Standard Costing

Definition

An accounting system that records the cost of operations at pre-determined standards. The system informs managers if the business is being badly managed or not. Standard costs are essential for the setting of budgets.

When actual costs differ from standards, this may be due to:

a) producing more/less goods than budget
b) using more/less materials than budget
c) the costs of the materials may be more/less than budget
d) labour may be more/less efficient than expected
e) wages may be more/less than budget

The differences between actual costs and budgeted costs are called VARIANCES.

Types of Standards

1. IDEAL STANDARDS
   – can only be met under perfect conditions
   - unrealistic as they are unlikely to be attained
   - demotivate managers

2. CURRENT STANDARDS
   - based on present levels of performance
   - may not apply to the future
   - no incentive to improve efficiency
   - only used when conditions are uncertain

3. ATTAINABLE STANDARDS
   - take wastage of materials and idle time of labour into account

Advantages of Standard Costing

1. make it easier to prepare budgets
2. reasons for variances are easy to identify
3. essential part of responsibility accounting *(judging managers on how well they perform within set budgets ie in financial terms)*
4. helps to estimate costs of new products and quotations for orders

Flexing Budgets

Budget volumes of production are seldom the same as Actual levels of production. In order to compare the actual costs to the budget costs, the budget need to be based on the actual number of products produced. This is called *flexing* the budget.

How to flex a budget?

IMPORTANT - only the sales and the variable expenses are adjusted to the actual volume of production.

Formula: $\dfrac{\textbf{Actual volume produced}}{\textbf{Budget volume produced}}$ **x budget variable expenses**

OR $\dfrac{\textbf{Budget Variable expenses}}{\textbf{Budget volume produced}}$ **x Actual volume produced**

Flexing budgets with semi-variable expenses?

Usually, production overheads and selling and distribution expenses do not vary in direct proportion to levels of production. This is because these costs usually contain a fixed cost as well as a variable cost portion.

Steps:

1. Find the production overhead cost per unit for the difference in units produced by:

   $\dfrac{\text{Flexed overhead – budget overhead}}{\text{Flexed units – budget units}}$

2. Calculate the Fixed costs: total budget production overheads – (budget units produced x unit cost from 1above)

3. Calculate the production cost: Fixed cost from 2 above + (flexed production level x unit cost from 1 above)

Variances

A Variance is the difference between the standard (budgeted) revenue and costs and the actual revenue and costs.

Variances must be described as ADVERSE or FAVOURABLE

Variances may be calculated for:

1. **Sales variances**

   a) Sales Volume Variance = Master budget sales – Flexed budget sales **(MBS – FBS)**

   b) Sales Price Variance = Flexed budget sales – Actual Sales **(FBS – AS)**

2. **Total Cost Variance** = Master budget total costs – actual total costs **(MBTC – ATC)**

3. **Quantity Variance** = Master budget total costs – Flexed budget total costs **(MBTC – FBTC)**

4. **Total Direct Labour Variance** = Flexed budget direct labour – Actual Direct Labour **(FBDL – ADL)**

5. **Total direct materials variance** = Flexed budget direct materials – Actual direct materials **(FBDM – ADM)**

6. **Total Overhead Variance** = Flexed budget total overheads – Actual total overheads **(FBTO – ATO)**

Commenting on Variances

1. Material usage variance

FAVOURABLE	ADVERSE
Better quality materials	Poor quality materials
Better skilled labour	Use of lower skilled labour

2. Labour rate variance

FAVOURABLE	ADVERSE
Employ lower skilled labour	Use of highly skilled labour
Wage decrease	Wage increase

3. Sales Volume variance

FAVOURABLE	ADVERSE
Lower selling price	Increased selling prices
In – season time of year	Goods became unfashionable / obsolete
Special discounts to selected customers	New products about to be launched
Less competitors	Increased competition

4. Sales Price Variance

FAVOURABLE	ADVERSE
Increased prices (due to increased costs)	Prices decreased (due to more competition)
Fewer discounts to customers	More discounts to customers
Better products so prices been increased	Prices decreased to sell more products