Application of Target Cost and its Impact on the Businesses

Economics

Keywords: Target Cost, strategy, accounting, technique, competition, performance, structure, organisation, market, design, profits.

Skender Ahmeti	**University of Prishtina, Economics Faculty, Prishtina, Kosova.**
Arbana Sahiti	**University of Prishtina, Economics Faculty, Prishtina, Kosova.**
Yllka Ahmeti	**University of Prishtina, Economics Faculty, Prishtina, Kosova.**

Abstract

Target Cost has been a topic of debate in terms of importance and the benefits it brings to the businesses that adopt this technique. Experts in the field of strategic management accounting have different views on the degree of relevance of the Target Cost technique. This research will conduct a critical evaluation of Target Cost using the qualitative research method from different viewpoints and perspectives, and is based on secondary data that are derived from books and scientific works of renowned experts in the field of strategic management accounting. Furthermore, this research paper adopts the narrative analysis method to assess the importance of technique usage. It concludes that Target Cost has proven to be a successful technique in the marketplace for many businesses and organizations..

I. Introduction

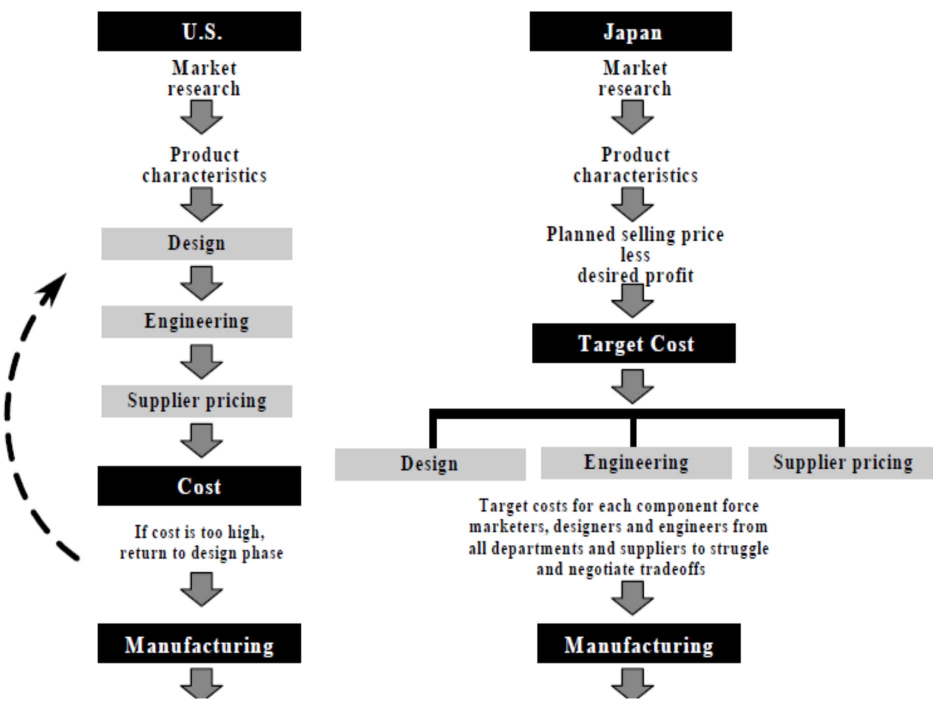
Target costing (TC) is one of the strategic management accounting (SMA) techniques that has challenged traditional way and changed organisational approach towards cost management in the recent decades. This has been an area of interest and a key driver for many businesses to retain their competitive edge in the marketplace and outperform competitors. The purpose of this essay is explore critically its origin, recent developments, and impact on the organisational level. It will also suggest whether TC has been helpful tool to sustain and create competitive advantages for companies that have embraced such a technique.

II. Literature Review

According to Kee (2010), TC technique is a part of cost management concept that enables companies to design and manufacture products that encompasses profitability margins at the satisfied level to justify their production. On the other hand, Cooper and Slugmulder (1999) describe the technique as a tool for companies to layout plans in order to strategically administer potential future profits. The whole concept of TC is based on the idea of setting the cost of the new profitable products over the lifecycle in terms defining functionality, quality, and price before launched in the market. Therefore, target cost is achieved *'by estimating the anticipated selling price of a proposed product and by subtracting desired profit margins'* ' (Cooper and Slugmulder, 1999, p.23). The ultimate goal of TC is to design and manufacture products that generate profits while meeting customers' needs concerning quality and functionality. At the same time, selling price of designated products should be set at the level of not jeopardizing customers' willingness to pay. Tracing back the roots and origin of TC, Feilt et al. (2004) state that technique was discovered back in 1960's in Japan by Toyota Motor Corporation. During this time, many manufacturing companies in Japan embraced the concept and incorporated into their cost management systems. The TC idea and framework was preserved and kept confidential for well around two decades against other rivals both in Europe and North America. Over the period, Japanese manufacturers enhanced their production techniques and processes. They managed obtain competitive advantage by boosting the quality of their products and reducing associated input costs in the international markets. When the TC concept was revealed, Western companies initiated implementation of the technique in order to counter Japanese dominance. However, over the time different types of TC were adopted across the world.

III. Using models target costs

Looking at the cost management processes between Western and Japanese models, it can be said that latter proved to be more efficient and more beneficial as it continuously provided the means of reducing the cost that resulted from the adoption of the TC concept. In simplest form, TC derives from the difference between sales price and target profit. The technique allowed to control the costs before and during production phase unlike Western model that waited much longer. As consequence, by that time Western manufacturing companies were unable to control costs as they were becoming already fixed (Feilt et al., 2004).



Source: Worthy, F. (1991) as cited in Feilt et al. (2004)

Above figures illustrate clearly the core differences between Japanese and Western cost systems. As reflected, TC enables business to gather information from all relevant organisational units to foster commitment among all actors involved in the process (Zuckerman et al., 1997). Besides determining product target prices and its profit margins, Japanese model decomposes the TC down to components such as design, engineering, and supplier pricing to accurately measure the cost of raw material required for purchase (Cooper, 1994).

IV. Elements of target costs

According to Cooper and Slugmulder (1999), the three main elements of target costing process are: Market-driven costing, Product-level target costing and Component -level target costing. Having the break-down of cost elements provide better insights to measure accurately each element. And, the factors that impact and application of TC are degree of competition, size of the business, competitive environment, and national business culture (Hamood et al., 2011).

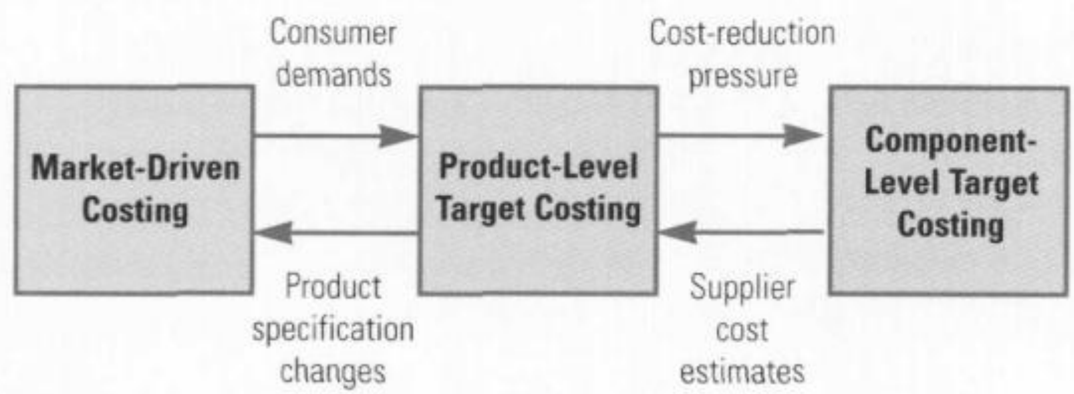


Figure 1
Three Main Elements of the Target Costing Process

Source: Cooper and Slugmulder (1999)

Research indicates that managerial implications play an incremental role in the adoption of TC. To succeed, solid coordination and fostering teamwork is required among all divisions and actors involved in the process. It is also crucial that costing is managed in the early product development phase and implementation of the TC is closely monitored for quality control purposes. Any discrepancy found can be easily eliminated and is less costly in early stages. And lastly, development of cost should occur at earliest possible stage, so products can be quickly placed in the market before customers' needs and preferences are altered as concluded by Helms et al. (2005). In addition, Consortium for Advance Management International's (CAM-I) has found that lack of TC knowledge among employees throughout organisations has been an obstacle for business to implement successfully the technique as reported by Ansari et al. (2009). Therefore, the author suggests training that are aligned to the organisational TC strategy should be incorporated in order to bring expected expect positive results.

Analysis on the adoption and use of target costing in Dutch firms (Deker and Smitd, 2003) indicate that primary benefit of using the technique is cost reduction. All companies covered in this study were listed on the Amsterdam stock exchange. Research also reveals that nineteen out of thirty-two of companies that embrace TC systems from various industries were more expose to highly competitive and unforeseeable environment. However, the research that was conducted by Ax et al. (2008) concludes that adoption of TC is positively correlated with competitive environment, but negatively with environmental uncertainty. Both studies emphasize the relevance of the technique to raise product quality and efficiency in the cost management field.

V. Impact of target cost increase in profit

The benefits of embracing the TC and embedding it onto organisational structure are relevant for businesses to flourish in the marketplace and retain their competitive edge as advised by Royaee and Khozein (2011). However, as authors point out the degree of success depends on the ability of upper management to plan accordingly. Continuous reviews on the process of assessing the ways to enhance procedures in order to omit activities that do not bring any value in the project is critical to increase the quality and decrease unnecessary costs. Hamood et al. (2011) suggests that businesses should be able to deal accordingly with all the issues and problems that come up during TC implementation in order to obtain desired firm value. Hence, the entire process needs to be carefully monitored in order to undertake timely and relevant decisions for value creation purposes.

If TC technique is handled carefully and if it matches with organisational goals and strategies while having proper tools to measure progress can bring enormous benefits and thus increase firm's value. According to Corrigan (1996), Pizza Hut managed to decrease the price of pizza by 100% in two years after the company implemented target costing and still was able to make profit and remain highly competitive. Author also reinstates that Japan's Seven-Eleven stores managed to sell twice products more than their counterparts throughout US using 50% less floor space by using the TC. The technique enabled the company to have a cost distribution system that was far by the most advanced and efficient in the world. Another success story that transformed drastically Company's position upon TC implementation is the case of Lexmark Printer as suggested by (Chen and Chung, 2002). Company managed to become the second biggest company world-wide in 1999, it outperformed its competitors by having an annual growth of 15-25 percent. Prior to that, its financial situation has been deteriorating due to loss of market share resulting from deficiencies in cost management system.

Concerning the limitations and problems associated with TC, Ross (2008) states that often product prices are imposed by strong customer base in the market. In addition, TC is seen as a technique mostly used in the manufacturing due to thorough analysis of variances and the nature of the system. Therefore, its applicability in some of the industry sectors such in agriculture is viewed unsuitable because of the "office based" nature of business. Other studies (Shank and Fisher, 1999; Dekker and Smitd, 2003; Feil et al., 2004; Rattray, 2007) also stress out the relevance and focus on the adoption of the technique only in manufacturing sector. However, recent research done by

Yazdifar and Askarany (2009) on the implementation of the technique in UK, New Zeeland and Australia reveal that TC adoption is perceived equally important for both manufacturing and service sectors, but still implementation of the technique on the latter is more dominant. It seems that there are signs on the growing interest concerning TC adoption for sectors other than manufacturing.

VI. Conclusion

In conclusion, TC originates from Japan. It was used and adopted primarily during 1960's by the Japanese manufacturing industry lead by Toyota. Technique came out as the result of the emerging needs, changing taste and social trends for different products having diversified characteristics (Ramanan, 2002). Management of TC involves not only accountants but all other supporting teams such as designers, engineers, marketers, and sales in order to succeed. The technique exerts pressure on the individuals engaged in R&D to come up with innovate ideas to improve operations and places strictest disciplines on the production line to adhere with directives as set forth (Jack and Jones, 2008). Having qualified employees to facilitate the technique while been equip with relevant trainings is of paramount importance to deliver consistently quality outcome. The TC has proven to be successful. Those companies that have embraced the concept based on their internal needs while matching up with organisational strategy have thrived in the marketplace. They have managed to reduce costs and still make profits without sacrificing quality of their products. Due to ever-changing business environment and stiff competition coming from domestic and international markets, incorporating TC into the organisational strategy will still remain crucial. Organisations that manage to succeed in their target costing management technique are more likely to prevail and retain their competitive edge.

References

1. Ansari, S. and Bell, J. and Swenson, D. (2009) " Strategies for Training in Target Costing ." *Cost Management* Vol. 23 No. 3, pp. 18-26.
2. Ax, C. and Greve, J. and Nilsson. U. (2008) " The impact of competition and uncertainty on the adoption of target costing." *International Journal of Production Economics* Vol. 115 No. 1, pp. 92-103.
3. Chen, C.R. and Chung, H.C. (2002) " Cause-Effect Analysis for Target Costing." *Management Accounting Quarterly* Vol. 3 No. 2, pp. 1-9.
4. Cooper, R. and Slugmulder, R. (1999) " Develop Profitable New Products with Target Costing." *MIT Sloan Management Review* Vol. 40 No. 4, pp. 23-33.
5. Corrigan, J. (1996) " Target Costing-- A New Approach." *Intheblack* Vol. 66 No. 3, pp. 54-54.
6. Dekker, H. and Smidt, P. (2003) " A survey of the adoption and use of target costing in Dutch firms." *International Journal of Production Economics* Vol. 84 No. 3, pp. 293-305.
7. Feil, P. and Yook, H.K. and Kim, W. (2004) "Japanese Target Costing: A Historical Perspective ." *International Journal of Strategic Cost Management*/ Spring 2004.

8. Hamood, H.H. (2011) " Target Costing Practices: A Review of Literature." *Asia-Pacific Management Accounting Journal* Vol. 6 No. 1, pp. 25-46.
9. Helms, M.M. and Ettkin, P.L. and Baxter, T.J. and Gordon. M.W. (2005) " Managerial Implication of Target Costing." *Competitiveness Review* Vol. 15 No. 1, pp. 49-56.
10. Jack, L. and Jones, V.H.J. (2008) " Facing up to new realities: The case for using relevant cost and target cost approaches in agriculture." *Journal of Applied Accounting Research* Vol. 8 No. 3, pp. 116-145.
11. Kee, R. (2010) " The sufficiency of target costing for evaluating production-related decisions." *Competitiveness Review* Vol. 126 No. 2, pp. 204-211.
12. Ramanan, R. (2002). Target Costing. In P.M Swamiddas.: Innovations in Competitive Manufacturing (e-book chapter), pp. 399-405. Available through: EBSCO- Business Source Complete Database. URL: http://web.ebscohost.com/ehost/resultsadvanced?sid=00baf0ae-e5c6-4e01-80f9-f02d98f5eb0a%40sessionmgr12&vid=3&hid=15&bquery=Target+Costing&bdata=JmRiPWJ0aCZkYj1yemgmZGI9bmxlYmsmZGI9MzBoJnR5cGU9MSZzaXRlPWVob3N0LWxpdmU%3d (accessed 01 April 2012).
13. Rattrey, J.C. (2007) "Target costing in New Zealand manufacturing firms." *Pacific Accounting Review* Vol. 19 No. 1, pp. 68-83.
14. Ross, L. (2008) " Target Cost Management." *Financial Management* Vol. 49 No. 9, pp. 42-43.
15. Royaee, A.R. and Khozein, A. (2011) " Effectiveness Implementing and Lunching the Target Costing System. " *International Research Journal of Finance and Economics* ISSN 1450-2887 No. 70, pp. 197-205.
16. Shank, J. and Fisher, J. (1999) " Case Study: Target Costing as a Strategic Tool." *MIT Sloan Management Review* Vol. 41 No. 1, pp. 73-82.
17. Yazdifar, H. and Askarany, D. (2011) " Comparative study of the adoption and implementation of target costing in the UK, Australia and New Zealand." *International Journal of Production Economics* Vol. 135 No. 1, pp. 382-392.
18. Zukerman, J.K. and Romocki, T. and Al Chen, Y.S. (1997) "Examination of U.S-Based Japanese Subsidiaries: Evidence of the Transfer of the Japanese Strategic Cost Management." *The International Journal of Accounting* Vol. 32 No. 4, pp. 417-440.