UCCC & SPBCBA & SDHGCBCA & IT

SYBCOM SEM-4

ADVANCED ACCOUNTING & AUDITING (PAPER-3)

CH: STANDARD COSTING

THEORY NOTES

Meaning

Standard costing is a system of cost accounting which is designed to find out how much should be the cost of a product under the existing conditions. Then the pre-determined cost is compared to the actual cost of production in order to find out the variance between the two. This enables the management to take necessary corrective measures.

Definition

The standard costing has been defined by the London Institute of Cost and Works Accountants as "An estimate cost, prepared in advance of production or supply correlating a technical specification of material, and labour to the price and wage rates estimated for a selected period of time, with an addition of the apportionment of overheads expenses estimated for the same period within a prescribed set of working conditions"

Steps involved in Standard Costing

Standard costing involves the following steps:

1. Determining the standard cost for the product.
2. Recording the actual cost incurred for the product.
3. Comparing the standard cost and actual cost for the same product.
4. Finding out of the variance.
5. Reporting of variance so as to find out inefficiency and take necessary corrective measures.

Advantages of Standard Costing

1. Measures Efficiency: By comparing the standard costs with actual costs the management can evaluate the performances of various cost centres.

2. It helps in the formulation of production and price policy: It becomes easy to formulate production plans by taking into account standard costs. It is also helpful for finding prices of various products.

3. Reduction of clerical work: Management is supplied with useful information in order to reduce the clerical work to a considerable extent.

4. Facilitates Cost control: Standard costing helps to achieve the aims of costing system, such as cost control and cost reduction.

5. Eliminates Inefficiency: For setting standards for different elements of cost, different studies are conducted (say for example: time and motion study to have control over labour and material). All these studies will make it possible to eliminate inefficiencies at different stages.

6. Management by Exception: With the use of standard costing, the targets of different individuals are fixed. If the things are going as per targets, then the management can devote its time to other important things.

7. Helps in taking important decisions: Standard costing provides useful information to the management in taking important decisions.

Limitations of Standard Costing

1. Standard costing cannot be used for products made according to the customer's specifications.
2. It requires a lot of time and money.
3. The conditions under which standards are fixed do not remain static.
4. The fixing of targets for different individuals is not an easy task.
5. In the era of technological development, standard costing system is not suitable.

ANALYSIS OF VARIANCES

Variance means deviation of actual performance from that of the standard. The variances may be favourable and unfavourable. If actual cost is less than the standard cost, the variance will be favourable. On the contrary, if actual cost is more than the standard cost, the variance will be adverse (or) unfavourable. The variances are related to efficiency. If variances are favourable it will show efficiency and if variances are unfavourable it will show inefficiency.

Classification of Variances

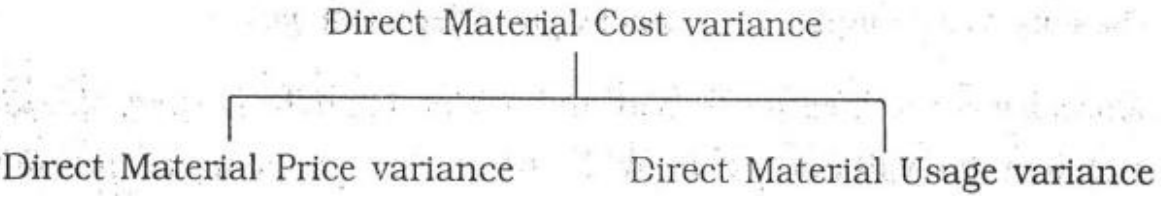
The variances may be classified into the following categories:

(1) Direct Material Variances

(2) Direct Labour Variances

Direct Material Variances

Direct Material Variances may be divided as under:



Direct Material Cost Variance

Direct Material cost variance is the difference between the standard material cost and actual material cost. Material cost variance arises due to the differences in the prices of materials used and the quantity of materials used.

Direct Material Price Variance

Material Price variance is a part of material cost variance. It is due to the differences in the Standard Price and Actual Price of Materials.

It may arise due to the following reasons:

1. Changes in basic prices of materials.
2. Discount on Purchases.
3. Bulk Purchases.
4. Freight on Purchases.
5. Time of Purchases, etc.

Direct Material Usage Variance

Material usage variance is another part of material cost variance. It arises due to the difference in standard quantity of materials and actual quantity of material used.

This variance may arise due to the following reasons:

1. Negligence in the use of materials.
2. Wastage by untrained workers.
3. Defective methods of production.
4. Pilferage, etc.

(1) Direct Material Cost Variance (DMCV) =

$$\left[\begin{array}{c}\text{Standard price}\\ \text{per unit of}\\ \text{raw material}\end{array} \times \begin{array}{c}\text{Standard quantity}\\ \text{of raw material}\\ \text{for actual output}\end{array}\right] -$$

$$\left[\begin{array}{c}\text{Actual price}\\ \text{per unit of}\\ \text{raw material}\end{array} \times \begin{array}{c}\text{Actual quantity}\\ \text{of raw}\\ \text{material}\end{array}\right]$$

(2) Direct Material Price Variance (DMPV) =

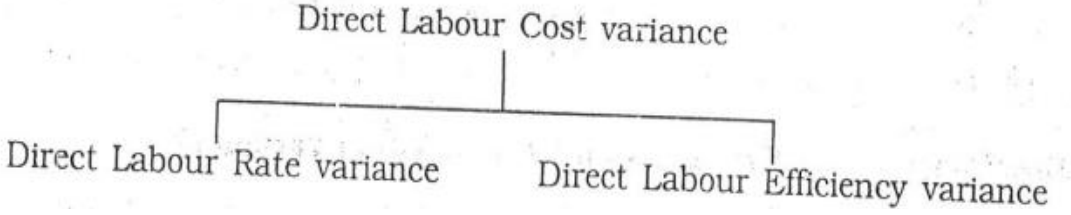
$$\begin{array}{c}\text{Actual}\\ \text{quantity of}\\ \text{raw material}\end{array} \left[\begin{array}{c}\text{Standard price}\\ \text{of raw material}\\ \text{per unit}\end{array} - \begin{array}{c}\text{Actual price}\\ \text{of raw material /}\\ \text{unit}\end{array}\right]$$

(3) Direct Material usage Variance (DMUV) =

$$\begin{array}{c}\text{Standard price of}\\ \text{raw material per}\\ \text{unit}\end{array} \left[\begin{array}{c}\text{Standard quantity}\\ \text{of raw material}\\ \text{for actual output}\end{array} - \begin{array}{c}\text{Actual quantity}\\ \text{of raw material}\end{array}\right]$$

Direct Labour Variances

Labour variances can be discussed as follows:



Direct Labour Cost Variance

It arises due to a change in either wage rates or in labour efficiency (time) or in both.

Direct Labour Rate Variance

It is a part of labour cost variance. It arises due to a change in wage rate.

The reasons for this variance are:

1. Change in basic wage rate.
2. Different grades of Employees.
3. Payment of more overtime wages.

Direct Labour Efficiency Variance

It is another part of Labour cost variance. It arises due to difference in labour time. (i.e. between Standard time and Actual time of Labour).

The reasons for this variance are:

1. Lack of proper supervision.
2. Defective machinery and equipment.
3. Bad working conditions.
4. Lack of training to workers.
5. Unsatisfactory personnel relations.

The following are the formula for computing the Labour Variances:

(1) Direct Labour Cost Variance (DLCV) =

$$\left[\begin{array}{c}\text{Standard Labour}\\ \text{time for actual}\\ \text{output}\end{array} \times \begin{array}{c}\text{Standard}\\ \text{Rate}\end{array}\right] - \left[\begin{array}{c}\text{Actual}\\ \text{Labour}\\ \text{Time}\end{array} \times \begin{array}{c}\text{Actual}\\ \text{Rate}\end{array}\right]$$

(2) Direct Labour Rate Variance (DLRV) =

$$\begin{array}{c}\text{Actual}\\ \text{Labour}\\ \text{Time}\end{array} \left[\begin{array}{c}\text{Standard}\\ \text{Rate}\end{array} - \begin{array}{c}\text{Actual}\\ \text{Rate}\end{array}\right]$$

(3) Direct Labour Efficiency Variance (DLEV) =

$$\begin{array}{c}\text{Actual}\\ \text{Labour}\\ \text{Time}\end{array} \left[\begin{array}{c}\text{Standard Labour}\\ \text{Time for Actual}\\ \text{Output}\end{array} - \begin{array}{c}\text{Actual}\\ \text{Labour}\\ \text{Time}\end{array}\right]$$