

# STANDARD COSTING

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# Topics to be discussed

1. Meaning of standard, standard cost and standard costing.
2. Steps involved in standard costing.
3. Types of standards.
5. Establishment of standards for different elements of cost.
6. Variances and analysis of variances.
7. Investigation of variances and treatment of variances.
8. Advantages and disadvantages of standard costing.
9. Conclusion.
10. Bibliography.

**Standard** – It is used to refer to the predetermined rate e.g. Rs 10 per unit

**Standard costs** - are predetermined cost which may be used as a yardstick to measure the efficiency with which actual costs has been incurred under given circumstance.

**Standard Costing** – This is a technique which uses standards for cost and revenues for the purpose of control through variance analysis.

## Standard costing involves the following steps:

Setting standard costs for different elements of costs



Recording of actual costs



Comparing between standard costs and actual costs to determine the variances



Analyzing the variances to know the causes



Reporting the analysis of variances to management for taking appropriate actions wherever necessary

## In simple Words:-

Standard costing involves in determining

- Standard Costs
- Actual Costs
- Estimated Costs

## **For example:-**

The system of standard costing can be used effectively to those industries which are producing standardized products and are repetitive in nature.

Examples are cement industry, steel industry, sugar industry etc.

From the above, we may note that standard costs are:

- ***Pre-determined cost:*** Standard cost is always determined in advance and ahead of actual point of time of incurring of costs.
- ***Based on technical estimated:*** Standard cost is determined only on the basis of a technical estimate and on a rational basis.
- ***For the purpose of Comparison:*** The very purpose of standard cost is to aid the comparison with actual costs.
- ***Based for price fixing:*** The prices are fixed in advance and hence the only variation basis is the standard cost.

The  
difference  
between  
actual  
costs and  
standard  
cost is  
known as

**Profit**

**Variance**

**Historical  
Cost**



# TYPES OF STANDARDS

- Current Standard
- Basic Standard

**Current Standard:** This standard is used over a short period of time and is related to current conditions.

**Basic Standard:** This standard is used over a long period of time, from which a current standard can be developed.

## **ESTABLISHMENT OF STANDARDS**

Analysis, experiment and training are fundamental prerequisites for establishing standards ,these were basic tenets of standard setting from early days.

## **Standard should be set for each element of cost as follows –**

**Direct material** – Standard direct material cost for each product should be established. This will involve

1. Determination of standard quantity of materials
2. Determination of standard price per unit of materials

## **Direct labor cost–**

Determination of standard DLC will involve determination of :

1. Standard time
2. Standard rate

## **Direct Expenses –**

Standards for these may be based on past performance records subject to anticipatory changes therein.

## **Standards for Overheads-**

The overheads are classified into fixed, variable and semi-variable overheads. Standard overhead rate is determined for these on the basis of past records and future trend of prices. It will be calculated per unit or per hour.

Setting standard for overhead cost involves the following two steps:

1. Determination of the standard overhead costs, and
2. Determination of the estimates of production

## **Standard hour—**

It is hypothetical hour which measures the amount of work that should be performed in 1 (one) hour.

## **Standard cost card –**

It shows the quantity and price of each type of materials, labor, time and rate, hours and rates of variables and overheads. In short a standard cost card should be maintained for each product showing total unit cost of production, breaking into respective elements of cost.

## Objectives of Standard Costing:

1. Cost Control
2. Management by Exception
3. Develops Cost Conscious Attitude
4. Fixation of Prices
5. Fixing Prices and Formulating Policies
6. Management Planning

# **Which in a simple word means:-**

The purpose of standard costing is to

1. Reduce Costs
2. Measure Efficiency
3. Control Prices



# VARIANCES

The deviation of actual from standard is called variance.  
The two types variance are:

1. Favorable – actual cost < standard cost
2. Unfavorable – standard cost < actual cost

**Variance may be divided into two groups:**

**1. Price variance** e.g. material price variance, sales price variance.

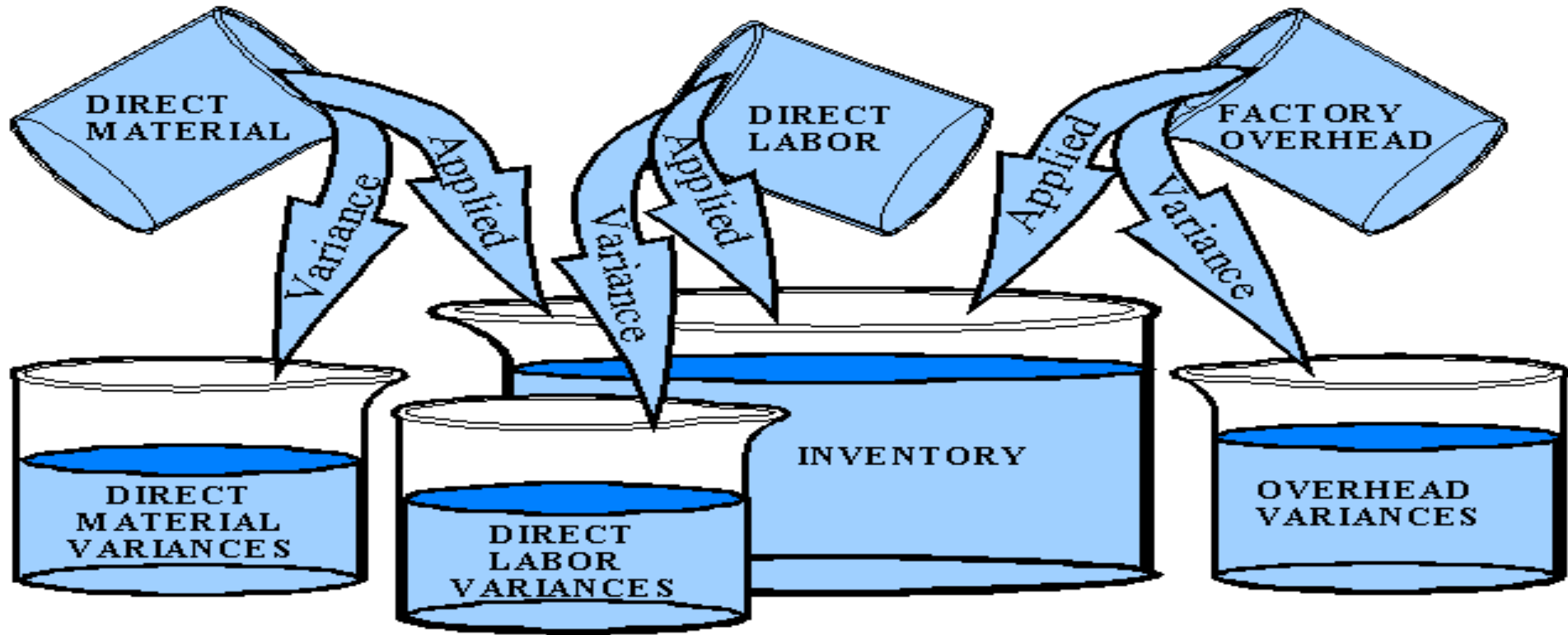
**2. Volume variance** e.g. material usage variance, sales volume variance.

# **ANALYSIS OF VARIANCE**

Variances are analyzed in respect of:

1. Direct material
2. Direct labor
3. Overheads:-
  - a. Variable overheads
  - b. Fixed overheads

# Standard Costing



In a standard cost system, all manufacturing costs are applied, or charged to the inventory using standard or predetermined prices, and quantities. The differences between the applied costs and the actual costs are charged to variance accounts as shown symbolically in the enlarged graphic given.

# Variance Investigation

Three approaches to variance investigations are:

1. Rules of Thumb method.
2. Cost benefit analysis.
3. Use of statistical quality control chart.

## **Rules of Thumb method-**

Based on experience, intuition and judgment, managers may develop some rules which guide them in investigation decision. This method has its own limitations because of its rule of thumb nature.

## **Cost- benefit analysis –**

Since not all variances are investigated by management, therefore decisions to investigate can also be taken by cost benefit analysis.

## **Use of statistical quality control –**

SQC can also be applied by the firm in deciding whether to investigate a variance. The key to SQC is a control chart.

## **TREATMENT OF VARIANCES-**

Three methods are involved:

1. Transfer to profit and loss account or to cost of sales - all cost variances are to be transferred to profit and loss account or to cost of sales. If this method is followed, the standard cost of sales will be converted into actual cost of sales.
2. Proration to inventories and cost of sales- cost variances are distributed to work- in- progress and finished goods inventories and cost of sales either on the basis of units of value. As a result, both the inventories and cost of goods sold will be shown at actual cost.
3. Setting up as reserves – variances are set up as reserves until they are set- off.

# Advantages of Standard Costing

**1. To measure efficiency**

**2. To fix prices and formulate policies**

**3. For Effective cost control**

**4. Management by exception**

**5. Valuation of stocks**

**6. Cost consciousness**

**7. Provides incentives**



## **Limitations of Standard Costing**

**1. Difficulty in setting standards**

**2. Not suitable to small business**

**3. Not suitable to all industries**

**4. Difficult to fix responsibility**

**5. Technological changes**

## Conclusion

Standard quantities of inputs can be established based on ideal performance, or on expected performance, but are usually based on ***efficient and attainable*** performance. Research in psychology has determined that most people will exert the greatest effort when goals are somewhat difficult to attain, but not extremely difficult. If goals are easily attained, managers and employees might not work as hard as they would if goals are challenging. But also, if goals appear out of reach, managers and employees might resign themselves to falling short of the goal, and might not work as hard as they otherwise would. For this reason, standards are often established based on ***efficient and attainable*** performance.

Hence, a standard is a type of budgeted number; one characterized by a certain amount of rigor in its determination, and by its ability to motivate managers and employees to work towards the company's objectives for production efficiency and cost control.

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