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STANDARD COSTING

Introduction

Standard costing is a technique of cost control. It is only a particular concept of cost accounting and not a separate system. It can be applied to all types of businesses and can be introduced very easily in industries engaged in mass production it seeks to establish the cost of a product, operation or process under standard operating conditions.

Standardization of cost leads to an effective control of costs by finding out the variation in cost between the standards and actual. The difference between the standard cost and the actual cost is called variance.

Standard

Standard is a predetermined norm or yardstick established by a scientific analysis of the factors of production for measuring performance and cost. This may be based on past performance after taking into consideration the present working conditions and future expectations.

Standard cost- *Meaning*

Standard cost is a predetermined cost after taking into account all the factors affecting cost. It means that the standard cost provides a yardstick against which actual costs and performance are measured. Standards may be used for measuring efficiency of department, cost center or a concern.

Definition

According to the Institute of Cost and Works Accountants, England, "*Standard costs are prepared and used to clarify the final results of a business, particularly by measurement of the variance of the actual costs from standard costs and the analysis of the causes of variances for the purpose of maintaining efficiency by executive action*".

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Standard costing – Meaning

Standard costing is the preparation and use of standard costs, their comparison with actual analysis of variances. It is designed to show in detail how much each product should cost, produce and sell when the business is operating at a stated levels of efficiency.

Definition

According to ICMA, London standard costing is *"a technique whereby the planned activities of an undertaking are expressed in budgets, standard costs, standard selling price and standard profit margins, and the differences between these and the comparable actual results are accounted for".*

Advantages of standard costing

1. **Provides a yardstick**: Standard costing provides a yardstick against which actual costs can be measured and the amount of variance determined.
2. **Helps in controlling cost**: Analysis of variance at periodical intervals provides a basis for controlling cost and performance
3. **Helps in formulating policies**: Standard costing is a valuable aid to management which may be used in formulating policies relating to price determination and production programming.

4. **Helps in improving efficiency**: Standard costing encourages the employees and the executives to improve their efficiency and performance.

5. **Reduces costs and improves economy in operation:** Determination of standard time andcost requires a thorough investigation and a critical analysis of plant layout, production methods and techniques, product design and material specification which may lead to considerable economy and improvement in efficiency.

6. **Helps in introducing incentive systems**: Standard costing helps in introducing incentives to supervisors, workers and other personnel to enhance productivity.
7. **Forward looking**: A forward looking mentality is encouraged at all levels of management.
8. **Helps in preparation of financial statement**: Opening stock and closing stock are valued at the standard price which helps in the preparation of financial statements within a short period.

9. **Reduces wastage**: Standard costing acts as a yardstick for measuring performance which helps in reducing avoidable wastages and losses.

Limitations of Standard Costing

Standard costing suffers from the following limitations:

1. **Difficult to set standards**: It is difficult to set accurate standard costs.

2. **Frequent change in standards**: Since business conditions are subject to frequent change, standards are to be revised frequently, which may be troublesome and at the same time a costly affair.

3. **Chance of affecting morale of employees**: Too high a standard will affect the morale of the employees.
4. **Difficulty in classifying variance**: There is difficulty in classifying variance into controllable and uncontrollable parts.
5. **It is costly affair**: As regards small concerns standard costing is a costly technique.
6. **Not applicable to job order business**: Standard costing cannot be applied to job order type industries.
7. **Difficult to apply where production process takes more than one year**: It is difficult to apply this method where production process takes more than one accounting period. Standard costing may not be effective in industries which deal in non-standardized products or jobs according to customer's requirements

Standard Costing Vs. Historical Costing

As we have stated earlier, standard costing is the ascertainment and use of standard costs and the measurement of variance. Standard costs are predetermined cost of manufacturing and selling a product or a number of products during a specified period in the immediate future. Such costs are based on the standard cost of material, labour and overhead chargeable to a Product or service. They are determined after taking into account all the factors affecting cost.

But historical costing is the ascertainment or recording of cost after they have been incurred. Historical costing is also known as actual costing which is not preceded by planned costs which are a must for effective cost control. It is not an effective method of exercising cost control, because it does not provide yardsticks with which actual performance may be compared. Historical cost is just postmortem of the expenditure which has been incurred; so it is not an effective device of cost control. The limitations and disadvantages of historical costing system have led to the development of standard costing technique.

STANDARD COST AND ESTIMATED COST

Both standard costing and estimated costing are predetermined costs. But the object of standard costing differs. The differences between these two costs

STANDARD COST	ESTIMATED COST
1.It is a scientifically used and regular system based on estimation and time studies	It is used as statistical data and leads to a lot of guess
2. Its object is to ascertain “what the costs should be.”	Its object to ascertain “what the cost will be.”
3. It is used for effective cost control and to take proper action to maximize efficiency.	It gives importance to cost ascertainment for fixing sales price.
4. It is a continuous process of costing and takes into account all the manufacturing processes.	It is used for a specific use; i.e., fixing sales price.
5. It can be used where standard costing is in operation.	It can be used where costing is in operation

are:-

Preliminaries or procedure for the establishment of standards

The following preliminary steps shall be taken before setting standards for different elements of costs. They are

i. Establishment of cost centers
ii. Classification and codification of accounts
iii. Period of use.
iv. Reasonable or desirable level of attainment.
v. Activity leave.

i. Establishment of cost centres

A cost Centre is a location, person or item of equipment (or group of these) for which costs may be ascertained and used for the purpose of cost control. Thus cost Centre may be personal or impersonal. Establishment of cost Centre is necessary for fixing responsibilities and for defining lines of authority.

ii. Classification and codification of accounts

Accounts are to be classified and codified in order to facilitate collection and analysis. With this end in view, codes may be used. A code is a symbolic representation of any particular item of information.

iii. Period of use

The next step for establishment of standard costs is the fixation of length of the operating period for which standards are to be used. Depending upon the length of operating periods the standards may be categorized into

(i) Current standards and (b) Basic standards.

(a) **Current standards**: Short term standards are known as current standards. These are more suitable for business since they take into account the current conditions related to the budget period.

(b)**Basic standards**: These are not altered for a long period of time; revisions are not frequent and there is a stability and stagnancy in standards fixed. These basic standards remain constant for a very long time and therefore are applied in industries where only a small range of products are manufactured and long term planning is required.

iv. Reasonable or desirable level of attainment

Standards should be set up only at a reasonable level of attainment. It shall be set at efficient working conditions and reasonably good performance.

v. Activity level

The level of activity or performance required must be decided upon before establishing any standards. The level of output or production which shall be attained over the forthcoming period for which the standards are to be computed, is to be assumed or judged with regard to the capacity of the plant and the marketability of the products. The sales potentials and production capacity decide the quantum of output to be manufactured within a particular period. The idle capacity, utilized capacity and other limiting factors should be taken into consideration before determining the attainable level of output.

Establishment of standard cost

The standard cost is determined for each and every element distinctly. Standard cost is a pre-determined cost after taking into account all the factors affecting it. It may be influenced by, the level of activity, volume of output market price and demand for the product. For fixing the standard cost of a product all the factors of production are segregated, and the standard cost of each factor is to be determined. As we know, the three main factors of production among other things are material, labour and overheads. The standard cost of product consists of (a) Standard material cost; (b) standard labour cost and (c) standard overhead cost.

a. **Standard material cost**: It is the cost of standard quantity of materials at standard price. The standard quantity of materials may be determined after taking into account the material content of finished product and also the normal losses that may be allowed in process. Standard quantity of material may be determined by the technical department after expert study. Standard prices of materials, are based on normal source of supply, discount allowed, economic ordering quantities, taxes and duties etc.

b. **Standard labour or wages cost**: It is the cost of standard labour hours at standard labour rate. Standard labour hours may be determined after taking into consideration the working conditions, production facilities available, production methods and techniques to be used, the skill or efficiency required etc. Standard labour rate is the rate fixed after taking into account the types of labour required, labour rates applicable in similar industries, nature of job and also other labour related expenses such as bonus, Gratuity, pension, dearness allowance, contribution to funds etc.

c. **Standard overhead cost:** It is the cost recovered at pre-determined standard recovery rate. Standard rate is the rate at which the overhead cost is to be absorbed in the output of a given period. The rate is obtained by dividing the standard overhead Cost by the standard.

Differences between budgetary control and standard costing

Budgetary Control	Standard Costing
It is extensive in its application, as it deals with the operation of department or business as a whole.	It is intensive, as it is applied to manufacturing of a product or providing a service.
Budgets are prepared for sales, production, cash etc.	It is determined by classifying recording and allocating expenses to cost unit.
It is a part of financial account and is a projection of all financial activities.	It is a part of cost account and forms a projection of all cost accounts.

Control is exercised by taking into account budgets actuals. Variances are not revealed through accounts.	Variances are revealed through different accounts.
Budgeting can be applied in parts.	It cannot be applied in parts
It is more expensive and broad in nature, as it relates to production, sales, finance	It is not that much expensive as it is relates with only the elements of cost.
Budgeting can be operated without standard costing.	Standard costing cannot be operated without budgeting.