conditions. Firms may avoid revising standards as it is a costly affair.

iv) Inaccurate and unreliable standards cause misleading results and thus may not enjoy the confidence of the users of the system.

v) Standard Costing is expensive and unsuitable in job order industries manufacturing non-standardised products.

- vi) It is difficult to distinguish between controllable and uncontrollable variances.
- vii) Some variances cannot be explained properly, e.g., material usage (other causes) variance.
- viii) It may require a high degree of technical skill as standards are based on technical assessments.
- ix) Management may not show much interest in standard costing, the implementation of which is very costly.
- x) Standard Costing facilitates only cost control and cost reduction.

SETTING UP OF STANDARDS

Establishment of Cost Standards

Setting up standards and the comparison of actuals with the standards are the essentials of standard costing. The effectiveness of standard cost as a technique wholly depends upon the establishment of accurate cost standards. Care should be taken in setting the standards considering all relevant factors such as the employees, their attitudes and abilities, the extent of control exercised over their operations and so on. There are several methods adopted for fixing the standards such as engineering estimates, observed behaviour, predicted behaviour and desired behaviour. The standard cost in a particular situation is based on two or more of these bases. When cost standards are determined on the basis of engineering estimates, it is but proper to consider the specifications of the machinery for accurately ascertaining the standard relationship between a given unit of output and a given unit of input. On the basis of such technical specifications cost standards can be fixed. The cost standards so fixed, represent only what can be accomplished.

Steps involved in Standard Costing

Standard Costing system involves the following important steps:

- i) Determination of standard cost for each element of cost - direct material, direct labour, and overhead;
- ii) Recording of both standard and actual costs in appropriate books of accounts;
- iii) Computation of variance between standard cost and actual cost;
- iv) Analysis and investigation of the variances; and
- v) Feed correction and suggest modification where required. Corrective actions are taken to ensure that future performance will be in accordance with pre-determined standards.

TYPES OF STANDARDS

a) Ideal Standards:

Ideal Standards are set at the level of maximum efficiency, representing conditions that can seldom if-ever be attainable. Such a standard fails to pay any attention to normal materials, spoilage and idle labour time. This type of standard can be used as standard of perfection rather than a standard for the measurement of practical results because conditions that satisfy ideal standards are extremely rare. Ideal standards are more effective for direct material costs and usage. The application of ideal standard makes variance accounts less significant for control purposes.

b) Normal Standards

Normal Standards are the standards that can be achieved by efficient working and efficient management. Such standards are set after taking into consideration the conditions that are expected to prevail over a long period of time sufficient to reflect the effects of seasonal and cyclical fluctuations. These standards are of great significance for manufacturing overhead expenses.

c) Basic Standards:

Basic Standards provide a measuring scale for performance over a long period of time. Such standards are not influenced by any change in material prices and labour rates and therefore, remain unchanged for a number of years. Basic standards are useful for such items of expenditure that are fixed in nature.

d) Attainable Standards:

Attainable Standards based on past performance can be achieved with reasonable effort. Perhaps the standards should be somewhat lower than what can be achieved by earnest effort. Such standards are set as closely as possible to that level which represents anticipated conditions. These standards are more realistic and satisfactory and thus represent desirable performance. Attainable standards are particularly useful in setting price standards for materials and labour.

e) Current Standards:

A current Standard is a standard which is established for a limited period and is related to current conditions.

VARIANCE

Meaning:

The difference between pre-determined standard costs and the actual costs is known as a Variance. Variances indicate the difference between planned performance and actual budgeted performance. Planned performances usually are indicated in the form of standards or costs whereas actual performances, are indicated in the form of actual costs. Hence, Variance is the extent of deviation of the actual cost from the standard cost.

Definitions :

i) The Terminology of CIMA, defines variance as, "the difference between the planned, budgeted or standard costs and actual costs".

ii) The Institute of Cost and Management Accountants, U.K. defines Variance as, "the difference between standard cost and the comparable actual cost incurred during a period".

VARIANCE ANALYSIS

Meaning:

The difference between actual cost and standard cost is termed as 'Variance' which is composed of variances arising from a number of causes. The systematic process of computation of individual variances, determination of the causes of each variance and reporting of the same to the responsible manager, it is known as 'Variance Analysis'. Variance analysis and reporting to management is based on the principles by exception. Thus, variance analysis is a cost accounting process that helps to calculate the influence

upon the cost of each cause of deviation.

Definitions:

- i) The Terminology of CIMA, defines Variance Analysis as, "the analysis of variances arising in a standard costing system into their constituent parts".
- ii) The Institute of Cost and Management Accountants, U.K. defines 'Variance Analysis as, "the process of computing the amount of, and isolating the cause of variances between actual costs and standard costs".

VARIANCE ACCOUNTING

Meaning:

The systematic and accurate accounting of variance is of obsolete importance. Standard costing is the control technique more useful to investigate the reasons for important variances so as to identify the basic problems and take necessary corrective action. Thus, standard costing makes appropriate use of Variance Accounting as a modern technique for controlling the ultimate costs.

Definition:

- i) The Terminology of CIMA, defines Variance Accounting as, "a technique whereby the planned activities of an undertaking are quantified in budgets, standard cost, standard selling prices and standard profit margins and the difference between these and the actual costs are compared."

Steps

Steps to be followed which are as follows:

- i) Preparation of well designed plans,
- ii) Fixation of achievable standards,
- iii) Computation of actual performance,
- iv) Continuous comparison of standard set and actuals achieved,
- v) Scientific analysis of variances into their constituent's parts,
- vi) Finding out the causes of variances and fixation of responsibility and
- vii) Taking corrective actions.

DIFFERENCES:-

STANDARD COST	ESTIMATED COST
1. Standard cost emphasizes as what the cost ' <i>should be</i> ' in a given set of situations.	1. Estimated cost emphasizes on what the cost ' <i>will be</i> '.
2. Standard costs are planned costs which are determined by technical experts after considering levels of efficiency and production	2. Estimated costs are determined by taking into consideration the historical data as the basis and adjusting it to future trends.

3. It is used as a devise for measuring efficiency	3. It cannot be used as a devise to determine efficiency. It only determines expected costs.
4. Standard costs serve the purpose of cost control	4. Estimated costs do not serve the purpose of cost control.
5. Standard costing is part of cost accounting process	5.Estimated costs are statistical in nature and may not become a part of accounting.
6. It is a technique developed and recognised by management and academecians	6.It is just an estimate and not a technique
7. It can be used where standard costing is in operation	7.It may be used in any concern operating on a historical cost system.

HISTORICAL COST	STANDARD COST
1. It is an after-production-recorded cost.	1. It is a predetermined cost.
2. It is, actually, incurred cost.	2. It is an ideal cost.
3. As it relates to the past, it is not useful for cost control.	3. It is a future cost. It can be used for cost control.
4. It is used to ascertain the profit or the loss incurred during a period.	4. It is used for the measurement of the operational efficiency of the enterprises.

BASIS FOR COMPARISON	STANDARD COSTING	BUDGETARY CONTROL
Meaning	The costing method in which evaluation of performance and activity is done by making a comparison between actual and standard costs, is Standard Costing.	Budgetary Control is the system in which budgets are prepared and continuous comparisons are made between the actual and budgeted figures to achieve the desired result.
Basis	Determined on the basis of data related to production.	Budgets are prepared on the basis of management's plans.
Range	It is limited to cost details.	It includes cost and financial data.
Concept	Unit Concept	Total Concept

BASIS FOR COMPARISON	STANDARD COSTING	BUDGETARY CONTROL
Scope	Narrow	Wide
Reporting of Variances	Yes	No
Effect of temporary changes in conditions	The short term changes will not influence the standard costs.	The short term changes will be shown in the budgeted costs.
Comparison	Actual costs and standard cost of actual output	Actual figures and budgeted figures
Applicability	Manufacturing concerns	All business concerns

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