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Lecture-8

Standard Costing

Standard Costing

Notes

Contents

Objectives

After studying this Chapter, you will be able to:

- Define Standard costing
- Distinguish between budgetary control and standard costing
- Describe Estimated costing
- Discuss Standard costing as a management tool and limitations of standard costing
- Illustrate the determination of standard cost and cost sheet

Introduction

Standard costing is a tool, which replaces the bottleneck of the historical costing. Historical costing is one of the tools, which fulfills the one of the objectives of costing i.e. ascertainment of costs. The cost of a product can be ascertained only after the production of a product; which is meant as "Historical costing". Historical costing facilitates to ascertain the cost of a product which is connected with yester operations or with past. The ultimate aim of studying this Chapter is to control the cost of a product as one among the objectives of cost effectiveness strategy of the business enterprise.

The profit maximization can be had by way of implementing the following two different strategies:

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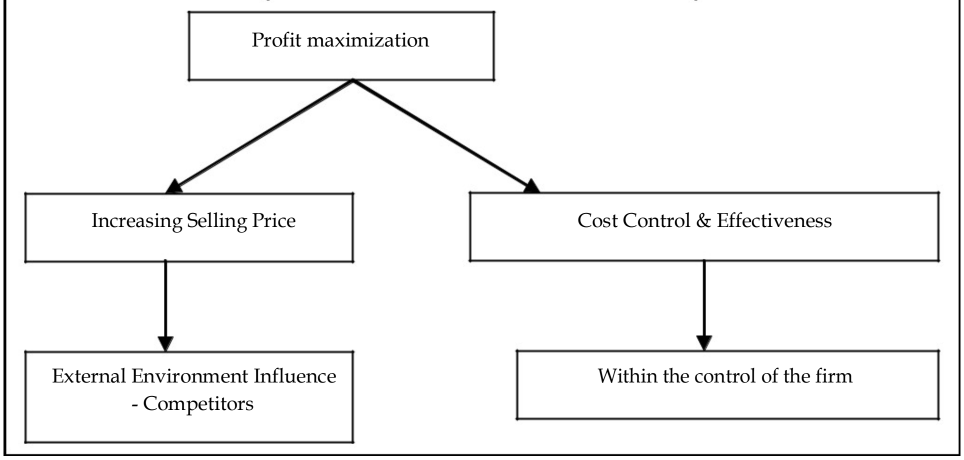
Figure 8.1: Profit Maximisation Strategies



From the following equation, the profit can be maximized

Selling Price – Cost = Profit

Caution There are two possible ways to maximize the profit:

1. Increasing the selling price and keeping the cost remains the same.
2. Reducing the cost and retaining the selling price as it is.

8.1 Meaning and Definition of Standard Costing

Standard is nothing but an expected or anticipated performance in normal situations. The standards are quantitative in phenomenon which are in connection with one activity and differs from the another.

Example: 1. Kg of raw materials expected to produce one Chapter of product.

3. Hours are expected/anticipated to consume for production of a single Chapter of product.

Standards are classified into two categories, viz. Revenue standards and Cost standards.

Standard cost is a predetermined cost, which is estimated from management's standard of efficient operation and the relevant necessary expenditure, according to ICWA (London).

Caution The standard cost is related to variable portion of the cost of a product. The variable portion of cost of product depends on the following:

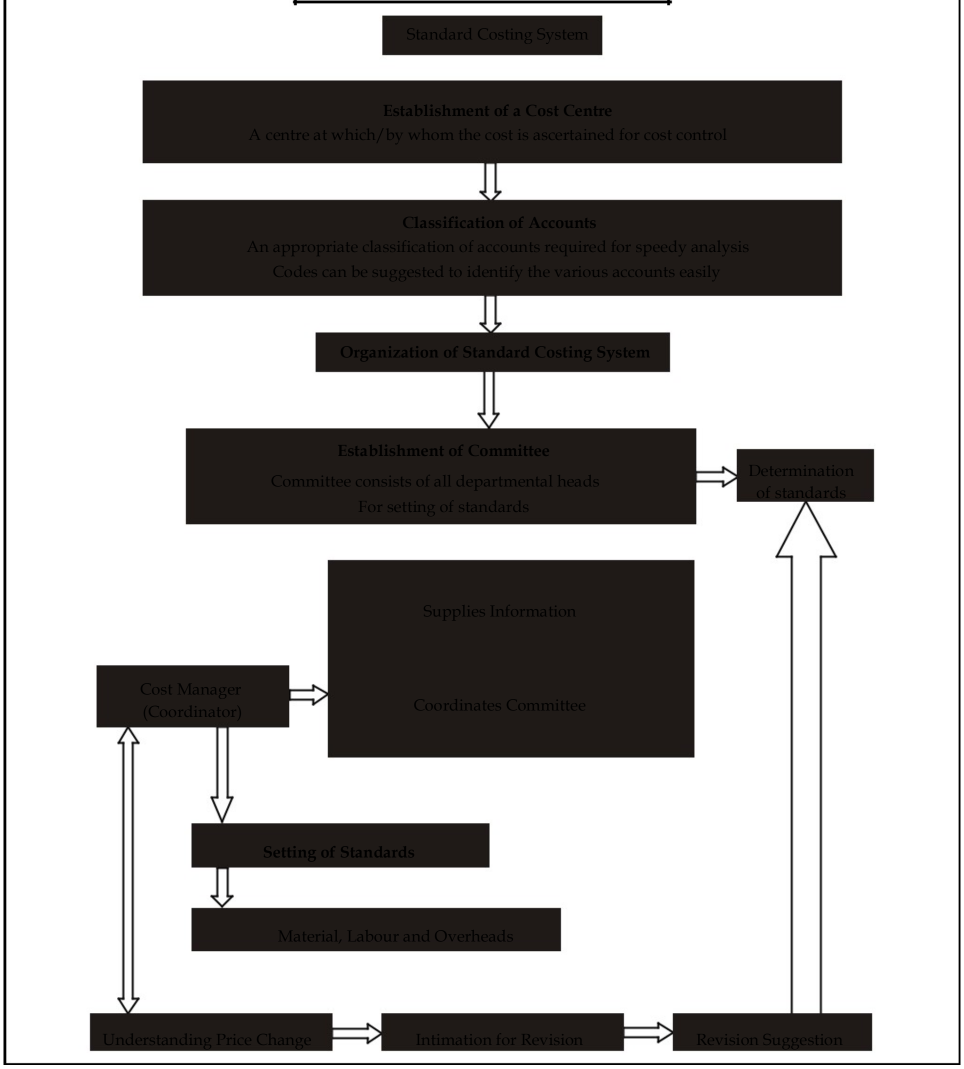
4. Material consumption
5. Hours taken/consumed
6. Incurring of miscellaneous expenditures - Overheads.

Notes

Standard costing is a system, which involves the various steps:

7. The first step in implementing the standard costing system is to develop the pre-determined standards, i.e., standard costs.
8. The second step is to record the actual costs through the ascertainment.
9. The third step involves with the comparison between the standards and actual costs; which is the origin of the variance analysis. Standard costing starts with the preparation of standards and ends with the comparison in between them. The preparation of standard costs is meaningful only through the completion of variance analysis.
10. The fourth step is the stage at which the reasons for variances are probed and analysed to incorporate the cost effectiveness not only to reduce cost but also to enhance the levels of profit.
11. The final step is the most important in the organization to take managerial decisions through an appropriate reporting. The figure 8.2 explains the standard costing system:

Figure 8.2: Standard Costing System



Notes

Caselet

Standard Costing in Jute Industry

Jute industry offers scope for implementing standard costing, says Dhruba Kumar Dutt in Industrial Management in India from Purple Peacock (www.bharatbooks.com). The author divides jute costing into three: Spun jute yarn, woven jute cloth, and finished jute cloth/ bag. "To arrive at the cost of jute yarn, one has to start from the stage of batching," explains Dutt. Jute mills use a ready-reckoner type of table to blend jute of various kinds in fixed proportions; this is softened and converted into `jute yarn of the required count.' Costing department receives daily reports that show `the quantity of each kind of jute consumed in the batching process.' Standardised numbers are available of raw jute consumption for producing one tonne of spun yarn; also known are percentages of waste in each process stage from batching to spinning.

"Direct and indirect labour costs are carefully split up and charged to the processed material of each kind," be it hessian/sacking warp/weft. Winding section has piece-rate workers winding both cops and beams. "In the weaving stage, costs of warp and weft yarns (in beams and cops) for producing jute cloth of any particular kind is calculated by ascertaining the consumption of beams and cops." Move on then to the sewing department, where you can compute the cost of jute cloth and jute yarns required to manufacture a bag. Sack sewers work on piece rate. Successful standardisation hinges on minute observations and experiments, notes Dutt. "Thus standard costing should be viewed as part of industrial management," he argues.

Source: http://www.thehindubusinessline.in

Self Assessment

Fill in the blanks:

12. ………………… facilitates to ascertain the cost of a product which is connected with yester operations or with past.
13. Standards are classified into two categories, viz. ………………… and Cost standards.
14. Selling Price – Cost = …………………
15. The preparation of standard costs is meaningful only through the completion of …………………
16. The standard cost is related to ………………… portion of the cost of a product.

8.2 Budgetary Control and Standard Costing

The systems of standard costing and budgetary control have the common objectives of controlling business operations by establishment of pre-determined targets, measuring the actual performances and comparing it with the targets, for the purpose of having better efficiency and of reducing costs. The two systems are said to be inter-related but they are not inter-dependent. Standard costing is introduced primarily to ascertain efficiency and effectiveness of cost performance. Budgetary control is introduced to state in figures an approved plan of action relating to a particular period. Both standard costing and budgetary control have the following common features:

17. Both have a common objective of improving managerial control.

Notes

(ii) Both techniques are based on the presumption that cost is controllable.

18. In both the techniques, results of comparison are analysed and reported to management.

Table 8.1: Difference between Standard Costing and Budgetary Control

	Standard Costing	Budgetary Control
(i)	It is revealed with the control of expenses and hence it is more intensive.	It is concerned with the operation of the business as a whole and hence it is more extensive.
(ii)	Standard costs are based on technical assessments.	Budgets are based on past actuals, adjusted to future trends.
(iii)	To establish standard costs, some form of budgeting is essential as there is the need to forecast the level of output and prescribed set of working conditions in the periods in which the standard costs are to be used.	Budgetary control can be applied even without the help of standard costing.
(iv)	Standards are set mainly for production and production expenses.	Budgets are compiled for all items of income and expenditure.
(v)	Standard cost is the projection of cost accounts.	Budget is a projection of financial accounts.
(vi)	Standards set up targets that are to be attained by actual performance.	Budgets set up maximum limits of expenses above which the actual expenditure should not normally exceed.
(vii)	In standard costing, variances are analysed in detail according to their originating causes. It reveals variances through different accounts, such as, material price variance, usage variance, etc.	In budgetary control, variances are not related through the related accounts but are revealed in total.
(viii)	Standard costs do not tell what the costs are expected to be, but rather what the costs should be under specific conditions of production performance and as such cannot be used for the purpose of forecasting.	Budgets are anticipated or expected costs meant to be used for forecasting requirements of material, labour, cash, etc.
(ix)	Standard costs are used in various management decisions, price fixing, value analysis, valuation of closing stock, etc.	It aims in policy determination, co-ordination of activities in different divisions and delegation of authority.

Self Assessment

Choose the appropriate answer:

19. Standard is ideally prepared for

    (a) Fixed cost (b) Variable cost

    (c) Sales (d) Variable cost and sales

20. If standard cost of the product is more than the actual cost

    (a) Favourable (b) Neither favourable nor unfavourable

    (c) Unfavourable (d) Both (a) & (c)

21. Standard is calculated for

    (a) Volume (b) Per batch

    (c) Per Chapter (d) Per batch or Chapter

Notes

9. Why the given standards are tuned to actual?

    22. To equate both of them

    23. To convert the standards at par with the actual performance

    24. To know the difference

    25. None of the above

8.3 Estimated Costing

Standard costs and estimated costs are predetermined costs, but their objectives are different. Important points of difference between the two are as follows:

Table 8.2: Difference between Standard Cost and Estimated Cost

	Standard Cost	Estimated Cost
(i)	Standard cost can be applied in a business operating under standard costing system.	Estimated costs can be used in any business which is running under historical costing system.
(ii)	Standards are meant for controlling future performances.	Estimates are prepared mainly for price fixing purposes.
(iii)	Standard costs are determined on a scientific basis keeping in view certain factors and conditions of efficiency.	Estimated costs are calculated on the basis of past performance adjusted in the light of anticipated changes in the future.
(iv)	Standard costs are used as a regular system of accounts from which variances are found out.	The use of estimated cost is as statistical data only.
(v)	Standard costs are to be fixed in respect of every element of cost and therefore, they incorporate whole of the manufacturing process.	Estimated costs can be ascertained for a part of the business and also for a particular purpose.

Self Assessment

Fill in the blanks:

26. Estimated costs are calculated on the basis of .... adjusted in the light of anticipated changes in the future.

27. Standard costs are used as a regular system of accounts from which .... are found out.

8.4 Standard Costing as a Management Tool

Standard costing is a very useful managerial tool for cost control and cost reduction. The following are the main advantages of standard costing:

28. Standard costing is a valuable aid to management in formulating price and production policies and in performing managerial functions.

29. Human beings often work hard to achieve standards that are within their reach; therefore, setting up of such standards will almost automatically mean greater efficiency in operations. Further, almost everyone will think in terms of setting the targets and of achieving them. This will be specially so if the system of rewards and punishment is also geared to the results.

3. Even for valuation of inventory, standard cost should be the proper basis. If actual costs are high only because there has been a wastage of resources, it is not proper to capitalise those losses by including them in the value of inventory. Nothing becomes more valuable simply because of wastage and, therefore, inventory values should better be determined on the basis of standard costs.

30. In short, one can say that if a firm practices standard costing on proper lines, i.e., standards are themselves determined in a way that will not impose too great a burden on the worker or other employees or the firm, it may infuse in the minds of the staff a desire to achieve the standards and thus show greater efficiency.

31. At every stage of setting the standards, simplification and standardisation of productions, methods and operations are effected and waste of time and material is eliminated. This assists in managerial planning for efficient operation and benefits all the divisions of the concern.

32. Costing procedure is simplified. There is a reduction in paperwork in accounting and less number of forms and records are required. There is considerable saving in clerical time and expenditure, leading to reduction in the cost of the costing system.

33. This system facilitates delegation of authority and fixation of responsibility for each department or individual.

34. Where constantly reviewed, the standards provides means for achieving cost reduction. This is attained through improved quality of products, better materials and men, effective selection and use of capital resources, etc.

35. Standard costs assist in performance analysis by providing ready means for preparation and interpretation of information.

36. This facilitates the integration of accounts so that reconciliation between cost accounts and financial accounts may be eliminated.

37. Standards serve as yardsticks against which actual costs are compared. Whenever variances occur, reasons are studied and immediate corrective measures are undertaken. Thus, it facilitates effective cost control and provides necessary information for cost reduction.

38. It creates an atmosphere of cost consciousness among executives, foremen and workers. It also provides incentives to employees for efficient work.

39. Standard costing facilitates management by exception. It helps the management in concentrating its attention on cases which are below the standards set.

40. Standard costing helps in effective delegation of authority and responsibility. As a result, the management can control the affairs of various departments effectively.

41. Setting of standard involves effective utilisation of men, material and machines. It leads to economy and increased productivity in all business activities.

42. It simplifies costing procedures and reporting. It reduces clerical work since standard rates are fixed for material pricing, overhead allocation apportionment, etc.

43. It makes the work of valuation of inventory easier. This is because inventory is valued at predetermined costs.

Self Assessment

State whether the following statements are true or false

44. Standard costing helps in effective delegation of authority and responsibility.

Notes

13. Standard costing increases clerical work since standard rates are fixed for material pricing, overhead allocation apportionment, etc.

8.5 Limitations of Standard Costing

Standard costing has certain limitations. These are the following:

45. Establishment of standard costs is difficult in practice. Even if the particular type of standard to be used has been properly defined, there is no guarantee that the standard established will have the same tightness or looseness as envisaged throughout the organisation.
46. In course of time, the standards become rigid, it is not always possible to change standards to keep pace with frequent changes in the manufacturing conditions. Frequent revision of standards is costly and creates problems.
47. Standard costing is an expensive technique for a small concern.
48. It is difficult to set accurate standard costs. Improperly set standards may do more harm than good.
49. It is not easy to distinguish variances as controllable or uncontrollable.
50. Since business conditions are changing, the standards are to be revised frequently. Revision of standards is a tedious and costly process.
51. Standard costing cannot be applied fully to job order industries dealing in non-standardised products. It may be applied partially but it would not be effective.
52. If standards are too high or rigid, they will be unattainable. It will adversely affect the morale and motivation of employees and lead to resistance.
53. Inaccurate, unreliable and out-of-date standards do more harm than any good.

Self Assessment

State whether the following statements are true or false

54. Standard costing is an effective technique for a small concern.
55. It is easy to distinguish variances as controllable or uncontrollable.

8.6 Determination of Standard Cost

As 'standard' is a relative expression; one has to determine for oneself what one deems appropriate as a 'standard'. However, one should not lose sight of the objective, which normally should be avoidance of all losses and wastages as far as possible. The management may certainly fix standards on the basis of maximum possible efficiency, possibly with an assumption of no wastage, no idle time, etc. However, this is not realistic; the standard will be the 'Ideal Standard' but impracticable-no one will even make an attempt to achieve it.

Alternatively, an average of past few years' costs could be taken as basis but this will mean perpetuating past inefficiencies, by making them the target. This will defeat the very purpose of standard costing.

A target should be such that it will induce the worker to give out his best. In order to make people believe in standards and to induce them towards achieving them, standards should better be such as can be achieved but with an effort; in other words, they should be somewhat idealistic.

1. ***Basic Standard:*** This is a 'standard' which is established for use, unaltered over a long period of time. Standards are fixed scientifically and hence it is more of a technical job. These standards are supposed to remain unchanged so long as quality requirements are constant. Moreover, if forward contracts are entered into regarding materials and labour pact signed for a certain period, the costs can be planned accordingly. Such costs, i.e., basic standards may, however, have to be adjusted for changes in circumstances in a period.

56. ***Current Standard:*** In practice, standards are fixed on the basis of scientific studies but adjusted for current subjective factors. A standard, therefore, is made realistic to reflect the anticipated conditions affecting operations; it is not too idealistic. Such a standard would bring to sharp focus the avoidable causes for variances, leading to control action. A current standard is a standard for a certain period, for certain conditions and for certain circumstances. Basic standards are more idealistic whereas current standards are more realistic. Most companies use current and not basic standards.

57. ***Expected or Attainable Standard:*** A standard though idealistic, should also be realistic. If targets are fixed for a certain budgeted period, taking into account the expected conditions, it can be known as "expected standard" or "attainable standard". It is defined by CIMA, London as, "A standard which can be attained if a standard Chapter of work is carried out efficiently, a machine properly operated or a material properly used. Allowances are made for normal losses, waste and machine downtime."

58. ***Normal Standard:*** Yet another target is one that is intended to cover a longer period of time— a period long enough to cover one trade cycle, i.e., roughly 7 to 10 years. This is defined as "the average standard which it is anticipated can be attained over a future period of time, preferably, long enough to cover one trade cycle".

59. ***Ideal Standard:*** This standard refers to the target that can be attained under most ideal conditions. Hence, it is more idealistic and less realistic. It is defined by the terminology as: "The standard which can be attained under the most favourable conditions, with no allowance for normal losses waste and machine down time".

Did u know? ***How to Prepare Standard Cost Sheet?***

When all the standard costs have been determined, a Standard Cost Sheet is prepared for each product or service. The process of setting standards for materials, labour and overheads results in the establishment of the standard cost for the product. Such a cost sheet shows for a specified Chapter of production, quantity, quality and price of each type of materials to be used, the time and the rate of pay of each type of labour, the various operations the product would pass through, the recovery of overhead and the total cost. The build-up of the standard cost of each item is recorded in standard cost sheet. These details serve as a basis to measure the efficiency against which actual quantities and costs are compared. The type of standard cost sheet varies with the requirements of individual firm hence no uniform format can be prescribed.

Self Assessment

Fill in the blanks:

60. Basic standards are more idealistic whereas current standards are more ………………
61. The build-up of the standard cost of each item is recorded in ………………
62. A ……………… is a standard for a certain period, for certain conditions and for certain circumstances.

Notes

Task Prepare the proforma of standard cost sheet.

8.7 Summary

- Standard costing is a tool, which replaces the bottleneck of the historical costing.
- Historical costing facilitates to ascertain the cost of a product which is connected with yester operations or with past.
- Standards are classified into two categories, viz. Revenue standards and Cost standards.
- The systems of standard costing and budgetary control have the common objectives of controlling business operations by establishment of pre-determined targets, measuring the actual performances and comparing it with the targets, for the purpose of having better efficiency and of reducing costs.
- Standard costing is a very useful managerial tool for cost control and cost reduction.
- When all the standard costs have been determined, a Standard Cost Sheet is prepared for each product or service.
- The process of setting standards for materials, labour and overheads results in the establishment of the standard cost for the product.

8.8 Keywords

Basic Standard: This is a 'standard' which is established for use, unaltered over a long period of time.

Budget: Budget is a projection of financial accounts.

Ideal Standard: This standard refers to the target that can be attained under most ideal conditions.

Standard Cost: Standard cost is a predetermined cost, which is estimated from management's standard of efficient operation and the relevant necessary expenditure.

8.9 Review Questions

70. Standard costing is a tool, which replaces the bottleneck of the historical costing. Give some suggestions to support the above statement.
71. The organisations can increase their profit either by increasing the selling price of their products or by reducing the cost of the product. Which strategy is more beneficial for the organisation?
72. Standard is nothing but an expected or anticipated performance in normal situations. Do you think the process of setting the revenue standards is same as the cost standards?
73. The budgetary control and standard costing systems are said to be inter-related but they are not inter-dependent. Discuss.
74. How standard costing is a useful managerial tool for cost control and cost reduction?
75. Prepare a standard cost sheet for any product or service and discuss the key elements.

Notes

7. The management may certainly fix standards on the basis of maximum possible efficiency, possibly with an assumption of no wastage, no idle time, etc. Do you think this is realistic?

76. As 'standard' is a relative expression; one has to determine for oneself what one deems appropriate as a 'standard'. Discuss.

77. Suggest some drawbacks of standard costing.

78. Standard costs and estimated costs are predetermined costs, but their objectives are different. What are the key points of differences between standard cost and estimated cost?

Answers: Self Assessment

1.	Historical costing	2.	Revenue standards
3.	Profit	4.	Variance analysis
5.	variable	6.	(d)
7.	(a)	8.	(d)
9.	(b)	10.	past performance
11.	variances	12.	true
13.	false	14.	false
15.	false	16.	realistic
17.	standard cost sheet	18.	current standard

8.10 Further Readings

Books

B.M. Lall Nigam and I.C. Jain, *Cost Accounting,* Prentice-Hall of India (P) Ltd.

Hilton, Maher and Selto, *Cost Management,* 2nd Edition, Tata McGraw-Hill Publishing Company Ltd.

M.N. Arora, *Cost and Management Accounting,* 8th Edition, Vikas Publishing House (P) Ltd.

M.P. Pandikumar, *Management Accounting,* Excel Books.

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www.authorstream.com

www.allinterview.com