

Is standard costing
relevant in a modern
business
environment?



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The Origin of Standard Costing

Industrial revolution marked the end of a small market exchange that occurred between individuals or organizations. These exchanges required accurate bookkeeping records to help in doing business in an open manner. However, the situation changed in the seventeenth century when the Royal Wallpaper Manufacturing Company in France implemented cost accounting to help in determining the relationship between labor and available materials in a bid to ensure that the goods produced by the company would meet a given standard (Fleischman and Tyson 1998, 93). A British accountant, Gorge P. Norton remains the father of standard costing when he introduced Textile Manufacturers Bookkeeping in 1889, and three years after his detailed report, an Anglo-American, Charter Harrison, who had a deep understanding of firm management established the first complete system of the standard cost (Innes and Falconer 1990, p. 13). Moreover, Harrison provides a clear and in-depth analysis of labor which formed the most considerable fraction production costs and, in most cases, considered to be variable. According to Harrison, workers suffered more because they did not know their exact working hours in a week, and in most cases, they had to report very early in the morning because timekeeping was majorly based on books. Consequently, cost accountants developed a more explicit framework to identify the total number of hours, under which employees work.

The concept of standard costing became predominant by the start of the 20th century in the manufacturing industries to provide a system of determining the cost of a manufactured product through weighing rates and the quantities of material used in the process of production (KPMG Financial <https://assignbuster.com/is-standard-costing-relevant-in-a-modern-business-environment/>

Report, 2018, p. 3-7). The standard cost of a product is obtainable by listing and adding all the standard costs of operations necessary in enhancing the creation of a given product. In the United Kingdom, the concept of standard costing was first applied to the United Steel Companies Limited. The company employed the system during the inter-war period, from 1920 to 1938, before the onset of the Second World War (Ijiri, 2018 p. 24). It is evident that the company borrowed some innovative concept from the United States' engineering and scientific companies that had adopted budgetary and standard costing. Consequently, a significant change occurred in management and the accounting process in the company; thus, leading to massive profits. As a result, the standard costing became more dominant in the manufacturing industries because it formed the basis of managing the cost of production and ultimately setting a standard price for the products.

After the Second World War, a lot of manufacturing and building industries, especially in the United Kingdom, began to reinforce the implementation of standard costing. Even though Maclean and Tyson argue that standard costing and budgetary control had a mere effect on most of the companies, there are some ship-building companies, primarily in the northeast coast of England, that employed the technology in its operations (2006, pp. 400-401). Most of the industries in west Scotland were reluctant in adopting scientific management technology and enjoy standard costing because they believed in having traditional information and were not willing to have variance analysis in their companies. All in all, in the 21st century, standard costing forms scientific management in nearly all manufacturing industries across

the world. It's beyond a reasonable doubt that the importance of having a well-laid foundation of calculating all the cost involved in producing a product is significant in determining a standard price for the latter.

Modern Business Environment and its Prospects

The introduction of standard Costing in the early 20th century led to a massive change in the business environment from cost control, stock valuation, and budgeting process. The latter has led to an increase in the performance due to the full application of technology and continued operations in the competitive market. First, the introduction of automation system led to the creation of a natural environment in Britain, with most of the firms abandoning the standard costing system to apply variance analysis in their firms to analyze their business environment (" Researchomatic n. d, para. 1-3). The same scenario applies to the US, where a lot of textile and apparel manufacturing companies are re-opening due to a new system of analyzing labor costs (Drury, 2013). Thus, proving that the current business environment brought about by standard costing is useful in the world market. Additionally, several manufacturing industries in India are applying standard costing to ensure that they increase their sales within a given time frame (Attiea 2010, p. 4). It is evident that Indian companies use standard costing to carry out cost function analysis. Industries in Dubai use standard costing for budgeting within global markets like other well-established countries (Attiea 2010, p. 6). Therefore, they are using the approach to make a sound decision that affects their level of operations.

Even though there is a massive crisis of standard costing, its prospect is bright due to its continuous use in the manufacturing industries. Most manufacturing industries that use standard costing have the ability to gain additional cost information that will enable managers to carry out the evaluation process, profit measurement and evaluating performance (Hasan 2015, p. 12). The firms will have greater insight, allowing them to make a decision and provide a basic outline of requirements for the betterment of the industry (Attiea 2010, p. 9). Moreover, the approach offers a strategic review in the way manufacturing firms are operating; thus, it helps to determine the profitability of the firm (Badem and Drury 2013, 22). . The variance systems help in providing firms with specific information on how to peruse zero production deficits. In doing so, they offer a precise analysis of how to explore labor and achieve standard output which is very instrumental in the future of any business.

Criticisms of Standards Costing

Even though accountants believed that standard costing is an instrumental factor aimed at meeting the needs of the business environment by creating a more defined and system of operations. The latter has not been the case with a majority questioning the applicability of the approach in modern businesses (Fleischman and Tyson 2008, pp. 342). The main point of their criticisms is based on the changing cost structure, diversity in the modernism management systems, over-emphasis on the relevance of having direct labor, and a delay in giving out feedback.

Changing cost Structure

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It is evident that most companies suffer from overhead costs that have become additional factory costs. As a result, direct labor cost has reduced in value leading to many of the firms becoming short-term and fixed. Since standard fixing is the system that views to be suitable in enhancing direct and variable costs, bringing fixed and indirect damages make its effectiveness questionable. Hiding to some of the recent analysis on cost structure, it is clear that many factories spend 75% direct costs and 25% average overhead of the total manufacturing cost (Drury, 2013, 27). From the report, direct materials dominate the cost of manufacturing in the manufacturing industries. As a result, direct labor cost becomes less significant and may fall under short-term variable costs. Therefore, analysis of standard costing becomes more appropriate in analyzing variable overheads and the cost of direct materials making it less useful; thus, drawing a lot of critics from most of the managers in different companies.

Inconsistency with Modern Management Approach

The changing nature of technologies make various organizations adopt new management practices that aim at enhancing zero defective production, but deliver high standard goods and services, and at the same time give room for improvement. It is evident that variance analysis has no correlations of supporting the contemporary managerial philosophies. The management is always set to look for new ways of obtaining suitable materials but at the lowest cost possible. The latter is achievable through having many suppliers and choosing one from them, purchasing materials in bulk in a bid to get discounts, or having indifference with the aim of only accepting on-time deliveries. In the contemporary world, factories focus more on their <https://assignbuster.com/is-standard-costing-relevant-in-a-modern-business-environment/>

performance rather than on purchasing functions. According to Drury (2013, p. 33) volume variance is crucial in meeting companies financial and accounting requirements since it motivates managers to expand the output and seek for relevant ways of improving inventories within the firm. The philosophy is essential in enhancing performance by increasing customers' satisfaction. These companies set defined standards. Therefore, standard costing can only remain relevant when used to measure the trend in performance, and ultimately give a rate of change of a company's performance. Moreover, for it to be effective, there is a need for reviewing and making improvements so that it can be relevant to companies.

Over-Emphasis of Direct Labor

Even though direct labor is continuously diminishing, standard costing variance analysis focuses more on it. The latter only remains to be a small part of the factory costs but used in the overhead allocation base. Thus, in a bid to reduce the allocation, managers tend to reduce labor allocation (Drury 2013, p. 45). The over-emphasis on direct labor results in an increase of indirect labor due to an error in the application of standard costing resulting from an excessive focus on volume variance for having short-term costs rather than performance. Therefore, standard costing becomes irrelevant because volume variance is primarily crucial in meeting financial and accounting obligations instead of focusing on cost control.

Delayed Feedback Reporting

Company's performance primarily depends on a timely report that provides room for the implementation of various proposed changes. Different <https://assignbuster.com/is-standard-costing-relevant-in-a-modern-business-environment/>

companies have different ways of preparing a performance report, with some carrying it out weekly or monthly. Hiding the fact that operations always take place in a factory daily, then, these lengthy timeframes prove unessential in improving day-to-day control operations (Drury 2013, p. 55). In the manufacturing industries, labor and materials should always be available at a real-time to ensure purposes of operational control. It is evident that long reporting hours make standard costing to be irrelevant for most manufacturing companies to use since there is need to have immediate feedback in a bid to have a clear framework of improving the operational process.

Addressing the Criticisms

Using Cost Management Approach:

In a bid to have a more practical solution, a management approach should be changed. Companies should apply cost leadership strategy because the method employs analysis on cost control abilities, a similar function that can be addressed by standard costing, given the fact that they will both aim at examining actual costs. It is evident that other management strategies, like scientific management, do not depend solemnly on reducing the cost of operation only, but the entire welfare of the company, making it hard for managers to focus solely on business operations that will help to reduce operation cost, at the expense of other factors (Freedman 2017, para. 2). Therefore, using cost leadership strategy will help to solve the criticism of inconsistency with the modern management approach that works towards

having a zero-defective production through exploring all the available options so that they can provide better goods and services at a reduced cost.

Applying New Technologies in Manufacturing Companies

Moreover, most of the manufacturing companies should employ a push system of management rather than the demand-pull system which pays more attention to direct labor. In recent days, the focus of manufacturing firms is to have a well-defined mechanism that reduces labor cost, considered an overhead allocation base. Therefore, concentrating on the company's performance should remain the top priority for manufacturing firms. In achieving this, manufacturing companies should apply various strategies that help to ensure performance. For instance, they should use a Just-in-Time system, a supply-chain-management that will help divert the emphasis from direct labor to direct cost of carrying out the production process (Bragg, 2018, para. 4). Apart from applying JIT policy to reduce over-emphasis on direct labor, firms should be in a position of implementing new technologies in manufacturing for example: automation, flexible manufacturing styles and cell manufacturing that has helped to shift the focus from direct labor variance. It is evident that firms using these technologies apply less or no labor, and as a result, it is possible to rate the labor use and make appropriate variances in a bid to have efficiency variances.

Variance reports are always essential in keeping managers informed about the various operations and when there is a difference between actual performance and the standards set. In any manufacturing company, control

production and cost involved is a timely matter that shows speed and variance in the report. Therefore, in order to address the problem of delayed reports, managers should immediately focus on off-standard conditions after every shift, that is day and nights instead of accumulating variance to summarize them at the end of a week or a month (Dugdale, D. and Lyne, 2006, p. 27). A week or a month is a long period in manufacturing industries to address the off-standard problems which makes it difficult to identify employees who are responsible for the production of unsatisfactory work. It is evident that carrying out quick reviews of variance will help to disclose areas that require urgent attention, and at the same time providing a manager with relevant information that will help him or her to make sound decisions that will affect the future of the company.

Financial Reviews

In a bid to solve the problem of cost structure, manufacturing companies should hire a financial analyst to continuously review financial statements of the company so that changes in commercial systems can be addressed as early as possible. The review will help to identify unnecessary expenses that have no added value to the company. The analyst should determine the cost structure of the manufacturing company, allowing the manager to find some feasible methods of reducing cost without necessarily affecting the quality of the product produced (Freedman 2017, para. 6). Moreover, an analysis should also have a close check on the cost trends so that there is continuous cash flow through cash allocations. Therefore, the latter will help to explain the main direct and indirect costs to be prioritized when handling the company's financial records.

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Alternatives to Standard Costing

Process Costing

Process costing is one of the best choices that can be used instead of standard costing. Most manufacturing industries produce goods in wholesome, and therefore, it becomes difficult to identify individual cost involved, since the output cannot be differentiated from the input. That is, the cost involved in manufacturing a product is always assumed to be the same for all products produced in the company (Panchenko 2017, p. 16). The method is useful in manufacturing industries, since it is rarely affected by the changing cost structure and over-emphasis of direct labor but accumulate all the cost involved in production over a given period, summarize the costs and provide allocations to various units based on consistency.

The effectiveness of the method is brought about by the application of the job costing mechanism used in accumulating relative costs and assigning both direct and indirect damages to products produced. Additionally, this process allows for the use of hybrid costing system to help in customizing elements that are instrumental in ensuring that all the necessary resources are available for use. The cost involved in implementing this process is less compared to carrying out standard costing, and that is why most of the food production and oil refining companies use the method to determine their cost of production (Panchenko 2017 35). Therefore, this process helps in managing the company's resources since it helps to understand the cost involved in producing a single product from mass items provided. As a result,

a manager will be in a position of knowing the specific costs involved in the production of products in the industry.

Target Costing

Manufacturing firms can also employ an approach alternative to standard costing. The approach is instrumental in developing quality, functionality and enhancing profits in a bid to ensure that the target cost is met. During production, there is a maximum amount of cost firms will incur when producing their products; therefore, it is the sole responsibility of the firm to set up a target price that will enable it to sell the products at a given price, to cater for the cost of production (Cooper 2017, pp. 3-16). Therefore, this approach involves having a well-planned design of production and determining all the value required from creation until the product reaches customers. The method is more appropriate than standard costing since it consists in achieving the desired loss rather than minimizing the cost of production, thus involving analysis of a value chain, and how the firm should cooperate with others in order to ensure the target value. Therefore, a management accountant will help to determine the based avenue of presenting both direct and indirect costs to ensure that the final price helps in accounting for all the cost involved in the production.

Conclusion

To summarize the argument, standard costing has been a vital factor in the growth of organizations in the past. It has allowed managers of firms to gain valuable information and aid with decision making. However, the creation of better alternatives such as process and target costing make standard costing <https://assignbuster.com/is-standard-costing-relevant-in-a-modern-business-environment/>

seem a little old fashioned, especially with the new technologies evolving every day. Therefore, we can say that standard costing is becoming slightly irrelevant within a modern businesses environment due to the changing of the world and inventions of better alternatives.

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