Objectives of standard costing

What is the definition of standard costing?

Standard costing is the system of using standard costs. Standard costing involves using the predetermined costs/standard costs to compare with the actual to find the difference or variance. Variance can be adverse (actual result is worse than standard) or favorable (actual result is better than standard). An adverse variance tells management that if everything else stays constant the company's actual profit will be less than planned. Whereas, a favorable variance tells management that if everything else stays constant the actual profit will likely exceed the planned profit.

- What are the major objectives of standards costing?
- What are types of cost standards?

The standard is the level of attainment accepted by management as the basis upon which standard costs are determined. There are four different standards to consider which are current standard, ideal standard, basic standard and normal standard. A current standard is a standard which is established for use over a short period of time and is related to current condition. It reflects the performance that should be attained during the current period. The period for current standard is normally one year. It is presumed that conditions of production will remain unchanged. In case there is any change in price or manufacturing condition, the standards are also revised. Current standard may be ideal standard and expected standard. However, ideal standard is the standard which represents a high level of efficiency. Ideal standard is fixed on the assumption that favorable conditions will prevail and management will be at its best. The price paid for materials will be lowest and wastes etc. will be minimum possible. The labor time for making the production will be minimum and rates of wages will also be low. The overheads expenses are also set with maximum efficiency in mind. All the conditions, both internal and external, should be favorable and only then ideal standard will be achieved. Ideal standard is fixed on the assumption of those conditions which may rarely exist. This standard is not practicable and may not be achieved. Though this standard may not be achieved, even then an effort is made. The deviation between targets and actual performance is ignorable. In practice, ideal standard has an adverse effect on the employees. They do not try to reach the standard because the standards are not considered realistic. Third standard which is basic standard may be defined as a standard which is established for use for an indefinite period which may a long period. Basic standard is established for a long period and is not adjusted to the preset conations. The same standard remains in force for a long period. These standards are revised only on the changes in specification of material and technology productions. It is indeed just like a number against which subsequent process changes can be measured. Basic standard enables the measurement of changes in costs. For example, if the basic cost for material is Rs. 20 per unit and the current price is Rs. 25 per unit, it will show an increase of 25% in the cost of materials. The changes in manufacturing costs can be measured by taking basic standard, as a base standard cannot serve as a tool for cost control purpose because the standard is not revised for a long time. The deviation between standard cost and actual cost cannot be used as a yardstick for measuring efficiency. The last one is normal standard. As per terminology, normal standard has been defined as a standard which, it is anticipated, can be attained over a future period of time, preferably long enough to cover one trade cycle. This standard is based on the conditions which will cover a future period of five years, concerning one trade cycle. If a normal cycle of ups and downs in sales and production is 10 years, then standard will be set on average sales and production which will cover all the years. The standard attempts to cover variance in the production from one time to another time. An average is taken from the periods of recession and depression. The normal standard concept is theoretical and cannot be used for cost control purpose. Normal standard can be properly applied for absorption of overhead cost over a long period of time.

What are the advantages and disadvantages of standard costing system?

Standard costing have several advantages. First advantage of standard costing is as a key element in a management by exception approach. If costs remain within the standards, managers can focus on other issues. When costs fall significantly outside the standards, managers are alerted that there may be problems requiring attention. This approach helps managers focus on important issues. Second advantage is standard costing is standards that are viewed as reasonable by employees can promote economy and efficiency. They provide benchmarks that individuals can use to judge their own performance. Besides that, standard costs can greatly simplify bookkeeping. Instead of recording actual costs for each job, the standard costs for materials, labor, and overhead can be charged to jobs. Last but not least, standard costs fit naturally in an integrated system of responsibility accounting. The standards establish what costs should be, who should be responsible for them, and what actual costs are under control. However, the use of standard costs can present a number of potential problems or disadvantages. Most of these problems result from improper use of standard costs and the management by exception principle or from using standard costs in situations in which they are not appropriate. Standard cost variance reports are usually prepared on a monthly basis and often are released days or even weeks after the end of the month. As a consequence, the information in the reports may be so stale that it is almost useless. Timely, frequent reports that are approximately correct are better than infrequent reports that are very precise but out of date by the time they are released. Some companies are now reporting variances and other key operating data daily or even more frequently. Besides that, if managers are insensitive and use variance reports as a club, morale may suffer. Employees should receive positive reinforcement for work well done. Management by exception, by its nature, tends to focus on the negative. If variances are used as a club, subordinates may be tempted to cover up unfavorable variances or take actions that are not in the best interest of the company to make sure the variances are favorable. For example, workers may put on a crash effort to increase output at the end of the month to avoid an unfavorable labor efficiency variance. In the rush to produce output quality may suffer. In some cases, a " favorable" variance can be as bad as or worse than an " unfavorable" variance. For example, McDonald's has a standard for the amount of hamburger meat that should be in a Big Mac. A " favorable" variance would mean that less meat was used than standard specifies. The result is a substandard Big Mac and possibly an unsatisfied customer. Another problem of using standard costing, there may be a tendency with standard cost reporting systems to emphasize meeting the standards to the exclusion of other important objectives such as maintaining and improving quality, on-time delivery, and customer satisfaction. This tendency can be reduced by using supplemental performance measures that focus on these other objectives. 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. In other companies, engineered standards are being replaced either by a rolling average of actual costs, which is expected to decline, or by very challenging target costs. In sum, managers should exercise considerable care in their use of a standard cost system. It is particularly important that managers go out of their way to focus on the positive, rather than just on the negative, and to be aware of possible unintended consequences. Nevertheless standard costs are still found in the vast majority of manufacturing companies and in many service companies, although their use is changing. For evaluating performance, standard cost variances may be supplanted in the future by a particularly interesting development known as the balanced scorecard.

How standard costs are sets?

Standards should be set for the quantities and prices of materials, labour and services to be consumed in performing each operation associated with a product. Product standard costs are derived by listing and adding the standard costs of operations required to produce a particular product. Two approaches are used or setting standard costs. First, past historical records can be used to estimate labour and material usage. Secondly, standards can be set based on engineering studies. With engineering studies a detailed study of each operation is unedertaken under controlled conditions, based on high levels of efficiency, to ascertain the quantities of labour and materials required. Target prices are then applied based on efficient purchasing to ascertain the standard costs.

How a standard costing system operates?

Standard costing is most suited to an organization whose activities consist of a series of repetitive operations and the input required to produce each unit of output can be specified. A standard costing system involves the following:

The standard costs for the actul output are recorded for each operation for each responsibilty centre.

Actual costs for each operation are traced to each responsibility centre.

The standard and actual costs are compared.

Variances are investigated and corrective action is taken where appropriate

Standards are monitored and adjusted to reflect changes in standard usage and/or prices.

Variances

What is the main purpose of variance analysis?

There are very few plans that turn out exactly as planned. Even when the overall objectives of the plan are achieved, some, if not all components of the performance will have varied from the sub-plans or standards that make up the overall picture. For example, a football team may win an important game, as planned, but within the team performance there may be many aspects that the manager will analyse during and after the match so that performance can be improved for next time. As in business, good points need to be encouraged, less positive aspects need to be discussed and corrected. In a game of football, a side may have won a high number of corner kicks, but conceded too many free-kicks in defending. There is little to be gained for the next match if we do not think about the last performance in detail.

Variance analysis provides a framework for business managers to breakdown the overall performance of an organisation, so that each individual element of the business can be isolated and analysed in turn.

What are the causes of labour, material, overhead, and sales margin variances?

Quantities cost variances arise because the actual quantity of resources consumed exceed actual usage or vice versa. Examples include excess usage of materials and labour arising from the usage of interior materials, careless handling of materials and failure to maintain machinery in proper condition. Price variances arise when the actual prices paid for resources exceed the standard prices or else. Examples include the failure of the purchasing function to seek the most efficient sources of supply or the use of a different grade of labour to that incorporation in the standard costs.

How to calculate material, labour, variable overhead, fixed overhead, and sales variances.