

Chapter 7

Standard Costing

Standard Costing is a method of costing used to compare the standard costs and revenues with the actual results, in order to determine the variances along with its causes, to inform the management about the variances or deviation and take corrective measures, for its improvement.

According Wheldon, standard costing is the method of ascertaining the costs whereby statistics are prepared to show standard cost, actual cost, and the difference between these costs which is termed as variance.

Brown and Howard described that standard costing is a technique of accounting which compares the standard cost of product and services with actual cost to determine the efficiency of operations so that remedial actions can be taken immediately.

The term '**standard cost**' can be defined as the expected cost per unit of the products produced during a period, which is based on various factors. It aims at measuring the performance, controlling the deviations, inventory valuation and deciding the selling price of the product. The three main elements of standard cost are Direct Material Cost, Direct Labour Cost and Overheads.

Features of Standard Costing

- Standard costing is a technique of cost accounting.
- The cost or service or product is predetermined.
- The predetermined cost is known as standard cost.
- Actual cost of product and service is ascertained.
- The comparison is made between standard cost and actual cost and variances are noted.
- Variances are analysed to find out the reason.
- Variances are reported to management to take corrective action.

Objectives of Standard Costing:

The objectives of standard costing technique are as follows:

- (a) To provide basis for assessing performance and efficiency.
- (b) To control costs by establishing standards and analysis of variances.
- (c) To enable the principle of 'management by exception' to be practised
- (d) To assist in setting budgets.
- (e) To assist in assigning responsibility in order to correct deficiencies or to capitalise on benefits.
- (f) To provide guidance on possible ways of improving performance.

Need of Standard Costing

Standard Costs are determined after considering all the future possibilities and uncertainties. It also helps in deciding whether a particular project is to be undertaken, by determining its profitability. Standard cost acts as targets or benchmarks to the cost centres. These targets are helpful in checking the performance through comparison with the actual results. The standard costs are used to prepare budgets and evaluate the performance of the individuals or group on the basis of these budgets. The basic objective of standard costing is to measure the differences between standard costs and actual costs, and analysing them to maintain the productivity of the organization

Types of Standards:

Current Standard: Current standard is a standard established for use over a short period of time, related to current conditions. The problem with this type of standard is that it does not try to improve on current levels of efficiency.

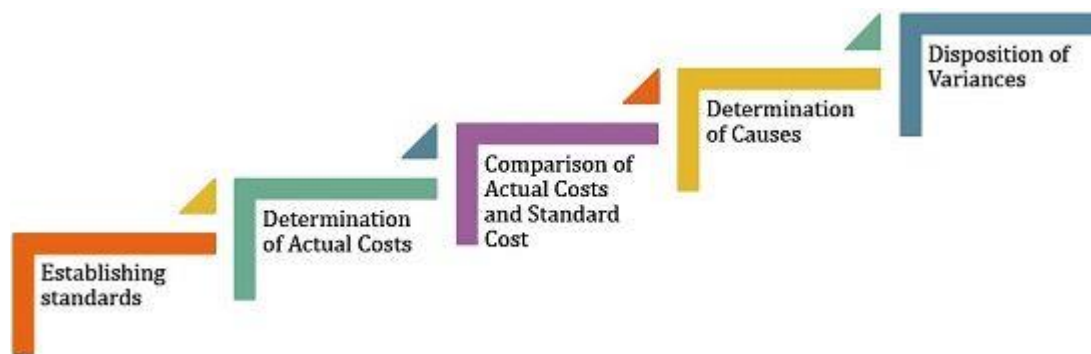
Basic Standard: Basic standard is standard established for use over a long period from which a current standard can be developed and remains unaltered over a long period of time.

Ideal Standard: Ideal standard is a standard which can be attained under the most favourable conditions. No provision is made, e.g., for shrinkage, spoilage, or machine breakdowns.

Attainable Standard: Attainable standard is a standard which can be attained if a standard unit of work is carried out efficiently, on a machine properly utilized or material effectively use. Allowances are made for normal shrinkage, waste and machine breakdowns.

Besides having a desirable motivational impact on employees, attainable standards serve other purposes, e.g., cash budgeting, inventory valuation and budgeting departmental performance. If correctly set attainable standards are the best type of standards to use.

Process of Standard Costing



1. **Establishing Standards:** First the standards are to be set based on management's estimation, wherein the production department anticipates the cost. In general, while fixing the standard cost, more weight is given to the past data, the current plan of production and future trends. Further, the standard is fixed in both quantity and costs.
2. **Determination of Actual Cost:** After standards are set, the actual cost for each element, i.e. material, labour and overheads is determined, from invoices, wage sheets, account books etc.
3. **Comparison of Actual Costs and Standard Cost:** Next is to compare the standard cost with the actual cost, so as to ascertain the variance.
4. **Determination of Causes:** After the comparison is made, the next step is to find out the reason for the variances, to take corrective actions and also to evaluate the overall performance.
5. **Disposition of Variances:** The last step to this process, is the disposition of variances by transferring it to the costing profit and loss account.

Advantages of Standard Costing:

- (a) Standard Costing serves as a guide to the management in various managerial functions while formulating prices and production policies etc.
- (b) 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.

(c) Analysis of variance and its measurement helps to detect inefficiencies and mistakes which enable the management to investigate the reasons.

(d) 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.

(e) 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.

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

(g) 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.

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

Disadvantages of Standard Costing:

(a) 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.

(b) The executives are liable for those variances that are found from actions which are controllable by them. Thus, to fix up the responsibilities, it becomes necessary to

segregate variances into non-controllable and controllable portions although that is not an easy task.

(c) Standards are always changing since conditions of the business are equally changing. So, standards are to be revised to make them comparable with actual results.

(d) If the standards are extremely high, it will adversely affect the morale and motivation of the employees.

Questions

1. Define the term 'Standard Costing'. How are the standards fixed? Illustrate your answer.
2. What is standard Costing. What are the different types of standard? Explain
3. Explain the term Standard Costing. Describe its merits and demerits.
4. Explain the different types of standard cost and the process of installing a standard costing.
5. Discuss feature and objectives of standard costing.