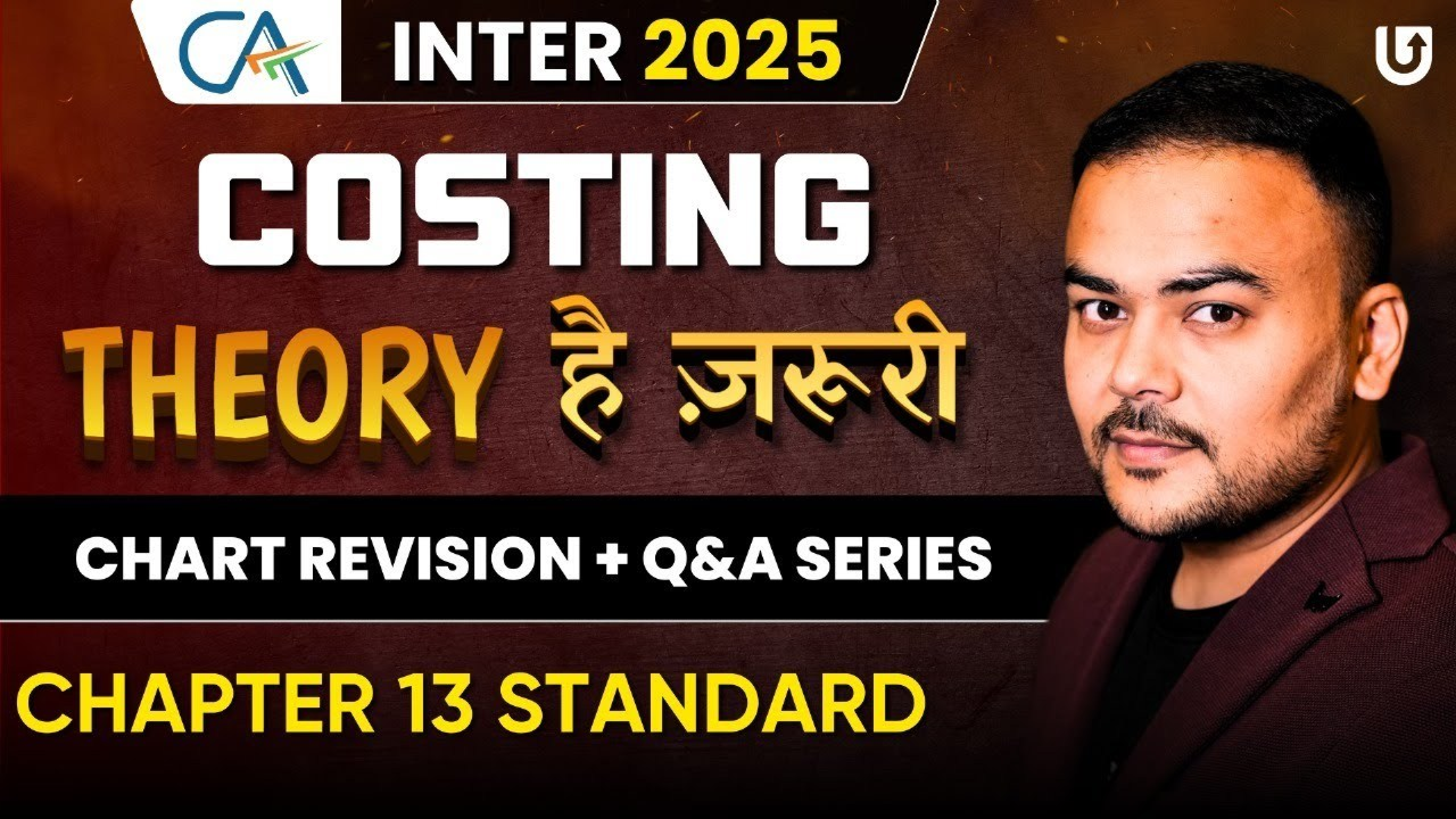
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COSTING
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CHART REVISION + Q&A SERIES
CHAPTER 13 STANDARD

Theory Chart

Chp13 Standard Costing

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BASICS

Standard Costing

- Standard costing is a method of cost and management accounting which starts with setting of standards and ends with reporting of variances to management for taking corrective actions.
- It is used to achieve cost control and here Management of an organization setups predetermined cost to compare the actual cost with the predetermined cost.

Standard Cost

- Standard cost is the planned or desired cost of the product, component or service produced in a period.
- The standard cost may be determined on a number of bases.
- The main use of standard costs is in performance measurement, control, stock valuation and in the establishment of selling prices.

Why is Standard Costing needed?

- **Prediction of future cost for decision making**: it is future cost for the purpose of cost estimation and profitability from a proposed project/ order/ activity.
- **Provide target to be achieved:** to monitor and measure performance of responsibility centres against the set standards.
- **Used in budgeting and performance evaluation**: it is used to set budgets and based on that managerial performance is evaluated.
- **Interim profit measurement and inventory valuation**: it is used to prepare profitability statement for interim periods for managerial reporting and decision making.

Budget vs Standard

- **Budget:** planned figures based on budgeted output
- **Standard**: planned figures based on actual output

Types of Variances

- **Favorable variances** are those which are profitable for the company. (lower cost than standard, higher sales than standard)
- **Adverse variances** are those which cause loss to the company. (higher cost than standard, lower sales than standard)

PROCESS OF STANDARD COSTING

- **Setting of Standards:** The first step is to set standards which are to be achieved/ desired.
- **Ascertainment of Actual Costs:** Actual costs are ascertained from books of account, material invoices, wage sheet, pay slip etc.
- **Comparison of actual cost with standard cost:** Actual costs are compared with the standards costs and variances are determined.
- **Investigate the reason of variance:** Variances arises are investigated for further action. Based on this, performance is evaluated and appropriate actions are taken.
- **Disposition of Variances:** Variances arise are disposed-off by transferring it the relevant accounts (costing profit and loss account) as per the accounting method (plan) adopted.

TYPES OF STANDARDS

Ideal Standards

- These represent the level of performance attainable when
  - prices for material and labour are most favourable,
  - when the highest output is achieved with the best equipment and layout and
  - when the maximum efficiency in utilisation of resources results in maximum output with minimum cost.
- **Criticism**: These types of standards are criticised on three grounds:
  - These are unattainable, no one would take these seriously.
  - The variances from the ideal standards would not indicate the extent to which they could have been reasonably and practically avoided.
  - There would be no logical method of disposing of these variances.

Normal Standards

- These are standards that may be achieved under normal operating conditions.
- These standards are, however, difficult to set because they require a degree of forecasting.
- The variances thrown out under this system are deviations from normal efficiency, normal sales volume, or normal production volume.
- If the actual performance is found to be abnormal, large variances may result and necessitate revision of standards.

Basic or Bogey Standards

- These standards are used only when they are likely to remain constant or unaltered over a long period.
- According to this standard, a base year is chosen for comparison purposes in the same way as statisticians use price indices.
- They are well suited to entities having a small range of products & long production runs
- Basic standards are set, on a long-term basis and are seldom revised.

Current Standards

- These standards reflect the management's anticipation of what actual costs will be for the current period.
- These are the costs which the business will incur if the anticipated prices are paid for the goods and services and the usage corresponds to that believed to be necessary to produce the planned output.
- The variances arising from current standards represent the degree of efficiency in usage of the factors of production, variation in prices paid for materials and services and difference in the volume of production.

SETTING UP OF STANDARD COST

Process of Setting Up

- Standard cost is set on the basis of management's estimation.
- Cost is estimated on the basis of technical specification provided by the engineering department or other expert such as production engineer.
- Generally, while setting standards, consideration is given to historical data, current production plan and expected conditions of future.
- For detailed analysis and control, standard cost is set for each element of cost i.e. material, labour, variable overheads and fixed overheads.
- Standard are also set for the sales quantity and sales value; this is generally known as budgeted sales.
- Standards are set in both quantity (units or hours) and in cost (price or rate). It is thus measure in quantities, hours and value of the factors of production.

Physical Standards

- Physical standards refer to expression of standards in units or hours
- At this stage standard quantity and standard hours are determined for a particular product or service.
- In manufacturing organisations, the task of setting physical standards is assigned to the industrial engineering department.
- While setting standards consideration is given to :
  - Company's operating plan i.e. budgets
  - Final output to be produced
  - Material Specification
  - Proportion of material to be used in case of multiple inputs.
  - Method of production i.e. fully automated, semi-automated or manual.
  - Skill set of workers and availability of workers.
  - Working conditions and internal factors.
  - External factors (such as Labour Law, Factories Act, Govt. policy etc.).

Procedure of setting Material Quantity Standards

- **Standardization of products:** At this phase, products to be produced are decided based on production plan and customer's order.
  - What to be produced?
  - Which type to be produced
  - How much to be produced?
- **Product study:** Product study is carried out by the engineering department or product consultants.
  - How can it be produced?
  - What are the prerequisites?
  - Which type of materials to be used?
  - How products can be accepted in the market?
- **Preparation of specification list:** It specifies types quality and quantity of materials to be used, substitute of the materials, quantity and proportion of materials to be used, process to be followed, pre-requisites and condition, expected wastage required etc.
- **Test runs:** Sample or test runs under specified conditions are carried out and sample products are tested for the desired quality and quantity. Any deviation from the specification is noted down and specification list is updated

Procedure of setting Labour Time Standards

- **Standardisation of product** and product study is carried out as explained above.
- **Labour specification:** Types of labour and labour time is specified. Labour time specification is based on past records and it takes into account normal wastage of time.
- **Standardisation of methods**: Selection of proper machines to use proper sequence and method of operations.
- **Manufacturing layout:** A plan of operation for each product listing the operations to be performed is prepared.
- **Time and motion study:** It is conducted for selecting the best way of completing the job or motions to be performed and the standard time which an average worker will take for each job considering learning efficiency and learning effect.
- **Training and trial:** Workers are trained to do the work and time spent at the time of trial run is noted down.

Procedure of setting Overheads Time/ Quantity Standards

- Variable overhead time/ quantity is estimated based on specification made by the engineering departments.
- Variable overheads may either be based on direct material quantity or labour hour.
- Fixed overhead time is based on budgeted production volume.

Problems faced while setting Physical Standards

- In case of new product line, employee have no experience in the job, this creates problem in setting standard time
- Changes in technology may necessitate installation of sophisticated machines. The precise estimation of output and standard of efficiency achievable will pose a problem until after a long time when the working conditions are settled.
- Standards of material specifications are established and if the materials are not available as per specifications, the standards may not be achievable.

Price/ Rate Standards

Broadly, the price or rate standards can be set on either of the following bases:

- Actual average or mean price expected to prevail during the coming period, say one year; or
- Normal prices expected to prevail during a cycle of seasons which may be of a number of years.

Procedure of setting Material Price Standards

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Procedure of setting Wage Rate Standards

- The type of labour required for performing a specific job would be the most important factor for deciding the rate of wage to be paid to workers.
- Standard wage rate for skilled and unskilled workers are set based on the following basis:
  - Time taken by the workers to complete a unit of production.
  - Time or piece rate prevailing in the industry. It can be known from the peers.
  - Wage agreement entered into between the management and workers' union.
  - Law prevailing in the area of operation, law like Payment of minimum wages Act, Payment of bonus Act etc.

Procedure of setting Overhead Expense Standards

- In computing the overhead expense standards, consideration should be given to the level of output and the budgeted expenses.
- A budgeted output is fixed considering practical manufacturing capacity and anticipated sales demand.
- These expenditures are classified as fixed and variable.
- If production is seasonal or it fluctuates during the year, a flexible budget may be prepared to facilitate comparison between the set target and actual expenditure for the period.

SETTING UP OF STANDARD COST

Procedure of setting Material Price Standards

- Material prices are not altogether within the control of the manufacturer;
- Purchasing dept should be able to estimate with reasonable accuracy by looking into current market conditions and trends.
- Standard Prices should be based on following factors:
  - Stock of materials on hand and the prices at which they are held;
  - The prices at which orders for future deliveries of materials (agreement entered into) have already been placed,
  - Minimum support price fixed by the appropriate authority and
  - Anticipated fluctuation in price levels
- In case there are unsystematic fluctuations in the market price, it may be difficult to determine standard costs of materials.
- The purchasing policy of the company and the objective to be achieved (from cost accounting) will also make a difference.
- The difficulty in determining the standard cost of material in such a situation can be resolved as follows:
  - In case prices fluctuate from month to month, the average of prices of a year corrected for the known secular changes and any other expected change can very well serve as the standard price for the next year.
  - If the fluctuations are seasonal, but the whole year's requirements are purchased at one time, the weighted average of the likely prices to be paid should be treated as the standard price.
  - If prices fluctuate from one year to another, a careful estimate of the price likely to prevail next year, based on a statistical study, should be adopted as the standard price.

ADVANTAGES AND CRITICISM OF STANDARD COSTING

Advantages

- It serves as a basis for measuring operating performance and cost control.
- It serves as a signal for prompt corrective action.
- It aids price fixing.
- It facilitates evaluation of jobs & introduction of incentives.
- It facilitates the estimation of the cost of new products with greater accuracy.
- It serves as a basis for inventory valuation.
- It is used in planning, budgeting and decision making.
- It is also used for the measurement of profit
- Standard costing is used in standardisation of products, operations and processes, it improves the overall production efficiency and reduces costs.

Crtiticism

- **Variation in price:** The variability of prices is so great that even actual prices are not necessarily adequately representative of cost.
- **Varying levels of output:** If the standard level of output set for predetermination of standard costs is not achieved, the standard costs are said to be not realised. This may be true only in some industries of jobbing type. In majority industries, use of forecasting techniques help to estimate output with reasonable accuracy.
- **Changing standard of technology:** In case of industries that have frequent technological changes affecting the conditions of production, standard costing may not be suitable.
- **Attitude of technical people:** Technical people are accustomed to think of standards as physical standards and, therefore, they will be misled by standard costs. Since technical people can be educated to adopt themselves to the system through orientation courses, it is not a big difficulty.
- Level of Performance Standards may be either too strict or too liberal because they may be based on (a) theoretical maximum efficiency, (b) attainable good performance or (c) average past performance. To overcome this difficulty, the management should give thought to the selection of a suitable type of standard.
- Fixation of standards may be costly