



BANGLADESH  
COST ACCOUNTING  
STANDARDS  
BCAS - 10

Target Costing

## BCAS 10: Target Costing

### 10.1 Introduction

The aim of target costing is to keep the cost within control for ensuring a competitive edge in the market. Cost-plus pricing, a widely used pricing methodology, reined the product costing literature for long; however, lose its rationality in a highly competitive market. If the selling price is set by the market with a selective design and functionality requirement, adherence to that price is the most critical requirement. The product design and development team should work hard to deliver the product at that target price leaving enough profit for the sustainability of the firm in the long run. Thus, the target cost must be achieved after every possible design variations. A target costing methodology brings all of these functions into focus and surely, offers a good number of advantages over cost-plus pricing.

### 10.2 Objectives

- a) The main purpose of target costing, a strategic cost management tool, is to use prospective or estimated cost information during the product and process design phases to reduce a product's life-cycle costs.
- b) Target costing also caters to serve as an organizing, coordinating, and communication method among the members of a cross-functional team charged with product development. Since target costing is market and customer oriented it requires that the organization have a market orientation. At the same time, target costing is implemented using multidisciplinary teams which require a strong organizational commitment so that problem-solving can be implemented as a team approach.
- c) Target costing is a comprehensive planning and control tool that is market focused and design oriented providing the organization with a cost advantage.

### 10.3 Scope

10.3.1 The standard shall be applied for determining the target cost of a product considering the target price of that product which a potential customer is willing to pay.

10.3.2 The **target costing approach** is developed in recognition of two important characteristics of markets and costs.

- a) The first is that many companies have less control over price than they would like to think that the market (supply and demand) really determines prices. Therefore, the anticipated market price is taken as a given in target costing.
- b) The second observation is that most of the cost of a product is determined in the design stage. Once a product has been designed and has gone into production, not much can be done to significantly reduce its cost. Most of the opportunities to reduce cost come from designing the product so that it is simple to make, uses inexpensive parts, and is robust and reliable. If the company has little control over market price and little control over cost once the product has gone into production, then it follows that the major opportunities for affecting profit come in the design stage where valuable features that customers are willing to pay for can be added and where most of the costs are really determined. It is where the effort is concentrated in designing and developing the product.

10.3.3 The standard is to be followed by all public limited companies where cost audit is made mandatory through Government's gazette notification from time to time.

## 10.4 Key Features

The key features of this standard are pointed below -

- a) Defining target cost, target selling price and target profit;
- b) Presenting the methodology of applying target costing to price products;
- c) Developing a multi-tasking team to develop, design and deliver satisfying products;
- d) Demonstrating the benefit of target costing over cost-plus pricing; and
- e) Bringing the issue of cost engineering to keep costs within the target.

## 10.5 Definitions

The following terms are used in this standard with the meanings specified:

- 10.5.1 **Target:** Target is a fixed goal or objective. It is a person or thing at which an action or remark is directed.
- 10.5.2 **Target Cost:** This is the maximum cost that the producer is willing to spend to have the product manufactured.
- 10.5.3 **Target Costing:** Target costing is a pricing method used by many organizations. It is a cost management tool for reducing the overall cost of a product over its entire life-cycle with the help of production, engineering, research and design. A target cost is the maximum amount of cost that can be incurred on a product and with it the firm can still earn the required profit margin from that product at a particular selling price.
- 10.5.4 **Target Price:** Target Price is the price at which a seller projects that a buyer will buy a product.
- 10.5.5 **Product:** A good, idea, method, information, object, or service that is the end result of a process and services as a need or want satisfier. It is usually a bundle of tangible and intangible attributes that a seller offer to buyer for purchase. In this standard product refer to goods and services.
- 10.5.6 **Product Life cycle:** The period of time over which a product is developed, brought to market and eventually removed from the market. The process includes research and development, production, market and rolled out. It encompasses Introduction Stage, Growth Stage, Saturation Stage and Declining Sales Stage.
- 10.5.7 **Cost center/level:** A cost center is a unit that does not generate revenue.
- 10.5.8 **Investment center/level:** An investment center is usually found at higher levels in an organization where a unit manager has the responsibility of generating returns on investment capital.
- 10.5.9 **Satisfying:** Satisfying is an evaluative criterion that looks for decisions that are good enough, in the sense of meeting expectations, rather than optimal.
- 10.5.10 **Value Engineering:** Value engineering is the systematic evaluation of a function to

identify the lowest possible cost of achieving it. Value engineering is usually accomplished in one of two ways:

- a. The planning team might work with component suppliers or redesign the product so that it uses standard components in order to reduce costs and improve quality. This has the effect of reducing flexible costs; or
- b. The planning team might consider an alternative way to build the function into the product so that the function's cost is reduced. This has the effect of reducing both flexible and capacity related costs.

10.5.11 **Price Point:** Price points are prices at which demand for a given product is supposed to stay relatively high.

## 10.6 Standards

10.6.1 *There are six key principles of target costing; namely, price-led costing, focus on customer, focus on design, cross-functional involvement, value chain environment, and a life-cycle orientation.*

10.6.2 Under **price-led costing** principle, the market prices are used to determine the target costs. Target cost is computed by deducting required profit margin from market price (**Target Cost = Market Price – Required Profit Margin**).

10.6.3 Under **focus on customer** principle, customer requirements for quality, cost and time are included in product and process decisions and these parameters guide cost analysis significantly. The value must be greater than the cost of providing those features and functionality.

10.6.4 The cost control is emphasized at the product and process design stage in case of **focus on design** principle. This results in lower costs and reduced "time-to-market" for few products.

10.6.5 In case of **cross functional involvement**, cross-functional product and process teams are responsible for the entire production from initial to final production.

10.6.6 In **value-chain environment**, the value-chain enabler like the suppliers, distributors, service providers and customers are involved in the process.

10.6.7 In case of a **life-cycle orientation**, a total life cycle cost which includes purchase price, operating costs, maintenance and distribution costs are minimized for both the producer and customer.

10.6.8 It is widely believed that between 60% and 90% of a product's life-cycle costs are committed during the planning stage when planners choose the product and process designs.

10.6.9 Once the product and process designs are in place, there is relatively little opportunity for cost improvement and the cost management focus becomes cost containment.

10.6.10 *This insight has led to the understanding that the most effective time to control product life-cycle costs is during the planning stage, not during the active stage when the product is being made.*

10.6.11 *Target costing is market, and therefore customer, oriented. It begins with the*

*product's price, quality, and functionality components that customers demand, and works toward designing a product and process that meet those requirements and whose prospective cost provides an adequate return to the organization. For this reason, practitioners call target costing as price-led costing so as to differentiate its perspective from that of conventional cost plus pricing, which is a form of cost-led pricing.*

**10.6.12** *In target costing, the role of the management accountant is very crucial who provides cost information for planning and coordinating the whole process. Three of such important roles that a management accountant performs can be pointed as below:*

- a) Developing good estimates of the prospective costs needed by the target costing team;*
- b) Serving in the general management role by reconciling the functional orientations of the target costing team members and focusing them on the organization's financial objectives; and*
- c) Ensuring that the allocation of cost reduction targets to subgroups on the target costing team is seen as fair and reasonable.*

**10.6.13** Firstly, the management accountant must ensure the costs used in the planning process are reasonable estimates. There are two types of costs used in target costing:

- a) The product's prospective life-cycle cost, which includes the estimated flexible and capacity related costs of designing, making, delivering, servicing, and terminating the product, given some product and process design; and
- b) The target profit, which is the opportunity cost of capital tied up in the product.

The estimate of prospective costs will be based both on past experience and on benchmarking with comparable processes that the organization now undertakes. The opportunity costs will reflect the deemed investment in the product multiplied by the organization's cost of capital.

**10.6.14** Secondly, the management accountant will often bring the general management perspective to the product design team.

- a) Since functional specialists often bring unique views to the product design team, their individual views will often conflict, thus requiring a super ordinate view that subsumes their individual perspectives to the organization's overall financial objectives. For example, engineers must understand that achieving engineering aesthetics that customers neither value nor are willing to pay to have included in the product is inappropriate.
- b) Similarly, marketing personnel must understand that adding product features whose costs exceed the price increment that customers are willing to pay is also inappropriate. For example, while an engineer will see the product as an engineering marvel, the manufacturing people might see it as a production nightmare.

The role of the management accountant will be that of an honest broker who reconciles the potentially conflicting views of the functional specialists into a profit-oriented view that coordinates the team's activities. In this sense, the management accountant plays a vital role in the target costing value-added team.

- 10.6.15 Thirdly, since the primary role of cost reduction standards in target costing is to motivate individual and group performance, the challenge to the management accountant is to develop performance targets that not only are challenging and achievable but are seen by the group members to be challenging and achievable. This will require the management accountant to develop and justify cost reduction targets in such a way that they are perceived to be achievable with a reasonable level of effort.
- 10.6.16 In addition, and again because the purpose of setting targets is to provide motivation, the management accountant must ensure that the process of dividing the burden of cost reduction among the subgroups of the target costing team is seen by team members as being fair and reasonable. Without a perception of fairness, the motivational effect of target costing will be lost as the team disintegrates into bickering about which group is carrying the largest burden.
- 10.6.17 Target costing is not so much a cost management technique but rather an overall approach or framework within which a range of different techniques are used for the cost management required to achieve the target costs. The choice of technique or combination of techniques varies from one company to another. The techniques used for target costing are value analysis, value engineering, just-in-time (JIT), total quality management (TQM), materials requirements planning (MRP), kaizen, lean manufacturing, activity based costing and management (ABC/M), cause-effect analysis ('fishbone' diagrams). Many scholars describes target costing as a system for reducing cost and promoting the use of cost-engineering tools as mentioned above.
- 10.6.18 Once the target costs have been determined, actual costs can be monitored and managed against the targets using the usual budgeting and costing methods such as standard costing.
- 10.6.19 In implementing target costing, the responsible co-ordination team should be careful about a number of issues as mentioned below to confirm the smooth operation of target costing.
- a) In an organization that traditionally uses a sequential design process the elements of the planning process are virtually uncoordinated. For individuals in that organization to move to a concurrent approach to product and process design will require considerable change. Some members of the development team might find it difficult to adjust to the give and take required in the concurrent design approach to product development that is implicit in target costing.
  - b) Conflicts may arise among members of the project team over the pressure exerted on each member or group to conform the cost reduction and time schedules. This can be particularly problematic when pressure is put on outside suppliers to reduce the cost of purchased materials or components.
  - c) The manager of the design team must be careful when assigning responsibilities so that each member of the team believes that they are being assigned a fair share of the work.
  - d) Reports from practice, particularly in Japan where the idea of target costing is originated and where it is most aggressively practiced, indicate the potential for a high level of employee burnout. The manager of the design team must take special care to ensure that while the target work-level chosen should be challenging, it should not be one that creates either alienation or risks to employee health.

10.6.20 ***Since the target selling price is determined by summing what customers will pay for each of the product's functions, one approach to cost reduction is to compare the cost and increment to product price of each of the proposed product's functions. This cost-benefit evaluation of the product's functions is called functional analysis.***

10.6.21 For example, an automobile manufacturer may be evaluating the computer-controlled ride on one of its luxury vehicles. Functional analysis compares the cost of the proposed design to provide the function, in this case the computer and its related systems, with the value of the function to the customer. If the cost of a function exceeds the retail value it adds to the product's target selling price, the planners have three alternatives:

- a) Ignore the loss on that function and plan to have the margins of price over cost for other functions recover this loss;
- b) Eliminate the function; or
- c) Undertake a process to reduce the cost of that function so that it provides a positive margin, a process called value engineering.

10.6.22 ***Target cost, which is the focusing tool used in target costing, is computed as follows:***

$$\text{Target Cost} = \text{Target Selling Price} - \text{Target Profit}$$

The target selling price is defined by the marketplace and reflects the product's quality and functionality. The target profit is chosen so that the product's profit margin will provide an adequate return on the invested capital that would be required by the selected product and process design. The target profit reflects the required return on capital invested to make the product and is not simply a percentage of target cost or target selling price.

10.6.23 As the product development team alters the product's functionality and quality, the product's target cost, the target profit, and the target selling price will change. Therefore, the target cost is defined by two givens: what the market will pay for the product with a given functionality and what the organization requires as a target profit.

10.6.24 ***It is useful to contrast the target costing formula with the traditional cost plus pricing formula, which is:***

$$\text{Selling Price} = \text{Projected Cost} + \text{Desired Profit}$$

In cost plus pricing, a desired profit is added to the product's projected cost to determine the selling or offering price for the product. While this approach to pricing may have been sustainable in an era with relatively little competition, in the present era of intense global competition most organizations have lost the ability to simply pass on any level of projected cost plus the desired profit to customers.

10.6.24 ***The target cost becomes the focus and organizing medium for the design team's product and process design activities. The idea for the design team is to come up with a prospective cost, which is usually called the as-if cost, that is equal to or lower than the target cost.***

10.6.25 The product design team, including representatives from purchasing, design, engineering, production, and marketing, continues to vary the prospective product's functionality and process design until the products as-if cost is less than its target cost.

- 10.6.26 In this sense, target costing assumes the underlying behavioral phenomenon of satisfying. This leads to the recognition that any decision can be improved if enough additional time and skill are invested. The idea in target costing is to continue investing time and skill until the prospective cost is less than the target cost.
- 10.6.27 Since target costing involves simultaneously varying three planning parameters, viz., target selling price, target cost, and target profit; target costing is only feasible if it is undertaken by a planning group that has, within it, the expertise to evaluate all facets of the planning activity. This creates the need for a multifunctional or multidisciplinary planning team.
- 10.6.28 The multidisciplinary team engages in a process of concurrent design, where the implications go to all the three planning parameters. The changes in product features are evaluated simultaneously by all the members of the team. Concurrent design works to reduce the cycle time of product development while improving the effectiveness of identifying and evaluating tradeoffs among functionality, target price, target profit, and target cost.

## 10.7 Recording and Reporting

10.7.1 As a practical matter the product's target cost is decomposed into:

- a) Final assemblies;
- b) Subassemblies; and
- c) Individual components.

This decomposition serves three purposes:

- a) It allows the delegation of responsibility for cost-cutting;
- b) It supports a systematic evaluation of the cost, the functionality, and the value added by different components of the product; and
- c) It provides data that can be used to decide whether to make or buy components or assemblies.

10.7.2 Once the operational objective is achieved, the planning team has concluded its task because there is a product and process design that meets the customer's requirements and the organization's profitability objectives.

10.7.3 The management accountant must ensure that estimates of cost and investment levels, which are critical components of target costing, are reasonable.

10.7.4 As a member of the product design team, the natural role for the management accountant is to bring both a financial management and a general management or business perspective to the team. As part of the general management role, the management accountant should ensure that the team's focus is on product profitability and that all decisions are evaluated relative to their estimated effect on profitability.

10.7.5 Since target costing is a collaborative process that requires a high level of effort and cooperation from each discipline on the target costing team, the project team leader must develop and maintain a high level of motivation and commitment to the group goal. To this end, the contribution required by each subgroup on the target costing team in



terms of both the performance targets and cooperation must not only be valid but must be seen to be valid. Therefore, cost reduction targets that are assigned to subgroups within the team and the procedures that allocate cost targets to the product's components should be developed and supported in such a way that each group member believes that the targets are valid and not the result of a political process.

10.7.6 To provide the appropriate motivation, cost reduction targets set during target costing should be achievable with a high level of effort and motivation. It is preferable to set a series of targets that are achievable over a period of time rather than one that may not be achievable within a specific time period. It is inappropriate and damaging to set targets that represent ideal standards that cannot be achieved.

## 10.8 Effective Date

This standard will be effective from January 1, 2015 onwards.

## Appendix 10A

### Different stages of setting up target costing method for product costing

There are a number of stages in the process of target costing. These stages may be pointed as below:

- a. Establish a selling price for the new product and estimated sales volume from an analysis of the market, and a target profit.
- b. Determine the target cost by subtracting the profit from the selling price.
- c. Perform functional cost analysis for individual components and processes.
- d. Determine the estimated cost for the product.
- e. Compare estimate with target.
- f. If estimated cost exceeds target cost, repeat cost analysis/value engineering to reduce estimated cost (an iterative process).
- g. Make the final decision whether or not to introduce the product once cost estimate is on target.
- h. Manage costs during production of the product.

In another way we may emphasis target costing system in the following four phases:

<b>Four Phases of Target Costing Setup</b>	
<b>Phase 1:</b> Get know price points - Market Research	To get know price point, two types of research to be conducted: <ul style="list-style-type: none"> <li>● Customers research</li> <li>● Competitive research</li> </ul> Both researches aim to get the followings: <ul style="list-style-type: none"> <li>● Customers' requirements</li> <li>● Product's features</li> </ul>
<b>Phase 2:</b> Determine margin and cost feasibility	Two steps to take: Step 1 - Determine margin and cost feasibility Step 2 - Determine initial margin goal and target cost
<b>Phase 3:</b> Meet margin goal and target cost through design improvements	Two steps to take: Step 1 - Finalize value engineering result Step 2 - Finalize design and process information
<b>Phase 4:</b> Implement continuous improvements	It can be achieved by performing two tasks: <ul style="list-style-type: none"> <li>● Initiate product production</li> <li>● Implement continuous improvement</li> </ul>

## Appendix 10B

### Determination of Target Cost

**Example 1:** XYZ Company estimated that there is a market niche for new innovated Ceiling fan. The marketing department believes that a price of Tk. 3,000 per fan would be the right for the ceiling fan. At that price they estimate 4,000 pieces of fan would be sold annually. To design, develop and production of these fan an investment of Tk. 20,000,000 would be required and the company desires a 15% return on investment (ROI). Given these data, the target cost to manufacture, sell and service one fan is Tk. 2,250 as calculated below:

	Amount (TK.)
Projected Sales (4,000 fans x Tk. 3,000 per fan)	12,000,000
Less: Desired profit (15% on TK. 20,000,000)	<u>3,000,000</u>
Target cost for 4,000 fans	<u>9,000,000</u>
Target cost per fan (Tk. 9,000,000 ÷ 4,000 fans)	2,250

This target cost of Tk. 2,250 would be broken into target cost for the various functions: manufacturing, marketing, distribution, after-sales service and so on. Each functional area would be reasonable for keeping its actual costs within target.

**Example 2:** A practical business oriented trial and perfect example is given below:

In the automobile industry, the target cost for a new model is decomposed into target costs for each of the elements of the car-down to a target cost for each of the individual parts. The designers draft a trial blueprint, and a check is made to see if the estimated cost of the car is within reasonable distance of the target cost. If not, design changes are made, and a new trial blueprint is drawn up. This process continues until there is sufficient confidence in the design to make a prototype car according to the trial blueprint. If there is still a gap between the target cost and the estimated cost, the design of the car will be further modified. After repeating this process a number of times, the final blueprint is drawn up and turned over to the production department. In the first several months of production, the target costs will ordinarily not be achieved due to problems in getting a new model into production. However after that initial period, target costs are compared to actual costs and discrepancies between the two are investigated with the aim of eliminating the discrepancies and achieving target costs.

## Appendix 10C

### Target Cost Calculation Worksheet

Price/Cost Element	Estimate	% Factor	Per Unit Factor (Tk.)	Amount (TK.)
Manufacturer's Suggested Retail Price				495.00
Less: Standard Retailer Margin		30%		148.50
<b>Cost to retailer</b>				<b>346.50</b>
Less: Distribution/Shipping Cost to retailer		0%	15.00	15.00
<b>Selling Price to Retailer</b>				<b>331.50</b>
Less: Distribution Cost/Mark-up		15%		49.73
Less: Shipping/Logistics Cost to Distribution Center				17.00 17.00
<b>Manufacturer's Selling Price</b>				<b>264.78</b>
Less: Profit Margin		8%		21.18
Less: Warranty Cost		2%		5.30
Less: Corporate Allocation		10%		26.48
Less: Business Unit Selling, General & Admin Cost		12%		31.77
Non-Recurring Development Cost	1,200,000			
Estimated Production Volume	200,000			
Less: Allocated Non-Recurring Development Cost			6.00	6.00
<b>Business Unit Target Cost</b>				<b>174.05</b>
Less: Overhead		45%		78.32
<b>Direct Target Cost (Labor &amp; Materials)</b>				<b>95.73</b>