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NAAC ACCREDITED 'A' GRADE



Topic: Standard Costing Overview

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Standard Costing Overview

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It is a method of costing by which standard costs are employed. According to ICMA, London, Standard Costing is "the preparation and use of standard costs, their comparison with actual cost and the analysis of variances to their causes and points of incidence".

According to Wheldon, it is a method of ascertaining the costs whereby statistics are prepared to show:

- (i) The standard cost;
- (ii) The actual cost;
- (iii) The difference between these costs which is termed the variance.

But W. Bigg expresses:

Standard Costing discloses the cost of deviations from standards and clarifies these as to their causes, so that management is immediately informed of the sphere of operations in which remedial action is necessary."

Thus, from the above, it becomes clear that Standard Costing involves:

- (i) Ascertainment and use of Standard Costs;
- (ii) Recording the actual costs;
- (iii) Comparison of actual costs with standard costs in order to find out the variance;
- (iv) Analysis of variance; and
- (v) After analysing the variance, appropriate action may be taken where necessary.

Objectives of Standard Costing:

- (a) It helps to implement budgetary control system in operation;
- (b) It helps to ascertain performance evaluation.
- (c) It supplies the ways to utilise properly material, labour and also overhead which will be economic in character.
- (d) It also helps to motivate the employees of a firm to improve their performance by setting up a 'standard'.

- e) It also helps the management to supply necessary data relating to cost element to submit quotations or to fix up the selling price of a firm.
- (f) It also helps the management to make proper valuations of inventory (viz., Work-in- progress, and finished products).
- (g) It acts as a control device to the management.
- (h) It also helps the management to take various corrective decisions viz., fixation of price, make-or-buy decisions etc. which will be more beneficial to the firm.

Advantages of Standard Costing:

- (i) Standard Costing serves as a guide to the management in several management functions while formulating prices and production policies etc.
- (ii) More effective cost control is possible under standard costing if the same is reviewed and analysed at regular intervals for improvements and immediate action can be taken if deviations from standards are found out which, ultimately, leads to cost reduction.
- (iii) Analysis of variance and its measurement helps to detect inefficiencies and mistakes which enable the management to investigate the reasons.
- (iv) Since standard costs are predetermined costs they are very useful for planning and budgeting. It also helps to estimate the effect of changes in Cost-Price-Volume relationship which also helps the management for decision-making in future.
- (v) As standard is fixed for each product, its components, materials, process operation etc. it improves the overall production efficiency which also ultimately reduces cost and thereby increases profit.
- (vi) Once the Standard Costing System is implemented it will lead to saving cost since most of the costing work can be eliminated.

(vii) Delegation of authority and responsibility becomes effective by setting up standards for each cost centre as the supervisors or executives of each cost centre will know the standard which they have to maintain.

(viii) This system also helps to prepare Profit and Loss Account promptly for short period in order to know the trend of the business which helps the management to take decisions promptly.

(ix) Standard costing also is used for inventory valuation purposes. Stock can be valued at standard cost which can reduce the fluctuation of profit for different methods of valuation for the same.

(x) Efficiency of labour is promoted.

(xi) This system creates cost-consciousness among all employees, executives and top management which increase efficiency and productivity as well.

(xii) Budgeting. A budget is always composed of standard costs, since it would be impossible to include in it the exact actual cost of an item on the day the budget is finalized. Also, since a key application of the budget is to compare it to actual results in subsequent periods, the standards used within it continue to appear in financial reports through the budget period.

(xiii) Inventory costing. It is extremely easy to print a report showing the period-end inventory balances (if you are using a perpetual inventory system), multiply it by the standard cost of each item, and instantly generate an ending inventory valuation. The result does not exactly match the actual cost of inventory, but it is close. However, it may be necessary to update standard costs frequently, if actual costs are continually changing. It is easiest to update costs for the highest-dollar components of inventory on a frequent basis, and leave lower-value items for occasional cost reviews.

(xiv) Overhead application. If it takes too long to aggregate actual costs into cost pools for allocation to inventory, then you may use a standard overhead application rate instead, and adjust this rate every few months to keep it close to actual costs.

(xv) Price formulation. If a company deals with custom products, then it uses standard costs to compile the projected cost of a customer's requirements, after which it adds a margin. This may be quite a complex system, where the sales department uses a database of component costs that change depending upon the unit quantity that the customer wants to order. This system may also account for changes in the company's production costs at different volume levels, since this may call for the use of longer production runs that are less expensive.

Disadvantages of Standard Costing:

(i) Since Standard Costing involves high degree of technical skill, it is, therefore, costly. As such, small organisations cannot, introduce the system due to their limited financial resources. But, once introduced, the benefits achieved will be far in excess to its initial high costs.

(ii) The executives are liable for those variances that are found from actions which are actually controllable by them. Thus, in order to fix up the responsibilities, it becomes necessary to segregate variances into non-controllable and controllable portions although that is not an easy task.

(iii) Standards are always changing since conditions of the business are equally changing. So, standards are to be revised in order to make them comparable with actual results. But revision of standards creates many problems, particularly in inventory adjustment.

(iv) Standards are either too liberal or rigid since the same are based on average past results, attainable good performance or theoretical maximum efficiency. So, if the standards are very high, it will adversely affect the morale and motivation of the employees.

(v) Cost-plus contracts. If you have a contract with a customer under which the customer pays you for your costs incurred, plus a profit (known as a cost-plus contract), then you must use actual costs, as per the terms of the contract. Standard costing is not allowed.

(vi) Drives inappropriate activities. A number of the variances reported under a standard costing system will drive management to take incorrect actions to create favorable variances. For example, they may buy raw materials in larger quantities in order to improve the purchase price variance, even though this increases the investment in inventory. Similarly, management may schedule longer production runs in order to improve the labor efficiency variance, even though it is better to produce in smaller quantities and accept less labor efficiency in exchange.

(vii) Fast-paced environment. A standard costing system assumes that costs do not change much in the near term, so that you can rely on standards for a number of months or even a year, before updating the costs. However, in an environment where product lives are short or continuous improvement is driving down costs, a standard cost may become out-of-date within a month or two.

(viii) Slow feedback. A complex system of variance calculations is an integral part of a standard costing system, which the accounting staff completes at the end of each reporting period. If the production department is focused on immediate feedback of problems for instant correction, the reporting of these variances is much too late to be useful.

(ix) Unit-level information. The variance calculations that typically accompany a standard costing report are accumulated in aggregate for a company's entire production department, and so are unable to provide information about discrepancies at a lower level, such as the individual work cell, batch, or unit.

Standard Cost Variances

[Source: <https://www.accountingtools.com/articles/2017/5/14/>]

A variance is the difference between the actual cost incurred and the standard cost against which it is measured. A variance can also be used to measure the difference between actual and expected sales.

Thus, variance analysis can be used to review the performance of both revenue and expenses.

There are two basic types of variances from a standard that can arise, which are the rate variance and the volume variance. Here is more information about both types of variances:

- **Rate variance.** A rate variance (which is also known as a price variance) is the difference between the actual price paid for something and the expected price, multiplied by the actual quantity purchased. The "rate" variance designation is most commonly applied to the labor rate variance, which involves the actual cost of direct labor in comparison to the standard cost of direct labor. The rate variance uses a different designation when applied to the purchase of materials, and may be called the purchase price variance or the material price variance.
- **Volume variance.** A volume variance is the difference between the actual quantity sold or consumed and the budgeted amount, multiplied by the standard price or cost per unit. If the variance relates to the sale of goods, it is called the sales volume variance. If it relates to the use of direct materials, it is called the material yield variance. If the variance relates to the use of direct labor, it is called the labor efficiency variance. Finally, if the variance relates to the application of overhead, it is called the overhead efficiency variance.

Thus, variances are based on either changes in cost from the expected amount, or changes in the quantity from the expected amount. The most common variances that a cost accountant elects to report on are subdivided within the rate and volume variance categories for direct materials, direct labor, and overhead. It is also possible to report these variances for revenue.

It is not always considered practical or even necessary to calculate and report on variances, unless the resulting information can be used by management to improve the operations or lower the costs of a business. When a variance is considered to have a practical application, the cost accountant should research the reason for the variance in detail and present the results to the responsible manager, perhaps also with a suggested course of action.

Standard Cost Creation

At the most basic level, you can create a standard cost simply by calculating the average of the most recent actual cost for the past few months. In many smaller companies, this is the extent of the analysis used. However, there are some additional factors to consider, which can significantly alter the standard cost that is used. They are:

- Equipment age. If a machine is nearing the end of its productive life, it may produce a higher proportion of scrap than was previously the case.
- Equipment setup speeds. If it takes a long time to setup equipment for a production run, the cost of the setup, as spread over the units in the production run, is expensive. If a setup reduction plan is contemplated, this can yield significantly lower overhead costs.
- Labour efficiency changes. If there are production process changes, such as the installation of new, automated equipment, then this impacts the amount of labor required to manufacture a product.
- Labour rate changes. If you know that employees are about to receive pay raises, either through a scheduled raise or as mandated by a labor union contract, then incorporate it into the new standard. This may mean setting an effective date for the new standard that matches the date when the cost increase is supposed to go into effect.
- Learning curve. As the production staff creates an increasing volume of a product, it becomes more efficient at doing so. Thus, the standard labor cost should decrease (though at a declining rate) as production volumes increase.
- Purchasing terms. The purchasing department may be able to significantly alter the price of a purchased component by switching suppliers, altering contract terms, or by buying in different quantities.