

FINANCIAL MANAGEMENT

# Standard costing

Insights from leading companies

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ADVISORY

in association with

**CIMA**

Chartered Institute of  
Management Accountants

# Executive Summary

The current economic crisis has created significant cost pressures on businesses. This coupled with foreign exchange, raw material and commodity price volatility has increased the focus on the appropriateness, application and use of standard costs.

Historically many companies have tended to calculate standard costs annually based on underlying costs at the time of budget preparation. In times of economic stability these standard costs have provided a good measure against which to manage the business through the following financial year. However, recent volatility has often resulted in significant management time being invested in understanding variances against standard cost that are driven largely by non-controllable macro-economic factors rather than the more useful and value-add activities of understanding and addressing manufacturing efficiency and effectiveness.

In the light of the current climate KPMG in the UK has undertaken some global research designed to highlight the current trends and issues around standard costing. This document sets out a summary of the key findings of that research.

All companies surveyed use standard costs and variances to value inventory for statutory purposes, for management reporting purposes and for performance measurement and management. Despite its prevalence no respondents are finding it easy to obtain the information and insight required to satisfy all three of these areas.

Key insights and themes from the survey include:

## 1. Standard costing is sometimes over-used as a decision making tool:

Where standard costing is used its limitations are not always fully understood with users often treating it as a science rather than an art. Many companies are moving away from using standard costing as their primary tool for pricing or global supply chain sourcing decisions.

## 2. Comparability of standard costs and variances can be compromised by inconsistent local application of global methodologies:

Many groups have one global approach but only a few can claim globally consistent application.

## 3. The best groups invest in governance and organisation structures to maintain the right balance between efficiency and insight:

Centralised and focussed variance calculation frees up local resources to focus on analysis, interpretation and action.

## 4. Understanding the key components of a standard product cost is vital:

At times using an extract of the standard cost card may be more appropriate to support certain business decisions, for example using direct costs only to support marginal production decisions. The best companies had more than one cost per SKU so had the functionality to identify just direct costs, best ever standard, asset optimised standard, local country standard and global standard for each SKU.



## 5. Increased economic volatility is leading to more frequent standard cost updates:

In general companies are updating standard costs on an annual basis however the trend is towards allowing more frequent updates in particular where significant underlying cost changes have been seen.

## 6. Policies and practices around absorption of overheads in standard costs vary:

Recent trends towards centralisation of support functions have often led to inclusion of what are now central overheads in standards despite the lack of control over these at a factory level.

## 7. Standard costs can be used as aspirational performance targets but care should be taken to ensure they do not bake in inefficiency:

Inclusion of wastage, scrap or under utilisation of assets in standards can lead to inefficiency on the shop floor and hence value leakage.

## 8. Effective performance management focuses on controllable costs:

Costing effort, variance analysis and remediation activity should focus on the controllable elements of performance.

## 9. Levels of automation vary but spreadsheets remain rife:

No respondents are finding standard costing easy or effortless, this is a resource intensive process. Leading groups are struggling to fully automate standard costing globally within ERPs and still rely in part on spreadsheets.



# About the research

KPMG in the UK conducted both telephone and face to face interviews covering 12 largely Fortune 500 manufacturing groups during summer/ autumn 2009 across the following sectors:

- Pharmaceuticals
- Consumer goods
- Industrials

There is a growing recognition from all interviewees that more sophistication is required around their costing methodology. Leading companies are using extracts of the standard cost card most relevant to a particular business decision or calculating more than one standard cost card to drive different behaviours, for example:

1. Use only direct costs for marginal production decisions
2. Build an alternative cost card based on an assumption of full asset utilisation
3. Build an alternative cost card based on best ever achieved cost

Further research by Cambridge University, commissioned by KPMG, indicates that as much 50 percent of management do not trust the information presented to them. This is due in large part to the use made of the information as well as the governance models deployed around it. In many organisations there is inconsistent ownership and application of definitions and standards. Many global companies are finding that communication regarding standards is misinterpreted, which makes like-for-like comparison difficult, if not impossible. Further challenges are that the information is not produced through a trusted channel and much manipulation of data is required. Organisations that have solved this problem are able to significantly reduce the cost of information delivery, speed of production and improve the usability (reference – KPMG report 2009: *Does your business intelligence tell you the whole story?*).

We conducted a series of interviews aimed at understanding the overall methodology including the policies and processes by which a number of global groups are calculating their standard costs as well as how those groups are using their standard costing information either as a control or otherwise.

All groups interviewed had a global supply chain.

Interviewees comprised group finance directors, group financial controllers, divisional finance directors, divisional finance controllers, supply chain finance directors and their direct reports, and factory controllers. The interviews were conducted using a standard structured questionnaire.

This document summarises the main findings against each of nine key themes identified.

## Background

### Standard costing – what do we mean?

CIMA, the UK's Chartered Institute of Management Accountants 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". It goes on to further set out that 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 the product".

Costs included within standards comprise direct material costs, direct labour costs together with indirect or overhead costs. For the purposes of this paper we have assumed the following definitions:

1. **Cost allocation** – the process of collecting together certain types of overhead cost related to production, and planned to be included within standard costs, such that it can then be either directly attributed to a product cost or included within a product costs by means of an absorption technique.
2. **Cost absorption** – the process of apportioning costs including those identified above to individual stock keeping units (SKUs) or products on the basis of production activity.

# CIMA commentary

This research by KPMG into standard costing illustrates the importance of ensuring the right information is both made available and used effectively. This provision of the most relevant management information and its proper use is part of a much wider issue of significance to business leaders and management accountants.

The Walker Review which scrutinised corporate governance in the UK financial sector highlighted the need for non executive directors to be better informed and more engaged. But non executive directors can never be close enough to the business to be certain of their precise information needs, nor to influence management's decision making at an operational level. This is because good governance at board level is a necessary but not a sufficient condition to ensure good performance and risk management.

It is difficult for the decision makers in any organisation to maintain a keen understanding of its competitive position, drivers of value, potential risks or even its fundamental economics; its revenues and costs.

Management accountants have a vital role to play in filtering the financial and other management information, including leading indicators and analysis, about position, costs, performance, risks and opportunities that is provided to decision makers. They can also help to implement strategy and cascade performance and risk management throughout the business. This 'percolator effect' is essential to ensuring not only good governance but also the proper management of the firm in the long term interests of shareholders and other stakeholders.

The shortcomings in costing information found in this KPMG survey illustrate why this percolator effect, with information filtered up and influence cascaded down, is crucial. In my opinion it's time to wake up and smell the coffee.

Leading organisations are already transforming their finance functions to be more efficient and provide better information to enable evidence based decision making. They are also developing and deploying management accountants who can influence performance and risk management in the long term interests of stakeholders. Organisations not transforming their finance function in this way could be putting their competitive position at risk.

**Charles Tilley**  
**Chief Executive CIMA**

## Key themes identified through our research

### **1. Standard costing is sometimes over-used as a decision making tool:**

Leading companies had very clearly defined where standard costing should be used as the primary decision support tool, and indeed where it should not be used. However, a number of participants were less structured in their approach and had not formally defined whether standard costing should be used as an indicator or measure for any or all of inventory valuation, performance management, factory efficiency, product sourcing (both short term / one off and long term), one off contract pricing decisions and overall pricing decisions.

Some of the survey participants had moved away from the use of standard costing as a key measure of operational effectiveness and long term sourcing decisions preferring instead to use other operational or financial measures and internal and external benchmarking.

Several of the survey participants had invested in enhancing the business-wide understanding of the strengths of, limitations of and alternatives to standard costing through training and communications.

### **KPMG point of view:**

Standard costing remains an important part of any decision making toolkit but it should not be the whole answer.

Companies that adopt industry best practice formally define where standard costing should be used as a primary measure or indicator for decision making, where it would be appropriate to use standard costs as a secondary or supporting measure and where standard costs should not be used.



**2. Comparability of standard costs and variances can be compromised by inconsistent local application of a global methodology:**

One of the most efficient approaches calls for one global methodology and one group-wide standard cost card together with a limited number of focussed extracts to support specific defined decisions.

The level at which participants define their standard cost methodology varies, with some groups simply setting an overall group-wide policy to say, fully absorb factory overheads, others defining specifically on a line by line basis the costs to be included within standards and the method by which to include them.

A number of groups defined one overhead allocation or absorption method however others left the decision as to the method used to the local factory controller's discretion.

**KPMG point of view:**

Consistent definitions are not enough in themselves. To deliver valuable information they should be applied consistently at a local level.

Organisations should seek to clearly define the items to be included in standard cost and the allocation and absorption methods to be used for overheads and then put in place governance structures to ensure data integrity is maintained.

**3. The best groups invest in governance and organisation structures to maintain the right balance between efficiency and insight:**

One participant had formed a 'global costing council' to set policy, ensure consistency and opine on items that should or should not be included within standards.

One of the groups surveyed had moved the back office analysis activity related to standard costs and variance analysis into higher value shared service centres leaving only the value adding analysis, interpretation and response activity at the factory.

**KPMG point of view:**

Centralised governance and centres of excellence focussed on calculating variances can help reduce inconsistencies and free up local factory based staff to understand and address the issues highlighted at the factory level.

**4. Understanding the key components of a standard product cost is vital:**

Half of the population surveyed had defined more than one type of cost for certain SKUs or products. A small number of the participants had defined these additional costs as a 'slice' or 'carve outs' from their standard cost cards; these defined 'slices' of cost are used to support marginal production decisions, measure performance and assist with long and short term sourcing decisions.

**KPMG point of view:**

Flexibility is a key element helping to ensure the right information is used to support the right decisions.

The most effective organisations stratify their business, products or decisions and determine where it would be valuable for decision making purposes to have more than one cost type per SKU.

**5. Increased economic volatility is leading to more frequent standard cost updates:**

Many groups update standard costs on an annual basis; increasingly groups are providing the option for more frequent updates when necessary.

Only one of the survey participants updated standard costs more frequently than annually, in this case quarterly. One group had chosen not to update standards for two years given the time and resource requirements of the update process.

In the current economic climate several groups were finding that an in-year update had been or was expected to be necessary reflecting commodity raw material price changes, foreign exchange movements and / or partial or full factory closures. In-year updates could be dealt with on a group-wide or factory specific basis.

**KPMG point of view:**

Standard costs should be updated at least annually and more frequently in times of economic turbulence.

In the current economic climate provision should be made for in-year updates, in particular where there are significant commodity price and foreign exchange movements or changes to the shape of the business. Time boxing the update process provides a means of limiting the drain on resources encouraging an 80/20 approach focussing activity on material items.

### 6. Policies and practices around absorption of overheads in standard costs vary. What costs should you include in standards and how fully absorbed should you be?

A number of participants allowed or required the inclusion of certain central overheads such as shared service centre costs. Many specified that only factory level overheads could be absorbed into standards however on further enquiry exceptions to this rule were often found.

Two participants chose not to absorb overheads during the year but instead to include such costs in inventory valuation by way of a year end adjustment.

All groups chose to adopt an asset life rather than product life approach to the inclusion of depreciation in standards.

While pure development costs were excluded from standard cost by all participants a number did include the costs of certain product development activity.

There was no clear trend in the treatment of freight costs when calculating standard cost factory specific basis.

#### KPMG point of view:

The level of absorption in standard costs is driven by a company's culture and behaviours around cost management.

Some form of allocation and absorption of overhead at the SKU, product or factory level is preferable in terms of the day to day management of your overall inventory levels. However we support the exclusion of certain costs in defined situations as part of the 'slicing and dicing' of your standard cost card. The key is have clear definitions and consistent application across the organisation to deliver valuable information. Where costs are not fully absorbed it is very important that finance communicate with those making decisions so they can understand what the standard cost includes and excludes.

### 7. Are standard costs aspirational performance targets or do they bake in inefficiency? – e.g. the inclusion of wastage, scrap or under utilisation of assets in standards can lead to inefficiency on the shop floor and hence value leakage:

A number of participants use their standard costing to drive performance improvement, choosing to set standards at a target 'best ever achieved' or 'asset optimised' level.

One participant found that in using standard costs as a target they were at times driving the wrong behaviours on the shop floor. Instead of striving for continuous cost reduction, once a target had been achieved workers continued to aim to meet that target rather than exceed.

#### KPMG point of view:

Significant shareholder value can leak through under utilised assets and or accepting normal wastage levels. Over periods of time in setting standards these core assumptions should be challenged. Where used correctly having more than one cost per SKU or using 'best ever standard' can drive behaviours to improve efficiency.

### 8. Effective performance management focuses on controllable costs:

A number of the participants make 'bonus' or 'performance' adjustments to remove the non-controllable elements included within standard costs and variance analysis when assessing individual, factory or regional results.

Adjustments are often manual and made on an ad hoc or one-off basis making performance comparisons across people, products and sites less meaningful and adding complexity to the performance management process.

#### KPMG point of view:

Focusing costing effort, variance analysis and remediation activity on the controllable elements of performance is vital, this enables management focus to shift variance analysis to understanding and acting rather than calculation and analysis.

### 9. Levels of automation vary but spreadsheets remain rife:

While many of the groups included in the research had group-wide or regional ERP systems very few benefitted from significant automation of standard costing and variance analysis. The majority of groups continue to rely on a significant number of spreadsheets to support this activity.

#### KPMG point of view:

Automation of the end to end standard costing and variance analysis process is not easy and this is usually a resource intensive process. Effective, value add use of resources and appropriate governance and control of off-system calculations is important in deriving value for money from your standard costing process





# Summary

Standard costing is an important financial tool that often is used to determine dimensional profitability e.g. the profit by customer, by product and by channel.

Standard costing needs to be considered in a wider framework of business intelligence where companies are seeking to improve performance and competitiveness.

Ensuring that the right information is delivered to the right people at the right time and focussing on how strategies and operations are connected can improve strategic competitiveness.

KPMG firms have developed a six layered business intelligence framework. Our professionals have found that some companies have failed to apply sufficient resource and investment to each layer on a sustainable basis.

## KPMG's Business Intelligence framework

KPMG Framework	Leading Practice
Business Strategy Alignment	<ul style="list-style-type: none"> <li>Align information requirements to strategic objectives</li> <li>Provide clarity of the role of standard costs in decision making</li> </ul>
Governance	<ul style="list-style-type: none"> <li>Define rigid process with clear guidelines via global costing council</li> <li>Develop one standard policy that is applied consistently across all global divisions</li> <li>Use shared services and centres of excellence to produce standard reports and variance analysis</li> </ul>
Performance Management Process & Reporting	<ul style="list-style-type: none"> <li>Automate data collection</li> <li>Concentrate on understanding and corrective action rather than collection and analysis</li> </ul>
Integrated Information Management	<ul style="list-style-type: none"> <li>Gain clarity and agreement on data definitions globally</li> <li>Remove data duplication</li> <li>Ensure there is dimensional profitability matching revenue with costs</li> </ul>
Business Intelligence Platform	<ul style="list-style-type: none"> <li>Consolidate tools and ensure application ability is maximised</li> <li>Exploit "software as a service"</li> </ul>
Infrastructure	<ul style="list-style-type: none"> <li>Standardise</li> </ul>

Research has demonstrated that as much as 50 percent of management do not trust the information presented to them. Addressing the relevance, timeliness and consistency of your standard cost information is a first step on the pathway to enhancing your business intelligence.

### Special thanks

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