Strategic Cost Accounting

M. Com (Semester IV)
Unit-IV
Topic- Target Costing

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What is Target Costing?

Target costing is a system under which a company plans in advance for the price points, product costs, and margins that it wants to achieve for a new product. Target costing is not just a method of costing, but rather a management technique wherein prices are determined by market conditions, taking into account several factors, such as homogeneous products, level of competition, no/low switching costs for the end customer, etc. When these factors come into the picture, management wants to control the costs, as they have little or no control over the selling price.

According to Computer Aided Manufacturing International (CAM-I) "A market-based cost that is calculated using sales price necessary to capture a predetermined market share is known as Target Cost." In competitive industries, a unit selling price is set independent of initial cost of the product. If target cost is lower than the initial forecast of product cost, the manufacture/producer drives the unit cost to come down over a definite period, so that it should compete. It should be noted that target cost is found by deducting desired profit from predetermined sales price. Hence,

Target Costing = Selling Price – Desired Profit

Here, sales price is one which is appropriate for a targeted market share. Desired profit is the contribution that the product is expected to make towards the enterprise's business sustaining costs. The residual is target cost. Thus, target costing takes full advantage of the equation Profit = Sales – Costs.

Example:

ABC Inc. is a big FMCG player that operates in a very competitive market. It sells packaged food to end customers. ABC can only charge ₹20 per unit. If the company's intended profit margin is 10% on the selling price, calculate the target cost per unit.

Solution:

Target Profit Margin = 10% of 20 = ₹2 per unit

Target Cost = Selling Price – Profit Margin (₹20 – ₹2)

Target Cost = ₹18 per unit

Features of Target Costing

The main features of target costing are as follows-

- The price of the product is determined by market conditions. The company is a price taker rather than a price maker.
- The minimum required profit margin is already included in the target selling price.
- It is part of management's strategy to focus on cost reduction and effective cost management.
- Product design, specifications, and customer expectations are already built-in while formulating the total selling price.
- The difference between the current cost and the target cost is the "cost reduction," which management wants to achieve.
- A team is formed to integrate activities such as designing, purchasing, manufacturing, marketing, etc., to find and achieve the target cost.

Objectives of Target Costing

The fundamental objective of target costing is to enable management to use proactive cost planning, cost management and cost reduction practices whereby, costs are planned and managed out of a product and business, early in the design and development cycle, rather to a during the later stages of product development and production. Broadly speaking, a target costing system has three objectives:

1. To lower the costs of new products so that the required profit level can be ensured.
2. The new products meet the levels of quality, delivery timing and price required by the market.
3. To motivate all company employees to achieve the target profit during new product development by making target costing a companywide profit management activity.

Process of Target Costing

Target Costing applies to new products and succeeding generations of a product. It begins with understanding the market thoroughly and an intention to satisfy customer needs, concerning product quality, features, timeline and price. The process of target costing is depicted in the following diagram-

Advantages of Target Costing

The major advantages/benefits of target costing are as follows-

- ❖ It shows management's commitment to process improvements and product innovation to gain competitive advantages.
- ❖ The product is created from the expectation of the customer and, hence, cost is also based on similar lines. Thus, the customer feels more value is delivered.
- ❖ With the passage of time, the company's operations improve drastically, creating economies of scale.
- ❖ The company's approach to designing and manufacturing products becomes market-driven.
- ❖ New market opportunities can be converted into real savings to achieve the best value for money rather than to simply realize the lowest cost.

Key Principles of Target Costing:

According to Hilton, target costing involves seven key principles listed as follows:

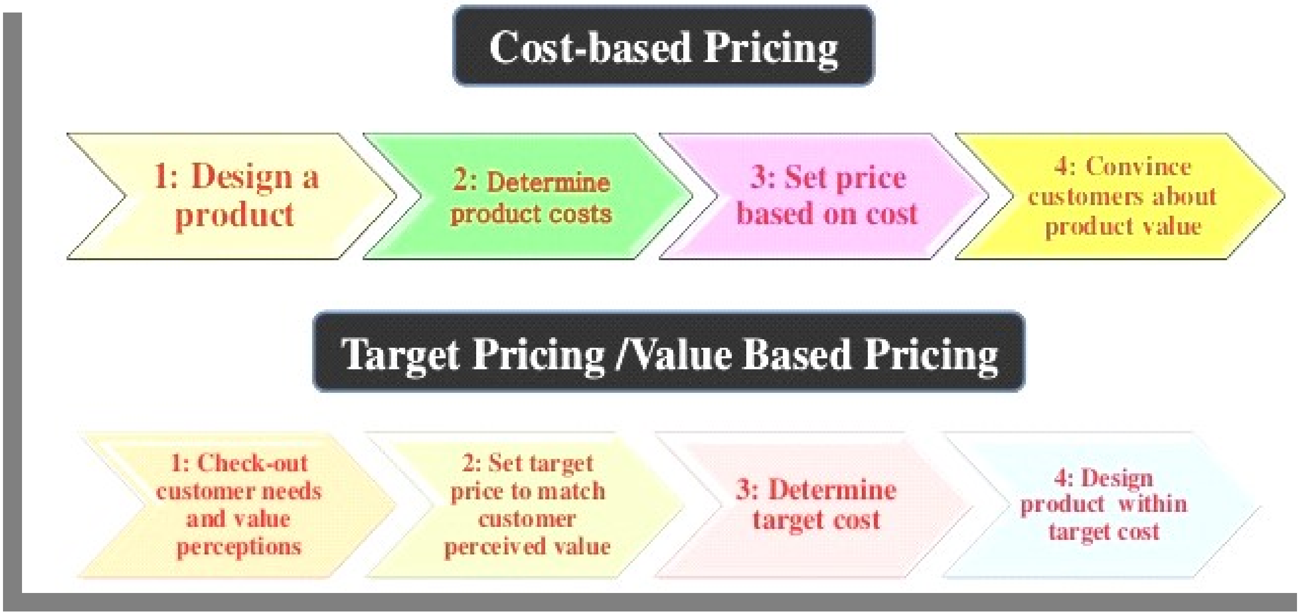
1. **Price-Led Costing:** Target costing sets the target cost by first determining the price at which a product can be sold in the marketplace. Subtracting the target profit margin from this target price yields the target cost, that is, the cost at which the product must be manufactured. Notice that in a target costing approach, the price is set first, and then the target product cost is determined. This is opposite from the order in which the product cost and selling price are determined under traditional cost-plus pricing.
2. **Focus on the Customer:** To be successful at target costing, management must listen to the company's customers. What products do they want? What features are important? How much are they willing to pay for a certain level of product quality? Management needs to aggressively seek customer feedback, and then products must be designed to satisfy customer demand and be sold at a price they are willing to pay. In short, the target costing approach is market driven.
3. **Focus on Product Design:** Design engineering is a key element in target costing. Engineers must design a product from the ground up so that it can be produced at its target cost. This design activity includes specifying the raw materials and components to be used as well as the labour, machinery, and other elements of the production process. In short, a product must be designed for manufacturability.
4. **Focus on Process Design:** Every aspect of the production process must be examined to make sure that the product is produced as efficiently as possible. The use of touch labour, technology, global sourcing in procurement and every aspect of the production process must be designed with the product's target cost in mind.
5. **Cross-Functional Teams:** Manufacturing a product at or below its target cost requires the involvement of people from many different functions in an organisation: market research, sales, design engineering, procurement, production engineering, production scheduling, material handling and cost management. Individuals from all these diverse areas of expertise can make key contributions to the target costing process. Moreover, a cross-functional team is not a set of specialists who contribute their expertise and then leave; they are responsible for the entire product.
6. **Life-Cycle Costs:** In specifying a product's target cost, analysts must be careful to incorporate all of the product's life-cycle costs. These include the costs of product

planning and concept design, preliminary design, detailed design and testing, production, distribution and customer service. Traditional cost-accounting systems have tended to focus only on the production phase and have not paid enough attention to the product's other life-cycle costs.

7. **Value-Chain Orientation:** Sometimes the projected cost of a new product is above the target cost. Then efforts are made to eliminate non-value-added costs to bring the projected cost down. In some cases, a close look at the company's entire value chain can help managers identify opportunities for cost reduction.

Cost-based Pricing vs. Target Pricing Method

A clear picture regarding process of both the methods can be understood by following diagram-



The basic difference between Target Costing and cost based pricing or traditional costing are as follows-

Target Costing	Traditional Costing
1. Competitive market considerations drive cost planning.	1. Market considerations not part of cost planning.
2. Price determine costs.	2. Costs determine price.
3. Design is focus for reducing cost.	3. Inefficiency is focus for reducing cost.
4. Customer input guides cost reduction.	4. Cost reduction is not customer driven.
5. Cross-functional teams manage costs.	5. Cost Accountants are responsible.
6. Suppliers are involved during product design.	6. Suppliers are involved only after product design.
7. Minimizes cost of ownership to customers.	7. Minimizes initial price paid by customers.
8. Involves the whole value chain in cost planning.	8. Little or no involvement of value chain in cost planning.

Conclusion

Target costing is an excellent tool for planning a suite of products that have high levels of profitability. This is opposed to the much more common approach of creating a product that is based on the engineering department's view of what the product should be like, and then struggling with costs that are too high in comparison to the market price.

Target costing is a tool for Cost Management which helps in reducing the cost of a product over its entire life-cycle. Target costing induces those actions which management must take for establishing reasonable target costs, developing methods to achieve these targets and developing the mechanisms to test the cost effectiveness of various reduction efforts.