

The use of standard costing as a control tool a new era essay sample

[Economics](#)



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Standard Costing became increasingly widespread at the beginning of the 20th century as a system for determining the manufacturing unit cost of a product, by setting standard rates and required material quantities for various production processes (Hyer & Wemmerlöv, 2002). Drury (2008) state that “ Product standard costs are derived by listing and adding the standard cost of operations required to produce a particular product.” The popularity of this technique increased significantly in the manufacturing industry, mainly because it could be used as a mechanism for managing cost, which could then be used to set product prices.

Over the years, standard costing systems have become more than just cost control tools by helping managers in other decision-making areas, such as performance evaluation and profit measurement. However, towards the end of the 20th century, standard costing has been increasingly criticised as an inadequate management technique. Authors such as, Kaplan and Johnson (1987), Ferrara (1995) and Monden and Lee (1993) have argued that standard costing is inconsistent in today’s extremely competitive and global business environment. They maintain that standard costing can produce certain types behaviour that could threaten the survival of modern businesses. Despite, the growing concerns regarding the application of standard costing in a rapidly changing economic environment, standard costing has remained a relatively common tool among business managers and is still regularly taught to students on various accounting and management courses.

This paper aims to critically analyse the use of standard costing as a control technique in a new era. Firstly, standard costing will be examined so as to <https://assignbuster.com/the-use-of-standard-costing-as-a-control-tool-a-new-era-essay-sample/>

understand its application in the business world. Secondly, arguments from various researchers will be presented, which support and criticized the use the standard costing. Finally, these arguments will be weighed, so as to draw conclusions as to whether standard costing is still relevant in this new international economic climate.

WHAT IS STANDARD COSTING AND HOW IS IT USED?

CIMA (2008) defines standard costing as a “ control technique that reports variances by comparing actual costs to pre-set standards, so facilitating action through management by exception. The principle of ‘ management by exception’ which applies to standard costing, allows managers to focus on issues relating to costs that deviate from the pre-set standards. Wood & Sangster (2005) note that actual costs that conform to the pre-set standard require little attention, instead management should focus on those actual costs that produce variances and fall significantly outside the standards.

Horngren et al (2002) show that finding the standard cost of a product or service basically requires two groups of calculations. According to Horngren et al, standard costing “ traces (a) direct costs to output produced by multiplying the standard price or rates by the standard quantities of inputs allowed for actual outputs produced and (b) allocates indirect costs/[overheads] on the basis of the standard indirect rates times the standard quantities of the allocation bases allowed for the actual output produced.” KMPG (2010) argues that under standard costing, indirect cost or overheads related to producing a single unit can be directly attributed to the

product cost or included in the product cost by using an absorption technique.

The pre-set standards of standard costing give information regarding the cost of producing one unit of a particular good or service. According to CIMA (2008) “ a standard cost is a carefully predetermined unit cost, which is prepared for each cost unit. It contains details of the standard amount and price of each resource that will be utilised in providing the service or manufacturing a product.” Drury (2008) explains that standard costs can be determined by using historical/prior period data or by using engineering studies. Drury states that “ with engineering studies, a detailed study of each operation is undertaken based on careful specifications of materials, labour and equipment and on controlled observation of operations.”

It is generally agreed that before standard costs can be developed, the organisation’s production system should be broken into recurring task. Lucas (1997) contends that the scientific management engineers, who support standard costing, divide production operation into a number of simple repetitive tasks, so as to gain the benefit of specialisation and also minimize time wastage from workers switching from one task to another. By identifying key tasks within the production system, standard costing allows management to pinpoint the specific production areas that might be accountable for those variances. The idea of accountability and dividing the production system into repetitive tasks makes standard costing ideal for manufacturing businesses. However, standard costing can also be applied to

service providing organisations, where output can be clearly translated into some unit of measurement.

BENEFITS OF USING STANDARD COSTING

Standard Costing gained widespread popularity since its invention due to the useful information it provides managers, which can then be used to make informed decisions. Different organisations use standard costing for various purposes; however researchers have generally outlined five main reasons for adopting standard costing.

CONTROL TOOL

The use of standard costing as a control tool is seen by many as one of its most important feature, because it allows managers to make a variety of control decisions that can improve the overall productivity of an organisation. An important task in any business is to minimize cost in order to maximize profit. Standard Costing allows managers to control costs by analysing the variances that arise between standard cost per unit and the actual cost per unit. Through variance analysis managers can perform responsibility accounting, which allows them to check efficiency and highlight those activities that do not perform to the set standard. These variances generally relate to the three main aspects of production, which include material, labour and overheads. Once these activities have been highlighted, employees can be held accountable for them and steps can be taken to remedy the problem, so that the standards are maintained.

Drury (2008) notes that “ only by comparing total actual cost with total

standard cost, for each operation or responsibility centre for a period can control be effectively achieved.”

PERFORMANCE EVALUATION AND MOTIVATIONAL TOOL

Standard Costing provides a yardstick to against which performance can be measured by using the standards as a base. The fact that it can measure performance can be used to motivate employees to achieve the standards set. Mott (2008) asserts that “ standard costing engenders cost consciousness in employees who know that costs are being monitored and it can act as motivator if the standards are realistically set.” Likewise, Drury (2008) suggests that research has shown that by setting standards, businesses create defined quantitative goals or targets, which motivate employees to achieve higher levels of performance than if there were no standards at all.

PRICE SETTING AND INVENTORY VALUATION TOOL

The ability to set price is a key task in any manufacturing or service producing business. Standard Costing gives managers the ability to develop the standard cost of a product or service, which is seen by many as the first step to scientifically setting price. Once a standard cost is determined, businesses can easily apply a mark-up to that cost, which can help forecast the potential profit on each unit. Jawaharlal (2002) states that “ standard costs as compared to actual costs can be used for estimating selling prices. When standard unit costs are available, expected costs and sales prices can be computed on the basis of standard costs. ” Additionally standard costing

can be used as valuable tool for valuing inventory at various stages of the production process.

BUDGET SETTING TOOL

Standard Costing can be particularly helpful in developing a budget because of the similarities between standard costing systems and budgeting systems. Hofstede (2003) contends that if current costs are charged to products, then the standard cost for all products during a year will be equal to the yearly budget. According to Hofstede “ the difference between the standard cost system and the budget system is that standard cost systems split all cost product-wise and budget systems split all cost department-wise.” Similarly, Drury (2008) states that having a standard costing system considerably reduces the time taken to prepare budgets because the standard costs of operations and products can be used to find total costs used in creating budgets.

SIMPLE TO SET-UP

The ability to accurately cost products and services is a necessary function of many businesses; therefore some costing system is essential. The task of implementing a costing system can be a time consuming and financially expensive project. However, as compared to other costing systems standard costing is relatively easy to set-up and requires less financial capabilities to do so. It is generally agreed that costing systems, such an Activity Based Costing (ABC) system can give a more accurate costing of products and services, because it identifies activities in an organization and assigns the

cost of each activity resource to all products and services according to the actual consumption and provides a more accurate allocation of indirect costs.

However, according to Accounting for Management (2010b), “ Implementing an ABC system is a major project that requires substantial resources. Once implemented an activity based costing system is costly to maintain.” It is for this reason, as of the year 2000, Horngren (2002) notes that around 70% of manufacturing companies within the United Kingdom still use some form of standard costing system within their organisation.

CRITICISMS OF STANDARD COSTING IN A MODERN BUSINESS ENVIRONMENT

The rapid changes in today’s business environment have led some researcher to question the widespread use of standard costing systems. It is believed that standard costing can generate behaviour that conflicts with the strategic objectives of modern manufacturing businesses and these objectives need to be maintained in order for businesses to survive.

Researchers have argued that the weaknesses of standard costing, in this current global business environment, no longer make it a suitable cost control tool. These weaknesses have been highlighted in regards to globalisation, shorter product life cycles and increases in consumer wealth.

GLOBALISATION

Today, many companies operate internationally, with businesses in several regions of world. When doing business in these different regions, companies must sometimes adjust by adopting business techniques that might be

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suitable for that particular market. In countries such as Japan, the Just in Time (JIT) production system is widely used in manufacturing businesses. This system aims to decrease costs, therefore increasing profits, by eradicating unnecessary stockpiling of inventory and efficiently using workspace. Standard Costing supports continuous production, which can require large amounts of inventory. Also, in order to reduce cost, standard costing also supports production of large batches, which lowers cost by spreading various fixed overheads over a large number of outputs and by buying inventory in bulk in order to gain product discounts.

Sulaiman, et al. (2004), explain that “ The implementation of JIT in Japanese manufacturing concerns has been cited as a strong reason for the falling down of the significance of standard costing, [because] the traditional cost accounting measures centred on standard costs make dysfunctional effects inside the organization resulting excess stock, increase in cost, lost opportunities, decrease in quality.” These issues make the two techniques incompatible. In a global environment, it is inevitable that business will encounter similar practices that are suitable for their target market, but are inconsistent with standard costing. However, De Zoysa & Herath (2007) explain that empirical evidence shows that standard costing is still widely used despite the increasing popularity of new techniques, such as JIT, and this suggest that the other benefits of standard costing outweigh its inconsistency with these new techniques.

Global companies often aim to maintain quality and consistency within their operations by implementing useful management approaches, such as

standard costing, to the various markets in which they operate. However, implementing standard costing on a global scale can prove to be problematic, because communication regarding standards can be misrepresented, therefore making comparison difficult. According to KPMG (2010), “Comparability of standard cost and variances can be compromised by inconsistent local application of global methodologies.” KPMG also notes that this problem can be monitored if management clearly defines the standards set and regularly checks them to ensure global consistency is maintained.

SHORTER PRODUCT LIFE CYCLES

In this new era of significant economic volatility, product life cycles have shortened due to increased competition and rapid changes in consumer behaviour. It is believed that these changes can negatively impact businesses that use standard costing because the information generated by using standard costing is only useful for a short period of time (Sulaiman, Ahmad et al, 2005). Therefore, companies need to frequently update standard costs when there is increased volatility, which can be more costly than the benefits gained from using standard costing. However, economic volatility is a constant phenomenon when companies operate many markets with high competition and shortened product life cycles. De Zoysa & Herath (2007) assert that “When the life cycle of products become short, even if the standard cost of each product is established by using the detailed scientific analysis, the benefits that derive from such standards are very small compared to the costs incurred to establish such standards and the

short time available to apply those standards. Under such situations, companies may be reluctant to establish standard cost systems.”

Shorter product life cycles and high levels of competition have increased the need for continuous product innovation. This has led some researchers to contend that the standard costing suppresses continuous improvement by compelling employees to achieve standards. According to Accounting for Management (2010), standard costing can facilitate innovation by following the trends highlighted when standard and actual costs differ. Accounting for Management (2010a) explains that “ Just meeting standards may not be sufficient; continual improvement may be necessary to survive in the current competitive environment. For this reason, some companies focus on the trends in the standard cost variances – aiming for continual improvement rather than just meeting the standards. “

For standard costing to work as a control mechanism, variances between standard and actual cost need to be analysed, so that corrective actions can be taken if the variances are found to be significant or negative. Cheatham and Cheatham (1996) have concluded that shorter product life cycles makes manufactures more reliant on automated systems, which can be so efficient that they make variances obsolete. Variance analysis is a core element of standard costing; therefore if this element is no longer useful, then standard costing as whole becomes ineffective. Gagne & Discenza (1992) explain that “ with the use of statistical quality control and automation, the production processes are very consistent and reliable. Variances often cease to exist.” Lucas (1997) contends that in cases where variances are obsolete, emphasis

should be directed towards the product design stage because significant costs are incurred in this phase.

INCREASED CONSUMER WEALTH

As the business environment has evolved, consumer wealth has increased, which in turn has resulted in consumers demanding higher quality goods. Given the extremely competitive industries in which some businesses operate, it is no longer profitable for businesses to compete solely on lower prices, through the reduction of cost, because a large group of consumers now demand higher quality products. This had led to companies implementing such management techniques as Total Quality Management (TQM), which focuses on improving and maintaining quality. Standard Costing is primarily concerned with reducing cost of producing a unit of a good or service, but in the process of doing so; the quality of that good or service can be sacrificed.

The increase in consumer wealth has made it essential for some businesses to compete on quality. Lucas (1997) contends that though cost control can be detrimental to product quality; this is not enough to justify abandoning the use of standard costing, because cost reduction is just as important. To maintain quality, some researchers have argued that Activity Based Costing (ABC) systems are more suitable, because they can be easily integrated with continuous improvement programs (Accounting for Management, 2010b). Alternatively, Lucas (1997) suggest that both cost and quality control can be maintained by implementing such techniques as ‘ Kaizen Costing’ used by Toyota, which uses similar cost control elements of standard costing.

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CONCLUSION

The weaknesses of standard costing have increased as the business environment has evolved. These weaknesses have been shown to be quite inconsistent with strategic objectives businesses aim to achieve, in order to survive in today's competitive environment. However, having a costing system, such as a Standard Costing system, is essential to many businesses regardless of its flaws. This can be proven by the large number of businesses that still use standard costing, despite the very vocal criticisms it has been subjected to.

Many critics of standard costing systems support the use of Activity Based Costing (ABC) as a suitable alternative, because it can more accurately cost products and services, as compare to standard costing. However, as noted, ABC systems can be extremely costly to implement and maintain. All business cannot afford to implement such expensive costing systems, but they still need to implement a costing system that allows them to control costs. It can be argued that having some costing system is better than none at all and standard costing has been proven to provide many benefits despite the weaknesses outlined.

Since standard costing has come under attack, there have been many suggestions that aim to rectify some the weaknesses it faces in this modern environment. While ABC systems might be superior in some ways, for those businesses where implementing such a system is not an option, standard costing should be used and more focus should be directed at further

rectifying its weaknesses, so as give those less financially capable businesses a more accurate costing system.

The changes within the environment due to globalisation, shorter product life cycles and increased consumer wealth can be proven to have a negative impact on standard costing; nevertheless, the core principles of standard costing remain sound. However, these principles can benefit from being updated. Researchers have shown that it is possible improve some elements of standard costing, so as to make it more adaptable to the current business environment. A costing system that has solid principles with scope for improvement should not be rendered obsolete, because it still is a significantly valuable management tool.

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STANDARD COSTING REFLECTIVE REPORT

The experience of writing this paper has been interesting because it has given me broader understanding of standard costing. My previous studies have generally given me a significant understanding of the calculation aspect of standard costing, but this paper allowed me to delve deeper into the issues that standard costing faces in this current economic environment, where globalisation, shorter product lifecycles and increased consumer wealth all of potentially negative impacts. The research has shown me that while these events might damage the value of standard costing, it is still a useful management tool.

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As well as broadening my understanding of standard costing, this paper has given me insight into other management tools that could be used along with or instead of standard costing such as the Just in Time (JIT) and the Activity Based Costing (ABC) techniques. In my academic studies, I have not encountered all of these techniques; therefore this paper has increased my knowledge of current management techniques that might be useful in an actual working environment.

As this paper has shown, a cost system is essential to many businesses, therefore, being able to understand costing systems, such as standard costing is an asset in the business world. The knowledge gained from this research will allow me to form a rounded opinion of standard costing, because I now have an understanding of its cons and pros. It is my belief that this will allow me to become more marketable as a potential professional accountant.