

2b

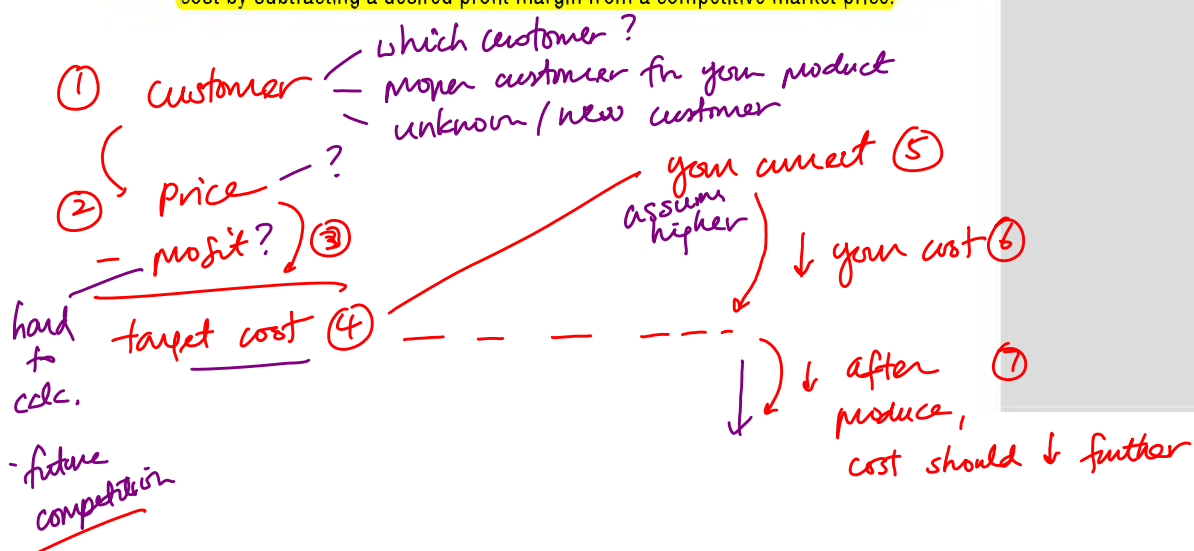
Target costing

Topic list	Syllabus reference
1 What is target costing?	A2 (a)
2 Implementing target costing	A2 (a)
3 Deriving a target cost	A2 (a)
4 Closing a target cost gap	A2 (c)
5 Target costing in service industries	A2 (b)

Introduction

Target costing is the second specialist cost accounting technique we will consider. In the modern competitive environment, organisations have to continually redesign their products or services and it is essential that they try to achieve a target cost during product and process development.

Target costing is a cost management process which involves setting a target cost by subtracting a desired profit margin from a competitive market price.



Study guide

		Intellectual level
A2	Target costing	
(a)	Derive a target cost in manufacturing and service industries	2
(b)	Explain the difficulties of using target costing in service industries	2
(c)	Suggest how a target cost gap might be closed	2

Exam guide

Target costing may form part of a question comparing its use to other costing techniques or it may form an entire question including calculation of a target cost.

1 What is target costing?

life cycle costing

FAST FORWARD

Target costing involves setting a target cost by subtracting a desired profit margin from a competitive market price.

*existing product = have price
12/07
product very common (competitive price)
(some use price)*

- cost
- best price?
- differentiation
- can account for the difference

To compete effectively, organisations must continually redesign their products (or services) in order to shorten product life cycles (see Chapter 2c). The **planning, development and design stage** of a product is therefore **critical** to an organisation's cost management process. Considering possible **cost reductions at this stage** of a product's life cycle (rather than during the production process) is now one of the most **important** issues facing management accountants in industry.

customer is willing to pay

Here are some examples of **decisions made at the design stage** which **impact on the cost of a product**.

- The number of different components
- Whether the components are standard or not
- The ease of changing over tools

cost when designing product - common practice

Japanese companies have developed target costing as a response to the **problem of controlling and reducing costs** over the product life cycle.

connect customer? connect product?

Key terms

Target costing involves setting a target cost by subtracting a desired profit margin from a competitive market price.

Target cost is an estimate of a product cost which is determined by subtracting a desired profit margin from a competitive market price. This target cost may be less than the planned initial product cost but it is expected to be achieved by the time the product reaches the maturity stage of the product life cycle.

*connect market
new entrant
- innovation to product or production process & cost
- if no existing products?*

2 Implementing target costing

6/12

In 'Product costing/pricing strategy' (ACCA Students Newsletter, August 1999), one of the examiners provided a useful summary of the steps in the implementation of the target costing process.

- Step 1** Determine a product specification of which an adequate sales volume is estimated.
- Step 2** Set a selling price at which the organisation will be able to achieve a desired market share.
- Step 3** Estimate the required profit based on return on sales or return on investment. *risk level?*
- Step 4** Calculate the target cost = estimated selling price – target profit.
- Step 5** Compile an estimated cost for the product based on the anticipated design specification and current cost levels.
- Step 6** Calculate target cost gap = estimated cost – target cost.

differentiation strategy cost leadership

Step 7 Make efforts to close the gap. This is more likely to be successful if efforts are made to 'design out' costs prior to production, rather than to 'control out' costs during the production phase.

Step 8 Negotiate with the customer before making the decision about whether to go ahead with the project.

*possible?
customers / market / competition can change
from now to production*



Case Study

Swedish retailer IKEA continues to dominate the home furniture market with more than 300 stores across 35 countries at the end of 2009. The "IKEA concept" as defined on the company website www.ikea.com is "based on offering a wide range of well designed functional home furnishing products at prices so low as many people as possible will be able to afford them."

IKEA is widely known for pricing products at 30-50% below the price charged by competitors. Extracts from the website outline how the company has successfully employed a strategy of target pricing:

"While most retailers use design to justify a higher price, IKEA designers work in exactly the opposite way. Instead they use design to secure the lowest possible price. IKEA designers design every IKEA product starting with a functional need and a price. Then they use their vast knowledge of innovative, low-cost manufacturing processes to create functional products, often co-ordinated in style. Then large volumes are purchased to push prices down even further.

Most IKEA products are also designed to be transported in flat packs and assembled at the customer's home. This lowers the price by minimising transportation and storage costs. In this way, the IKEA Concept uses design to ensure that IKEA products can be purchased and enjoyed by as many people as possible."

3 Deriving a target cost

The target cost is calculated by starting with a market-based price and subtracting a desired profit margin. The target cost is simply the price minus the profit.

3.1 Example: Target costing

A car manufacturer wants to calculate a target cost for a new car, the price of which will be set at \$17,950. The company requires an 8% profit margin.

Required

What is the target cost?

Solution

Profit required = $8\% \times \$17,950 = \$1,436$

Target cost = $\$(17,950 - 1,436) = \$16,514$

The car manufacturer will then need to carefully compile an estimated cost for the new car. ABC will help to ensure that costs allocated to the new model are more accurate.

3.2 Example: Target costing and the target cost gap

Great Games, a manufacturer of computer games, is in the process of introducing a new game to the market and has undertaken market research to find out about customers' views on the value of the product and also to obtain a comparison with competitors' products. The results of this research have been used to establish a target selling price of \$60.

Cost estimates have been prepared based on the proposed product specification.

<i>Manufacturing cost</i>	\$
Direct material	3.21
Direct Labour	24.03
Direct machinery costs	1.12
Ordering and receiving	0.23
Quality assurance	4.60
<i>Non-manufacturing costs</i>	
Marketing	8.15
Distribution	3.25
After-sales service	1.30

The target profit margin for the game is 30% of the proposed selling price

Required

Calculate the target cost of the new game and the target cost gap.

Solution

	\$
Target selling price	60.00
Target profit margin (30% of selling price)	18.00
Target cost (60.00 – 18.00)	42.00
Projected cost	45.89

The projected cost exceeds the target cost by \$3.89. This is the target cost gap. Great Games will therefore have to investigate ways to drive the actual cost down to the target cost.

4 Closing a target cost gap

12/07

The **target cost gap** is the estimated cost less the target cost. When a product is first manufactured, its target cost may well be much lower than its currently-attainable cost, which is determined by current technology and processes. Management can then set **benchmarks for improvement** towards the target costs, by improving technologies and processes. **Various techniques can be employed.**



- Reducing the **number of components**
- Using **standard components** wherever possible
- **Training** staff in more efficient techniques
- Using **different materials**
- Using **cheaper staff**
- Acquiring new, more efficient **technology**
- Cutting out **non-value-added activities** (identified using **activity analysis** etc)

Even if the product can be produced within the target cost the story does not end there. **Target costing can be applied throughout the entire life cycle. Once the product goes into production target costs will therefore gradually be reduced.** These reductions will be incorporated into the budgeting process. This means that cost savings must be actively sought and made continuously over the life of the product.

Exam focus point

When answering a question on closing a target cost gap, make sure you refer to the specific circumstances of the business in the question.

Target costing is difficult to use in service industries due to the **characteristics and information requirements** of service businesses.

5.1 Characteristics of services

FAST FORWARD

Unlike manufacturing companies, services are characterised by **intangibility, inseparability, variability, perishability and no transfer of ownership.**



Examples of service businesses include:

- (a) **Mass service** eg the banking sector, transportation (rail, air), mass entertainment
- (b) **Either / or** eg fast food, teaching, hotels and holidays, psychotherapy
- (c) **Personal service** eg pensions and financial advice, car maintenance

Key term

"Services are any activity of benefit that one party can offer to another that is essentially intangible and does not result in the ownership of anything. Its production may or may not be tied to a physical product."
(P Kotler, *Social Marketing*)

There are **five major characteristics** of services that distinguish services from manufacturing.



- (a) **Intangibility** refers to the lack of substance which is involved with service delivery. Unlike goods (physical products such as confectionery), there is no substantial material or physical aspects to a service: no taste, feel, visible presence and so on. For example, if you go to the theatre, you cannot take the 'play' with you.
- (b) **Inseparability/simultaneity.** Many services are created at the same time as they are consumed. (Think of dental treatment.) No service exists until it is actually being experienced/consumed by the person who has bought it.
- (c) **Variability/heterogeneity** Many services face the problem of maintaining consistency in the standard of output. It may be hard to attain precise standardisation of the service offered, but customers expect it (such as with fast food).
- (d) **Perishability.** Services are innately perishable. The services of a beautician are purchased for a period of time.
- (e) **No transfer of ownership.** Services do not result in the transfer of property. The purchase of a service only confers on the customer access to or a right to use a facility.

5.2 Information requirements of services

FAST FORWARD

Service businesses need the same **aggregate information** as manufacturing firms, but also need performance data as to their cost and volume drivers. Operational information is likely to be more qualitative.

A service business needs a mix of **quantitative** and **non-quantitative** information to price its services properly, to optimise capacity utilisation and to monitor performance.

- (a) They need to control the **total cost** of providing the **service operation.**
- (b) They need positive **cash flow** to **finance activities.**
- (c) They need **operating information** to identify how costs are incurred and on what services.

Arguably, small service businesses, whose expenses are mainly overheads, provide a model, in miniature, of the requirements of **activity based costing.**

Are 'mass services' any different?

(a) Because mass services, such as cheque clearing, are largely automated, there may be a large **fixed cost base**.

(b) Even if a service is heavily automated, each time the service is performed is a 'moment of truth' for the customer. Ensuring consistency and quality is important but this is true for small service businesses too.

Service industries, perhaps more than manufacturing firms, **rely on their staff**. Front-line staff are those who convey the 'service' – and the experience of the brand – to the consumer. They convey the 'moment of truth' with the customer.

For service businesses, **management accounting information should incorporate the key drivers of service costs.**

- Repeat business *loyalty*
- Churn rate (for subscriptions) *
- Customer satisfaction surveys, complaints *measurement*
- Opportunity costs of not providing a service *alternative costs*
- Avoidable / unavoidable costs

* For any given period of time, the number of participants who discontinue their use of a service divided by the average number of total participants is the churn rate. Churn rate provides insight into the growth or decline of the subscriber base as well as the average length of participation in the service.

fast service
kpi
measurement

** info from marketing + sales*
after sales services
warranty cost

- **Target costing** involves setting a target cost by subtracting a desired profit margin from a competitive market price.
- Unlike manufacturing companies, services are characterised by **intangibility, inseparability, variability, perishability** and no **transfer of ownership**.
- **Service businesses need the same aggregate information** as manufacturing firms, but also need performance data as to their cost and volume drivers. Operational information is likely to be more qualitative.

1 Fill in the blanks using words from the list (a) to (h).

Target cost = -

Cost gap = -

- | | |
|----------------------------|-----------------------------|
| (a) target cost | (e) target selling price |
| (b) cost gap | (f) estimated cost |
| (c) budgeted selling price | (g) estimated selling price |
| (d) production cost | (h) target profit |

2 Which of the following are the five major characteristics of services that distinguish services from manufacturing?

- | | |
|------------------------------|-------------------|
| (a) Intangibility | (e) Heterogeneity |
| (b) Perishability | (f) Variability |
| (c) Inseparability | (g) Simultaneity |
| (d) No transfer of ownership | |

- 1 Target cost = estimated selling price – target profit
Cost gap = estimated cost – target cost
- 2 This was a bit of a trick question as there are no 'odd ones out'. Inseparability and simultaneity mean the same thing, as do variability and heterogeneity.