Unit-9: Standard Costing

The management must continually search for ways to obtain maximum operating effectiveness from the available resources. One of the most important functions of management accounting is facilitating managerial control. A manufacturing firm is usually concerned with producing its product at the lowest possible costs consistent with the quality it wishes to maintain. Actual costs become a factor in the determination of the net income for the period. Such actual cost information can also be useful in establishing a basis for product costing and pricing, as it reflects a desirable level of performance. Management, in assigning responsibility for the actual results of operations, wants to know that those results were measured accurately. For that reason a measure of acceptable performance i.e., a standard must be applied to actual results. So the standard cost is an effective management tool for planning, decision-making, coordination and control.

This unit contains the theoretical understanding of standard costing, determining the various types of variances, etc.

Lesson 1: The Understanding of Standard Costing

Learning objectives

After completing this lesson, you should be able to:

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Introduction :

The term standard means a benchmark or yardstick. It is the level of performance, which is desired to be attained with reasonable efficiency. The setting of standards costs to produce a unit of product is a difficult task. Precise measurement requires standards. It requires input from all persons who have responsibility for costs and quantities. Standard is the predetermined measurable quantity, by means of detailed analyses of manufacturing operations, reveals a very good idea what selling price per unit will be, the standard selling price; also reveals what material cost per unit will be, the standard material cost, etc. A standard cost is expressed in monetary unit. It is built up from an assessment of the value of cost elements. Its main objectives are providing bases for performance measurement, controlled by exceptional reporting, valuing closing stock and establishing selling prices. A standard is understood to be a rule of measurement established by authority. It is usually developed by a group composed of representatives from cost accounting, industrial engineering, personnel, data processing, purchasing and management. Moreover, developing a standard cost involves judgment and practicality in identifying the material and labor types, quantities, and prices as well as understanding the kinds and behaviors of organizational overhead.

Definition of Standard Costs:

In managerial accounting, standard costs are predetermined unit costs, which are used as measures of performance. The literal meaning of the word "standard" is predetermined goal or target. Standard cost is a scientifically pre-determined cost, which is arrived at assuming a particular level of efficiency in utilization of material, labor, and overheads.

In the opinion of Eric L. Kohler:

"standard is a desired attainable objective,a performance, a goal, a model."

Horngreen, Sundem and Stratton :

"A standard cost is a carefully developed cost per unit that should be attained."

Brown and Howard :

"The standard cost is a predetermined cost which determines what each product or service should cost under given circumstances".

Official Terminology of CIMA,London (Chartered Institute of Management Accountants, previously known as the Institute of Cost and Management Accountants) defines standard cost is:

"A pre-determined cost, which is calculated from management standards of efficient operations and, the relevant necessary expenditure. It may be used as a basis for price-fixing and for cost control through variance analysis."

Thus, standard cost is like a model. Which provides basis for comparison for actual cost. This comparison of actual cost with standard cost reveals very useful information for cost control.

Concept of Standard Costing :

In simple words, Standard costing is the use of standard costs in product costing, especially in the cost accounting cycle from materials inventory through work-in-process inventory to finished goods inventory and, finally, to cost of goods sold.

In the words of W.W.Biggs:

"A comparison is made of the actual cost with a pre-arranged standard and the cost of any deviations (called variances) is analyzed by causes. This method permits management to investigate the reasons for these variances and to take suitable corrective action. It is, therefore, a system of cost control ass well as cost ascertainment."

Brown and Howard :

"A technique of cost accounting which comprises the standard cost of each product or service with the actual cost, to determine the efficiency of the operations so that any remedial action may be taken immediately".

According to the Terminology of CIMA, London:

"Standard costing is the preparation and use of standard costs, their comparison with actual costs and analysis of variances as to their originating causes and points of incidence."

So from the definitions of standard costing it is clear that the following four steps are involved in this system:

(a) Setting of standards costs for different elements of cost.

(b) Measurement of actual costs and comparison of the same with the standard.

(c) Analysis of variances between actual costs and standard cost for the purpose of evaluation of performance.

(d) Ascertaining the reasons of variances and reporting to management for taking action to maximize the efficiency.

Distinction Between Estimated Cost and Standard Cost:

Both standard cost and estimated cost are predetermined costs. The term "standard costs" should not be confused with "estimated Costs". Following are the points of differences between estimated cost and standard cost.

Point of Difference	Estimated Cost	Standard Cost

(i) Purpose	The purpose of estimated cost is to ascertain in advance what will be the probable cost.	Standard cost is determined to ascertain what should be the ideal cost in a given situation and on the premises of certain assumed preconditions.
(ii) Method of determination.	Estimated cost is determined on the Basis of statistical data and leads to a lot of guess work.	Standard cost is always fixed up scientifically and it is a regular system of account based upon stimation and time studies.
(iii) Basic aim	The object of estimated cost is to ascertain "what the costs will be."	Its object is to ascertain "what the cost should be."
(iv) Importance	Its gives importance to cost ascertainment for fixing sale price.	It is used for effective cost control and to take proper action to maximize efficiency.
(v) Main Thrust	It is mainly used to restrict cost as per previous level of actual cost performance.	Standards costs are primarily used for helping the management To reduce the cost.
(vi) Flexibility	Necessary changes can easily be made to the estimated cost to tune it up with the changed situation.	It is very difficult to change because it is assumed on the premises of a specific set of conditions.

Types of Standards:

Standards may be broadly classified into five types. They are:

(i) Perfection (or ideal) standard: Ideal standard is set up under ideal condition. It is one that can be attained only under nearly perfect operating conditions. This standard is fixed and needs a high degree of efficiency, best possible conditions of management and performance. As such it provides no scrap, no idle time, no rest period and no machine break down. This is also known as theoretical standards. The setting of such standards may motivate employees to increase their output to a maximum, but if the standards are still not attained their morale may be seriously affected. As it is difficult to attain, it has little practical value.

(ii). Current Standards: It is a standard that is set for use over a short period of time and is related to current conditions. These standards outline what cost should be under current conditions and call for periodic review and frequent revisions.

(iii) Normal Standards: These standards are based on past averages adjusted to anticipated future changes. It is established for a long period generally covering a trade cycle period. In formation of these standards, allowances are given to normal waste and scrap, normal fatigue and breaks, normal machine breakdown and maintenance and normal mistakes in production. Use of normal standard is not very much effective for cost control and difficult to apply in practice.

(iv). Basic Standards: Basic standards also called long-range standards provide a measuring scale for performance over a long period of time. The main benefit of basic standard is that it makes it possible to compare actual costs with standard over a long period of time and therefore, efficiency can be ensured over the period. These standards can be used in industries ,where routines and operations are well established and working conditions do not normally change for a long time.

(v). Practical(or attainable) Standard:) Standard: Standards that are as tight as practical, but still are expected to be attained, are called practical or attainable standards. In formation of these standards reasonable allowance is made for normal spoilage, machine breakdown, loss of time etc., so an employee with reasonable efficiency can attain the target. It is more realistic than ideal standard. These standards are most accurate and very useful to management in product costing, inventory valuation, estimates, analyses, performance evaluation, planning, employee motivation, cost control, and for managerial decision-making and external financial reporting.

Advantages of Standard Costing:

The Standard costing technique, if properly implemented, would offer the following benefits:

(i). Carefully determined standard costs and effort to restrain actual costs within the standard limit are helpful for effective control of costs.

(ii). Prices can be determined in anticipation of the actual production as standard costs for various inputs are already available.

(iii). Standard costs enable the managerial accountant to compute the standard allowed cost, given actual output, which serves as a sensible benchmark to compare with the actual cost.

(iv). Determination of standard costs is based on Engineering studies.This gives the scope to determine the best method of production and use of best material. This will bring in economy in production.

(v). Computation of standard costs and the cost variances enables managers to employ management by exception. This approach conserves valuable management time.

(vi). The principle of management by exception facilitates performance evaluation and rewards for employees.

(vii). Since the variances are used in performance evaluation, it motivates employees to strive for accomplishment of definite targets.

(viii). Standard costing Facilitates timely cost reports to management and a forward looking attitude is encouraged at all levels of management.

(ix). The use of standard costing is helpful for budgetary control. The standard costs fixed for each product can be used to convert the sales estimates into projection of materials, labor and overhead.

(x). If standard costing is used, stock ledgers can be kept in terms of quantities only. This eliminates much clerical effort in pricing, balancing and posting on stores ledger cards.

Limitations of Standard Costing:

Standard costing is a powerful tool of planning, controlling and decision-making. But it should be used giving regard to the following limitations.

(i). Setting of standards is a very difficult task. It requires a lot of scientific studies such as time study, motion study, etc., and therefore it is very costly. Small manufacturing concern may find it difficult to operate such a system.

(ii). Variance analysis is useful, whereas deviations are linked with responsibilities. Sometimes, it is difficult to fix responsibility, because the result happens to be the outcome of a number of contributory factors.

(iii). The conditions based on which standard cost for an element has been set may undergo change thus making the standards useless. This involves further5 revising of standards, which is very much problematic.

(v). Indifference of top management and lack of interest by appropriate level of management to standard costing very often acts as a hindrance to its introduction.

Standard costing involves reflecting standards costs and variances in a company's product costing system. Each company, based on its history, current needs, size, and cost-benefit trade-offs should establish its own specific standard costing system It is generally recommended that standards be revised when operating conditions are sufficiently altered to render the old ones inadequate.